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25 • 2002

Peik Granlund
Research Department
30.9.2002

Bank exit legislation in US, EU and Japanese financial centres

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Bank exit legislation in US, EU and Japanese financial centres

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Peik Granlund
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Abstract

This paper analyses bank exit (ie reorganisation and liquidation) legislation in selected financial centres: New York, London, Frankfurt, Helsinki and Tokyo. The focus is on bank exit legislation applicable to commercial banks. The legislation is analysed from the perspective of bank stakeholders, ie bank creditors, depositors and bank shareholders. The analysis is restricted to those legislative provisions that provide security and rights for stakeholders in case of bank exit. In addition to current conditions, the paper covers the main legislative changes of the latter part of the 1990s.

Key words: bank, regulation, supervision, reorganisation, liquidation

JEL classification numbers: G28, K23

Pankkien uudelleenjärjestely- ja likvidaatiolainsäädäntö Yhdysvaltain, Euroopan ja Japanin rahoituskeskuksissa

Suomen Pankin keskustelualoitteita 25/2002

Peik Granlund
Tutkimusosasto

Tiivistelmä

Tässä tutkimuksessa tarkastellaan pankkien uudelleenjärjestely- ja likvidaatiolainsäädäntöä New Yorkin, Lontoon, Frankfurtin, Helsingin ja Tokion rahoituskeskuksissa. Tarkastelun kohteena on liikepankkeja koskeva lainsäädäntö. Lainsäädäntöä arvioidaan pankkien eri sidosryhmien näkökulmasta. Sidosryhmiä ovat pankkien luotonantajat, tallettajat ja osakkeenomistajat. Painopiste on niissä säädöksissä, jotka sääntelevät sidosryhmien oikeuksia ja sijoitusten turvallisuutta uudelleenjärjestely- ja likvidaatiotilanteissa. Tutkimus kattaa ensisijaisesti nykytilanteen ja toissijaisesti lakimuutokset 1990-luvun puolivälistä saakka.

Asiasanat: pankit, sääntely, valvonta, likvidaatio, uudelleenjärjestely

JEL-luokittelu: G28, K23

Contents

Abstract ... 3

1 Introduction ... 7

2 Viewpoints on the legal frameworks for bank exit and the supervision of banks in five financial centres ... 9
2.1 Legal frameworks for bank reorganisation and liquidation ... 9
2.2 Banking supervision in New York, London, Frankfurt, Helsinki and Tokyo ... 16

3 The banks' creditors and bank exit in the US, UK, Germany, Finland and Japan ... 24
3.1 Bank reorganisation and liquidation in the US ... 24
3.2 Bank creditors and the administration of problem banks in the EU ... 31
3.2.1 London-based banks' creditors and UK laws on bank exit ... 31
3.2.2 The reorganisation and liquidation of Frankfurt (German) banks ... 37
3.2.3 The new Finnish procedures for bank exit ... 43
3.3 The reorganisation and liquidation of banks in Tokyo (Japan) ... 51

4 Bank depositors and various national deposit protection schemes ... 58
4.1 The protection scheme applicable to New York banks ... 58
4.2 Principles for depositor protection in certain EU financial centres ... 61
4.2.1 London (UK) ... 61
4.2.2 Frankfurt (Germany) ... 64
4.2.3 Helsinki (Finland) ... 68
4.3 The depositor and the reorganisation and liquidation of banks in Tokyo ... 71

5 Bank reorganisation and liquidation relative to bank shareholders ... 76
5.1 Bank exit in the USA ... 76
5.2 EU bank exit from the shareholders' perspective – the case of UK, Germany and Finland ... 79
5.2.1 UK ... 79
5.2.2 Germany ... 84
5.2.3 Finland ... 88
5.3 Reorganisation and liquidation of problem banks in Japan ... 93

6 Conclusions ... 98

References ... 102

1 Introduction

The aim of this paper is to describe *bank exit regimes* in some of the world's financial centres. The financial centres concerned are New York (USA), London (UK/EU), Frankfurt (Germany/EU), Helsinki (Finland/EU) and Tokyo (Japan). The paper is the first part of a larger study aiming to evaluate different bank exit regimes in respect of their effects on financial centre competitiveness. In this first paper, the bank exit regulation of the financial centres is closely analysed. In a later, second paper the bank exit regimes will be evaluated in an comparative manner using legislation evaluation methodology. – Since this first paper may be linked to a tradition of economic evaluation of law provisions a number of *arguments supporting an economic interest in bank exit regulation*, are presented below. Further on, *the main features of this analysis* are discussed.

One can distinguish at least five groups of **arguments supporting an economic interest** in bank exit regulation. One group of arguments is *value-based*. Though it often may be difficult to distinguish these arguments from the other groups, these arguments concentrate on the fact that the interest in economic assessment of features of society has increased. On a more detailed level, the interest in economic issues may eg result in a focus on certain aspects of the markets or transparency issues. Moreover, ambitions to eliminate sources of "moral hazard" problems in market activities derive from an economic market perspective. – Arguments supporting an economic interest in bank exit regulation also stem from *the eventual systemic effects of bank failures*. In the case of bank failures, substantial economic problems may emerge due to systemic effects in the form of a) widespread losses for bank stakeholders or, b) protective stakeholder behaviour in relation to all or similar banks. Following this logic, large bank failures are a bigger problem than small ones. From a judicial perspective, all banks should preferably be equal under the law. – Another group of arguments supporting the economic interest in bank exit regulation is linked to *the foundation of the European Union* (EU) and more specifically its internal market dimension. Creating conditions for the free flow of utilities between member states, economic assessment of the legislation of the states is important. Focusing on the financial sector, a need to assess rules and practices also for bank

rehabilitation and dissolution arises.[1] – Furthermore, *the position of the taxpayers* in bank exit proceedings may be used as an argument for analysing bank exit legislation on economic grounds. Experience indicates that the cost of bailig out troubled banks has often been high in relation to the country's GDP. Focusing on costsk, history has shown that poorly designed bank exit mechanisms have been worse than ineffective in the prevention of banking distress. If countries use taxpayers' money ineffectively, taxpayers may vote by switching tax regimes.[2] – In this analysis, *the concern for the competitiveness of financial centres* directs the interest in bank exit. In an increasingly international world, one could assume that competition between banks also implies competition between the terms that various financial centres may provide banks. The banks' stakeholders should be interested in assessing the terms for bank activities since these constitute the terms for their investments. If the jurisdiction that a financial centre can offer its banks' stakeholders is significantly worse than the jurisdiction of other centres, this may influence the decision where to establish a bank.[3]

Another entity requiring further attention is **the main features of this analysis**. As for *the subject* of the analysis, the immediate aim is to compare bank exit regimes in some of the world's financial centres. Bank exit is defined in a broad manner including both voluntary and compulsory reorganisation and liquidation of banks. Financial centers covered are New York (USA), London (UK/EU), Frankfurt (Germany/EU), Helsinki (Finland/EU) and Tokyo (Japan). The term bank is restricted only to commercial banks in the form of limited liability companies. – In the comparison of the bank exit legislation *the perspectives* are the ones of the banks' creditors, depositors and shareholders. The perspectives reflect such aspects of the legislation that matter in an economic sense. In other words, the focus is on the level of security (financial assistance to banks, depositor protection, authority supervision etc.) that the legislation provides bank stakeholders. In addition, the amount (or lack) of powers (right to commence bankruptcy, risk for capital loss in bank reorganisation etc.) that the legislation transfers to bank stakeholders is also analysed. The emphasis in the

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[1] A number of regulative steps have been taken by the EU/EEA that affect the reorganisation and liquidation of banks. A Recommendation concerning Deposit Guarantee Schemes (87/63/EEC) and a Directive concerning Deposit Insurance Systems (94/19/EEC) have been issued and implemented into the jurisdictions of the member states. The latest Parliament and Council Directive concerning the Reorganisation and Liquidation of Credit Institutions (2001/24/EEC) is supposed to be implemented before May 2004. This directive does not unify the procedures for the reorganisation and liquidation of EU/EEA banks, it merely directs which national jurisdiction should be applied in the reorganisation and liquidation of banks.

[2] According to Milhaupt (1999), the cost has often been between 20 and 50% of the affected country's GDP to bail out troubled banks.

[3] One step reflecting a concern about the international competitiveness of regulatory regimes is the work by the World Bank on global unification of insolvency criteria.

analysis is on the provisions most relevant when estimating the risk for stakeholders' capital loss. – Another feature of importance in the analysis is the fact that legislation may not be assessed without considering *the authority practice* linked to it. Some bank exit regimes may be characterised by significant differences between the formal procedures and the procedures used. As a consequence, also bank exit practice in the financial centres is described. – Moreover, the analysis comprises *a time dimension*. Though the analysis focuses on current conditions, most of the 1990's regulatory development and changing practices have also been dealt with. – *The structure of this analysis* is as follows. First, in chapter 2, general viewpoints on the legal frameworks and the supervision of banks in each financial centre are presented. This sub-analysis is meant to provide an overall picture of the regimes. In chapter 3, the reorganisation and liquidation legislation is focused on from the creditors' perspective. The different bank exit regimes are presented and compared in a way relevant to the bank creditors. In chapter 4, the legislation is analysed according to the depositors' interests. Deposit insurance systems with similarities are analysed together. The angle in chapter 5 is the shareholders'. Considerable differences exist between the jurisdictions. Shareholders may or may not lose their capital in authority-administered bank rehabilitation. Finally, in chapter 6 legally oriented conclusions concerning the various regimes are made.

2 Viewpoints on the legal frameworks for bank exit and the supervision of banks in five financial centres

2.1 Legal frameworks for bank reorganisation and liquidation

In order to create a basis for the assessment of bank exit regimes in New York (the US), London (UK/EU), Frankfurt (Germany/EU), Helsinki (Finland/EU) and Tokyo (Japan), the legal frameworks for the bank exit regimes are analysed below. When analysing bank exit regimes one important question is whether reorganisation and liquidation of banks is carried out under *specific or general laws*. Specific laws are laws applicable to banks only. General laws are laws that apply to all companies including banks. Specific laws may be better suited to deal with the specific problems that bank failures represent. On the other hand, one could question if the differences between banks and other companies are sufficient to legitimate specific legislation for banks. In this respect, the US bank exit regime is unique. It is the only regime that provides for specific legislation

both in the case of bank reorganisation and liquidation. The other extreme is the UK. General reorganisation and liquidation laws also apply to banks. Germany, Finland and Japan represent different types of compromise. In Germany, reorganisation is to a large part regulated in the Banking Law. On the other hand, the German general Insolvency Law comprises reorganisation means as alternatives to liquidation. The reorganisation of banks in Finland follows the general Law concerning the Reorganisation of Companies. Finnish banks are wound up pursuant to the general Law concerning Limited Liability Companies or the general Bankruptcy Code. In Japan, reorganisation is regulated both in the Deposit Insurance Law and general reorganisation laws. General procedures exist for the liquidation of banks. – Another important question concerns bank exit practice. Often, national *bank exit practices* are limited to one or a few of the avenues that the formal bank exit regimes provide. Sometimes, formal bank reorganisation or liquidation is not considered to be an alternative. In these cases, problems are dealt with in a "voluntary" manner beforehand. In the US, liquidation is actually used as an alternative to reorganisation (at least for other than large banks). In the UK, problems have usually been dealt with through mergers and acquisitions. Germany has a history of preventive action, especially what comes to large banks. In Finland, it does not seem probable that large banks would be liquidated in a way that severely would harm creditors. The same principle has been applied to bank failures in Japan.[4]

When analysing the legal frameworks for bank reorganisation and liquidation in each financial centre, the focus is on the following topics. First, legislation directing bank activities is listed. Second, laws for supervision of banks are shortly presented. Finally, the regulations concerning bank reorganisation and liquidation are shortly discussed. – Studying **the US banking system** more closely, this system is characterised by *three distinct legislative parts*, ie federal legislation, state legislation and legislation relating to certain options. In principle, federal legislation creates the foundation for national banking. State legislation represents a high degree of variety and is primarily applied to banking carried out in a particular state. The options referred to above are regulatory alternatives that banks may choose from. Being a member of the Federal Reserve System (FRS) or being insured by the Federal Deposit Insurance Corporation (FDIC) specific legislation will then apply. Federal regulations concerning banks and banking are included in *the US Code title 12* (12 U.S.C.). Title 12 comprises the most

[4] This paper focuses on the various national regulations concerning bank exit only. Still, bank exit as a phenomenon also actualises a number of related legal topics. Competition law constitutes such a legal topic. Bank reorganisation in the five financial centres is subject to national competition legislation. For many (mainly larger) banks in EU-countries, articles 85–86 of the Treaty of Rome also direct the measures taken. Moreover, an integral part of competition law concerns state aid. National state aid to banks seldom contradicts with national legislation. In some cases, EU member state aid to banks has not been consistent with articles 92–94 of the Treaty of Rome.

important acts incorporated in a cumulative manner into 49 chapters. *Central US banking acts* are – the National Bank Act of 1864, the Federal Reserve Act of 1913, the McFadden Act 1927, the Banking Acts of 1933 and 1935, the Federal Deposit Insurance Act of 1950, the Bank Holding Company Act 1956 (BHCA), the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA), the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994 and the Gramm-Leach-Bliley Act of 1999.[5]

The supervision of US banks is dependent on the applicable legislation and the options chosen. In case of national banks, *the Office of the Comptroller of the Currency* (OOC) is in charge of the supervision.[6] If the national bank has been granted FDIC insurance *the FDIC* is entitled to certain supervisory action.[7] For the state banks the supervisory authority is *the state banking agency* in question. *The FRS* supervises state banks that are members of the system.[8] A state bank that is not a member of the FRS but has been granted FDIC insurance is supervised by the FDIC.[9] Additionally, the responsibility for controlling bank and financial holding companies rests with the FRS.[10] To promote consistency in the examination and supervision of financial institutions the Federal Financial Institutions Examination Council was established in 1978.[11]

The applicable legislation and the chosen options also guide *the reorganisation and liquidation* of US banks. To begin with, *the 12 U.S.C. chapter 2* regulates the reorganisation and liquidation of national banks. The reorganisation and liquidation of state banks is regulated by state legislation. Moreover, if a national or state bank has received FDIC insurance the provisions concerning reorganisation and liquidation in *12 U.S.C. chapter 16* will apply. Accordingly, the membership of the FRS for national or state banks actualises the small number of reorganisation and liquidation provisions of *12 U.S.C. chapter 3*. – In other words, the federal banking legislation provides for an independent and exclusive scheme for dealing with the reorganisation and liquidation of banks. The regulations of the US Bankruptcy Code chapter 7 (liquidation) and 11 (reorganisation) do not apply.[12]

In **the EU**, there are several directives and recommendations concerning bank activities and supervision. The most central directives are *the 1st Banking*

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[5] *Central parts of the 12 U.S.C.* consist of chapter 2 “National Banks”, chapter 3 “Federal Reserve System”, chapter 16 “Federal Deposit Insurance Corporation” and chapter 17 “Bank Holding Companies”.

[6] 12 U.S.C. chapter 1 and 2.

[7] 12 U.S.C. chapter 16.

[8] 12 U.S.C. chapter 3.

[9] 12 U.S.C. chapter 16.

[10] 12 U.S.C. chapter 3 and 17.

[11] 12 U.S.C. chapter 34.

[12] 11 U.S.C. s. 109.

Directive and *the 2nd Banking Directive*, both issued by the Council.[13] The 1st Banking Directive includes the basic rules for the free establishment of banks and other financial institutions and the abolition of the barriers to the free supply of services. The 2nd Banking Directive aims to harmonise the laws and regulations concerning the establishment and activities of banks. EU authorities have also issued directives and recommendations applicable to the liquidation and reorganisation of banks. The Commission Recommendation concerning Deposit-Guarantee Schemes and the Parliament and Council *Directive concerning Deposit Insurance Systems* deal with depositors in the case of bank failure.[14] The latest Parliament and Council *Directive concerning Reorganisation and Liquidation of Banks* is supposed to be implemented before May 2004.[15] This directive mainly directs which national reorganisation and liquidation legislation should apply to banks with activities in several EEA countries.

In 2000 *the Financial Services and Market Act* (FSMA) was introduced in **the UK**, changing the basis for the regulation of financial markets. As a result of the reform banks became one of several groups of financial institutions regulated by the same comprehensive legislation. The FSMA replaced the Banking Act of 1987. The primary aim of the Banking Act was to regulate the deposit-taking business of banks. The FSMA also replaced the Financial Services Act of 1986. This legislation regulated other types of financial services offered by banks and other financial institutions. – *The Financial Services Authority* (FSA) is in charge of *the supervision* of UK banks. The supervision of banks is currently regulated in the FSMA Part I. The Bank of England Act of 1998 transferred the responsibility for banking supervision from the Bank of England to the FSA. The Securities and Investment Board was to a large extent responsible for the supervision based on the former Financial Services Act of 1986.

The *reorganisation and liquidation* of UK banks are regulated in *the Insolvency Act of 1986* and *the FSMA part XXIV*. To the extent that reorganisation may include business transfers there are special provisions in *the FSMA part VII* concerning the control of business transfers. *The Companies Act of 1985* also affects the reorganisation and liquidation of banks. Depositor protection is regulated in *the Financial Services Compensation Scheme* (FSCS) issued by the FSA. Reorganisation and liquidation of banks before the FSMA were based on the

[13] 73/183/EEC and 89/646/EEC, respectively.

[14] 87/63/EEC and 94/19/EEC, respectively.

[15] 01/24/EEC.

Insolvency Act of 1986, the Banking Act of 1987 and the Companies Act of 1985.[16]

German banks have been regulated by *the Banking Act* (Kreditwesengesetz, KWG) since the beginning of the 1960's. Since then the Banking Act has been amended six times, mostly as a result of EU directives implemented into the German jurisdiction. In addition to the Banking Act, most German banks are, as a result of their activities in the area of investment services, regulated by *the Securities Trading Act* (Gesetz uber den Wertpapierhandel, WpHG) of 1994. The Securities Trading Act replaced a system of self-regulation. – *The supervision* of German banks is currently the responsibility of *the Financial Supervisory Authority* (FSA) (Bundesanstalt für Finanzdienstleistungs aufsicht, BAFin). The qualities and activities of the FSA are regulated in the Law concerning the Financial Supervisory Authority (Gesetz über die Bundesanstalt für Finanzdienstleistungsaufsicht, FinDAG) and in the Banking Act part I, division 2. Before 1.5.2002 banks were supervised by the Federal Banking Supervisory Office (FBSO) (Bundesaufsichtsamt für das Kreditwesen, BAKred). Supervisory measures against the banks initiated by the Securities Trading Act were handled by *the Federal Securities Supervisory Office* (FSSO) (Bundesaufsichtsamt für den Wertpapierhandel, BAWe). The role of *the German Central Bank* (Deutsche Bundesbank) in the supervisory system is central.[17]

The reorganisation and liquidation of German banks are regulated in *the Banking Act part III, division 4* concerning "Measures in special cases". Moreover, banks are not excluded from *the Insolvency Act* (Insolvenzordnung, InsO) of 1999. The Insolvency Act comprises both reorganisation and liquidation measures and was preceded by the Bankruptcy Act (Konkursordnung) and the Composition Act (Vergleichsordnung). The reorganisation and liquidation of sound banks are regulated in the German *company-legislation*. Questions relating to deposit guarantees and investor protection are in turn regulated in *the Deposit Guarantee and Investor Compensation Act* (Einlagensicherungs- und Anlegerentschädigungsgesetz) of 1998. Alongside this legislation the Association

[16] The most important parts of the FSMA comprise provisions on I) The regulator (ie the FSA), II) Regulated and prohibited activities, III) Authorisation and exemption, IV) Permission to carry on regulated activities, V) Performance of regulated activities… VII) Control of business transfers… X) Rules and guidance, XI) Information gathering and investigations, XII) Control over authorised persons… XIV) Disciplinary measures, XV) The financial services compensation scheme, XVI) The ombudsman scheme… XXII) Auditors and actuaries… and XXIV) Insolvency. – The FSMA is supplemented by a substantial amount of secondary legislation. The secondary legislation comprises statutory instruments and regulations issued by authorities.

[17] The Banking Act part I, division 2, s. 7.

of German Banks (Bundesverband Deutscher Banken) administers a more comprehensive, voluntary deposit protection scheme applicable to its members.[18]

Two laws regulate **Finnish banks** in an institutional sense, *the Law concerning Credit Institutions* (1607/1993) and *the Law concerning Commercial Banks* (1501/2001). The Law concerning Credit Institutions also applies to other banks than commercial banks. The former Law concerning Commercial Banks (1269/1990) was valid until the end of year 2001. *The Financial Supervision Authority* (FSA, Rahoitustarkastus) is in charge of *the supervision* of banks and FSA activities are regulated in the Law concerning the Financial Supervision Authority (503/1993). *The Ministry of Finance* (MoF) handles questions related to the licensing of banks.[19]

Compulsory reorganisation of Finnish banks is regulated in *the Law concerning Reorganisation of Companies* (47/1993). The Law concerning Temporary Suspension of the Activities of a Deposit Bank (1509/2001) directs an eventual suspension of bank activities. Provisions for voluntary reorganisation, through mergers etc., are found in *the Law concerning Limited Liability Companies* (734/1978). Before 2002, banks were only reorganised on a voluntary basis. *The liquidation* of Finnish banks may be actualised pursuant to the Law concerning Limited Liability Companies (734/1978) and *the Bankruptcy Code* (31/1868). The former Law concerning Commercial Banks also established an additional, separate liquidation procedure for banks. The new Law concerning Commercial Banks (1501/2001) only comprises complementary provisions on the reorganisation and liquidation of banks. A *Law concerning the Government's Guarantee Fund* (379/1992) also exists. The fund's aim is to assist voluntary guarantee funds and banks in crises.[20]

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[18] The structure of the German Banking Act distinguishes six different parts of the legislation. Part I (concerning general provisions) deals with the character of regulated institutions and the activities of the FSA. Part II concerning provisions for institutions, regulates own funds, liquidity, lending business, advertising, special duties of institutions and managers and accounting. Part III, ie provisions on the supervision of institutions, comprises rules on licensing, the protection of certain designations, information and audits, measures in special cases and enforceability and sanctions. Parts IV, V and VI focus on cross-border matters, penalties and fines and transitional questions. The last (6th) major amendment of the Banking Act was made in 1998.

[19] From 2002 onwards, the Finnish jurisdiction also comprises a new Law concerning the Supervision of Finance and Insurance Conglomerates (44/2002).

[20] The Law concerning Credit Institutions includes provisions on eg a) the establishment and ownership of a bank, b) bank activities, c) annual reports, more frequent reports and the auditing of accounts, d) deposit banks, e) voluntary guarantee funds, f) deposit guarantee funds and g) the solvency of banks. – The structure of the new Law concerning Commercial Banks is the following. Chapter 2 regulates mergers, chapter 3 covers division and the decrease of share capital, chapter 4 concerns the transfer of activities, chapter 5 comprises provisions on bank-initiated withdrawal of the license and chapter 6 directs liquidation and bankruptcy.

During the 1990's, **the Japanese financial regulatory system** has undergone several major changes as a result of the crises confronting the country's financial sector. In principle, the current banking legislation comprises *the Banking Law of 1981* and *the Long-Term Credit Bank Law of 1952*. The Banking Law applies to "ordinary" banks. As a consequence of the historical separation between short- and long-term financial institutions long-term credit banks are regulated in their own law. Moreover, *the Commercial Code of 1938* is applicable to both types of banks. *The Securities and Exchange Law* regulates certain bank activities. The Foreign Exchange and Foreign Trade (Control) Law restricted foreign exchange transactions until 1998. Transactions were only possible for and through authorised banks. – *The supervision* of Japanese banks is currently handled by *the Financial Services Agency* (FSA) pursuant to the Banking Act chapter IV. The FSA was established in 2000 in order to replace the former Financial Supervisory Agency. In turn, the Financial Supervisory Agency was a substitute of supervisory functions of the Ministry of Finance (MoF).[21]

There are two legal entities governing *the reorganisation and liquidation* of Japanese banks. First, there are specific laws applicable to banks as a category of financial institutions. Second, there are general laws regulating company (including bank) reorganisation and liquidation. – *The specfic laws* concerning the reorganisation and liquidation of banks cover *the Deposit Insurance Law of 1971* and *the Banking Law chapter VI*. As the problems of the Japanese financial sector have grown, new legislation has also been implemented alongside the Deposit Insurance Law and the Banking Law. *The Law concerning Special Treatments to Reorganisation Procedures for Financial Institutions of 1996* increased the authorities' powers to manage bank reorganisation. The temporary Financial Reconstruction Law of 1998 provided special measures for financial institution (including bank) bankruptcy. The temporary Financial Function Early Strengthening Law of 1998 introduced emergency measures to re-capitalise financial institutions. Before the Financial Function Early Strengthening Law capital injections into banks were possible to a limited extent in accordance with the Financial Stabilisation Law. In 2001 the temporary laws were incorporated into the Deposit Insurance Law. *The Banking Law chapter V* and *the Law concerning Amalgamation and Conversion of Financial Institutions of 1968* also regulate certain reorganisation measures (ie mergers, transfers and acquisitions of business) of Japanese banks.

As a consequence of the applicability of *the general laws* concerning company rehabilitation and bankruptcy to banks several reorganisation and liquidation procedures exist for banks. Reorganisation may be carried out

[21] The Bank of Japan is not a supervisory body per se, but it conducts inspections in order to keep a safe and sound financial system. Today, these inspections are based on the Bank of Japan Law of 1998, but were previously based only on agreements with the banks.

pursuant to *the Corporate Reorganisation Law of 1952* or *the Commercial Code of 1938*. Composition as a means to rehabilitate the company activities is available under *the Composition Law of 1922* or as compulsory composition under the Bankruptcy Law. Liquidation of a bank may follow *the Bankruptcy Law of 1922* or the Commercial Code.[22]

2.2 Banking supervision in New York, London, Frankfurt, Helsinki and Tokyo[23]

As previously mentioned **the structure for supervising the US banks** is dependent on *the applicable legislation* and *the options chosen* (Federal Reserve System (FRS) membership or Federal Deposit Insurance Corporation (FDIC) insurance). As a result, national banks are directed by supervisory action a) based on *the 12 U.S.C. chapter 2* "national banks", b) because of FRS membership through *12 U.S.C. chapter 3* "Federal Reserve System" and c) in case of FDIC insurance by *12 U.S.C. chapter 16* "Federal Deposit Insurance Corporation". While 12 U.S.C. chapter 3 s. 222 states that a national bank automatically is a FRS member and all significant national banks are FDIC insured, supervisory accountability for authorities in relation to national banks derive from all *three legislative sources*. – Starting with the 12 U.S.C. chapter 2 the powers to supervise national banks are given to *the Office of the Comptroller of the Currency* (OCC). According to 12 U.S.C. chapter 3 the supervisory powers of the FRS against singular national banks are few. Chapter 3 regulations often refer to or entitle the OCC. Supervisory means deriving from the 12 U.S.C. chapter 16 grant both the OCC and *the FDIC* certain powers. Usually OCC action is primary and FDIC action secondary. Supervision of bank (and financial) holding companies (which are very common) is the responsibility of *the FRS*.[24] The supervision covers the bank (and financial) organisation as a whole.

Considering the supervision of US banks both in a judicial sense and in practice one could say that the emphasis in supervision is on the identification of potential problem banks. On the other hand, all insured banks are to be frequently

[22] The Japanese Banking Law comprises the following main elements. Chapter I deals with general provisions, chapter II with the banks' business and chapter III with accounting principles. Supervision, mergers, transfers and acquisitions of business and the quitting of business including the banks' eventual dissolution are the subjects of chapter IV, V and VI, respectively. Chapter VII concerns branches of foreign banks and chapters VIII–IX include miscellaneous provisions and provisions regarding penalties.

[23] For global viewpoints on banking supervision since the beginning of the 1990's see Mayes, Halme & Liuksila 2001.

[24] 12 U.S.C. chapter 17.

inspected. The supervisory authorities are clearly more of controllers than consultants. To assess the supervision of US banks one could distinguish between authorities' *channels for receiving information* about the banks and *methods for influencing* banks. Moreover, as a consequence of the special feature of *the "prompt corrective action" –scheme,* this supervisory scheme will receive special attention below.

When it comes to *the channels for the authorities to receive information* about the banks there are two types identified by the US code. Information is received through reports and inspections. Reports of conditions (RCs) constitute the main information flow to the OCC on supervisory matters. RCs are collected quarterly from all banks.[25] Another avenue for receiving information about the banks is *the bank examination*. Bank examinations are used to collect on-the-spot information that will indicate the current financial condition of a bank and its compliance with applicable laws and regulations. An insured bank should be inspected at least once during a 12 month-period. Since late 1990s, inspections are risk-focused and usually limited to the bank's records. The risk-focused inspections require examiners to perform a risk assessment first before beginning any on-site supervisory activities. Federal supervisors review six aspects of a bank's operations and condition in their CAMELS-risk rating procedure. These are capital adequacy, asset quality, management and administrative ability, earnings level and quality, liquidity level and sensitivity to market risk.[26]

Apart from the regulations concerning the information flow to the OCC/FDIC *methods for influencing* the banks also constitute a separate group of supervisory means. In principle these methods do not deviate from international standards and may be divided into two groups, a) rule-making powers and b) enforcement actions. General *rule-making powers* of the OCC stem from the 12 U.S.C. chapter 2 s. 93a and for the FDIC from the 12 U.S.C. chapter 16 s. 1820. According to the 12 U.S.C. chapter 3 the Board of the FRS has the right to issue minor regulations in specific areas. – The OCC/FDIC can initiate a number of *enforcement actions* and penalties to direct banks and their management to correct problems and prevent further deterioration. As a primary supervisor the OCC has the authority to pursue enforcement actions. The FDIC has two-dimensional backup enforcement powers for any insured bank. First, it may recommend that an institution's primary supervisor take enforcement steps. Second, the FDIC may initiate such steps itself, provided that the primary supervisor fails to act and an emergency situation exists.[27]

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[25] 12 U.S.C. chapter 2, 161–164 and 12 U.S.C. chapter 16 s. 1817a.

[26] Examinations of US national banks may be executed on behalf of 12 U.S.C. chapter 3 (the FRS) ss. 481–486 or chapter 16 (the FDIC) s. 1820. The first provisions recognise special examinations while the latter provisions deal with both special and regular examinations.

[27] 12 U.S.C. chapter 16 s. 1818t.

The Federal Deposit Insurance Corporation Improvement Act of 1991 created a new supervisory framework linking enforcement actions closely to the level of capital adequacy.[28] The framework, known as *prompt corrective action* (PCA), introduces a timely, detailed and progressive legislative concept for supervisory action in case of capital declines. PCA standards currently are the primary regulatory means influencing bank capital levels. In the framework banks are assigned to five possible capital categories: well capitalised, adequately capitalised, undercapitalised, significantly undercapitalised and critically undercapitalised banks. Assignment is based on three capital ratios.[29] The PCA framework establishes *mandatory* and *discretionary action* for the supervisor in different capital categories. Well and adequately capitalised banks will not be subject to mandatory action. For undercapitalised and significantly undercapitalised banks the focus is on submitting and implementing an acceptable plan to restore capital. Critically undercapitalised banks are those with tangible equity equal to or less than 2 percent of their total assets. Critically undercapitalised banks should face receivership within 90 days (unless their condition improves quickly) and consequently activities that might increase their risk exposure are restricted or require approval by the authorities.

In the case of **the UK**, major changes have taken place both in the legal framework for supervision and in supervisory routines. To begin with, the responsibility for banking supervision was transferred from the Bank of England to the FSA in 1998. Before, the Bank of England supervised banks in accordance with the Bank of England Act of 1946. Furthermore, *the Financial Services and Market Act* (FSMA) totally changed the legal base for bank regulation in 2000. Prior to the FSMA, banks in the UK were regulated by the Banking Act of 1987. On a general level, the regulatory powers of the FSA have increased relative to former Bank of England powers. Moreover, the historical and close relation that existed between the Bank of England and the supervised banks has been cut off. The new FSA has announced supervision to focus on problem banks.[30]

One of the objectives for the supervisory reform was to improve the flexibility of regulatory action. Legislators stressed the need to anticipate and to adjust to the rapidly changing nature of the financial services industry. In practise this meant that the FSMA received the structure of an enabling regulative framework, giving

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[28] 12 U.S.C. chapter 16 s. 1831o.

[29] These are total capital to risk-weighted assets (total risk-based capital ratio), tier 1 capital to risk-weighted assets (tier 1 risk-based capital ratio) and tier 1 capital to total average assets (leverage ratio).

[30] Preceding the FSMA, some of the banks' more recently developed activities were regulated in the Financial Services Act of 1986. The Securities and Investments Board (SIB) was mainly responsible for the supervision on behalf of the Financial Services Act of 1986.

the regulator, the FSA, considerable *regulative powers* to reach its objectives.[31] Measures relating to the regulative function of the FSA in respect of banks are based on the FSMA part X and the provisions concerning market conduct in the FSMA s. 64. The regulative powers of the FSA are large in relation to the powers of supervisory authorities in most European countries. Rules, in the form of issued statements and codes, and guidance are the primary means to enforce the regulative function. Rules are usually required to be supported by guidance.

Closely related to the FSA's regulative function is the authority's *supervisory function*. In turn, the supervisory means do not differ significantly from other countries. The flow of information concerning banks to the FSA is in theory fourdimensional. The FSA is entitled to require information, demand specific reports to be made, appoint investigators and require information from auditors and actuaries. The systematic flow of information mostly includes data on capital adequacy, liquidity and large exposures.[32] Mechanisms for steering the banks in terms of sanctions comprise a) disciplinary measures, in the form of public censure and financial penalties, b) the new market abuse scheme, c) notices in the form of injunctions and restitution, d) withdrawal of authorisation and cancellation of permission, e) prohibition orders against individuals, f) the approval procedure for particular arrangements and g) traditional offences.[33]

Another area where basic structural differences to other countries are found is *the legal comprehensiveness* of the FSMA. The FSMA introduced a single, coherent regulative system that did not make unnecessary distinctions between different financial actors. The scope of regulated activities is indicated in general terms in the FSMA part II s. 22, specified in schedule 2 and supplemented by secondary legislation. Most of the activities of banks are defined as regulated activities. Dealing and arranging deals in investments, taking deposits, safekeeping and administering assets, managing investments, giving investment advice and establishing investment schemes are classified as regulated activities.

The foundation for **the supervision of German banks** is fairly straightforward. Supervision is based on *the Law concerning the Financial Supervisory Authority* (Gesetz über die Bundesanstalt für Finanzdienstleistungsaufsicht, FinDAG) and *the Banking Act* (Kreditwesengesetz, KWG). From 1.5.2002 the Financial Supervisory Authority (Bundesanstalt für Finanzdienstleistungsaufsicht, BAFin) is in charge of the supervision. Earlier the Federal Banking Supervisory Office (FBSO) (Bundesaufsichtsamt für das

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[31] The objectives comprise a) market confidence, b) public awareness, c) the protection of consumers and d) the reduction of financial crime. The objectives are listed in the FSMA part I s. 2.

[32] The FSMA part XI s. 165–168 and part XXII s. 342.

[33] The FSMA part III s. 33 and part IV s. 45, part V s. 56 and 59, part VIII, part XIV s. 205–206, part XXVI s. 380 and 382, the FSMA part XXVIII.

Kreditwesen, BAKred) was in charge of the supervision. The FSA cooperates closely with the German Central Bank (Deutsche Bundesbank). Much of the information received by the FSA about the state of banks constitutes reports transmitted to the Central Bank. Formally, co-operation is put into effect through the Forum for Financial Market Supervision (Forum fur Finanzmarktaufsicht). Bank activities in the area of investment services are regulated by the Securities Trading Act (Gesetz uber den Wertpapierhandel, WpHG) of 1994. In this respect supervision of banks is handled by the FSA also. Before 1.5.2002 this supervision was handled by the Federal Securities Supervisory Office (FSSO) (Bundesaufsichtsamt fur den Wertpapierhandel, BaWe).

The aim of the FSA in terms of the supervision of German banks is characterised in the Banking Act part I, division 2, s. 6 using a negative description. Pursuant to these provisions the FSA shall counteract undesirable developments that may endanger the safety of the assets entrusted to institutions, impair the proper conduct of banking business or involve serious disadvantages for the national economy.[34] In sum, *the information flow* to the FSA relies heavily on reports. The weight put on reports distinguishes the German supervisory system from other systems.[35] Moreover, the obligations of the German auditors in relation to the FSA are quite wide by international standards. The auditor shall eg examine the financial circumstances of the institution when auditing the accounts and report on facts that might impair the bank's development to the authorities. On site inspections of German banks are rare though legal conditions for inspections exist. The FSA may also require specified information, carry out special audits and attend shareholders' and other meetings at the bank.[36] Another important source of information, both for the FSA and any bank, is *the credit register* concerning loans of EUR 1,5 million or more. These provisions stipulate that banks must report issued loans in line with the above-mentioned sum to the Central Bank, which adds the loans for each individual borrower and subsequently notifies the lenders of the total indebtedness of borrowers and the number of lenders involved.[37]

FSA *powers to intervene* in bank activities do not deviate from the powers of corresponding authorities in other countries. The most important ones are listed below. The FSA may issue instructions to the bank and its managers that are appropriate and necessary to prevent or overcome undesirable developments. The

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[34] The Banking Act part I, division 2, s. 7.

[35] The legislation requires monthly reports on own funds, liquidity and returns (the Banking Act part II, division 1, s. 10–10a, 11 and part II, division 5, s. 25 respectively). Quarterly reports should be made on loans of or exceeding DEM three million (the Banking Act part II, division 2, s. 14). The audited accounts of the banks shall be transmitted to the FSA on a yearly basis (the Banking Act part II, division 5).

[36] The Banking Act part II, division 6 and part III, division 3, s. 44.

[37] The Banking Act part II, division 2, s. 14.

Ministry of Finance (MoF) has been given the right to issue regulations concerning the specification of several topics regulated in the Banking Act. These include large exposures, reporting and auditing.[38] The Banking Act entitles the FSA to revoke banks' licenses on certain grounds and dis-miss managers when specified conditions are met. Measures taken by the FSA are usually immediately enforceable despite objections or appeals made. The FSA may also impose sanctions. Revocation or expiry of the licence entitles the FSA to request liquidation of the bank.[39]

Similarly, in respect of the scope of banking legislation, provisions on licensing, capital requirements, liquidity and restrictions on activities, it is difficult to find significant differences between German and international supervisory standards. As in other countries, Basle recommendations and EU directives form the regulatory foundation for banking supervision.

In **Finland**, as a result of the banking crisis in the beginning of the 1990s, organisational measures were taken in order to promote the efficiency of banking supervision. The Financial Supervision Authority (FSA) (Rahoitustarkastus, Rata) was transferred from the MoF to become an independent part of the Bank of Finland. FSA supervision of Finnish banks is mainly based on *the Law concerning the Financial Supervision Authority* (503/1993) and the new *Law concerning the Supervision of Finance and Insurance Conglomerates (44/2002)*. The MoF still makes many of the major decisions concerning banking supervision.

As a consequence of the small number of banks, the strategic choice between focusing on risky banks or closely keeping track of all banks is not as central as in countries with many banks. Accordingly, the aims of the Finnish FSA deviate from those of eg the UK FSA. The Finnish FSA aims towards an insight in all banks, in spite of recent announcements that lack of resources may direct the attention only to the larger ones. The emphasis in Finnish banking supervision may best be described as varied. The focus in banking supervision will be on the topics that the FSA considers most relevant at that time. The small number of supervised banks also creates conditions for close relations between the supervisors and the supervised. In theory, this may lead to a situation where the supervisor will become more of a consultant than a controller. On the other hand, Finnish banks have been very likely to act in accordance with directives given.

[38] The Banking Act part I, division 2, s. 6, part II, division 2, s. 22, division 5, s. 24 and division 6, s. 29.

[39] The provisions also define other, more neutral grounds for measures against the banks. In certain situations the FSA may prohibit banks' acquisitions of shares of non-financial companies or the use of voting rights in relation to these shares. In case of inadequate own funds, liquidity and insolvency or dangers for creditors, entrusted assets and the national economy several severe means may be applied.

The Law concerning the Financial Supervision Authority (503/1993) provides the FSA with control measures that in a general sense correspond to international standards. The formal *means for receiving information* about the banks comprise four channels according to the law. The FSA has the right to attend and convene banks' administrative meetings, carry out inspections and access data. Auditors are obliged to inform the authority about specific events and the authority may require a special audit to take place.[40] Most provisions on continuous reporting (ie capital adequacy, liquidity etc.) to the FSA are included in the Law concerning Credit Institutions (1607/1993). Practices for receiving information comprise both reports and frequent inspections. The formal *avenues for influencing banks' behaviour* are several. Still, the FSA has no general regulatory powers. The FSA has the right to recommend change or withdrawal of the banking licence (to the MoF). There is the possibility for the supervisor to hinder the implementation of decisions, to issue auditing instructions and induce restrictions on the use of profits. The FSA is also entitled to authorise an agent to control the operation of the bank and prohibit or restrict the collection of deposits.[41] Furthermore, provisions for the establishment and ownership of a bank and the activities of a bank are quite similar in comparison with other countries.

In identifying the main features of **the supervision of Japanese banks** that distinguish it from its US and European counterparts there are several paths to follow. The legal base for Japanese banking supervision is *the Japanese Banking Law of 1981 chapter IV*. The Financial Services Agency (FSA) is responsible for the supervision since 2000. Its predecessor was the Financial Supervisory Agency. In 1998 it replaced the Ministry of Finance (MoF) as a banking supervisor. – Analysing *the strategy* for FSA supervision, supervision may best be undertaken by concentrating on actual aims of authority action. In practice, the changes to FSA supervision have been thorough. The period until 1996 was characterised by what was known as the *"convoy" style* of banking administration, ie an integrated supervision policy. During this period the Japanese MoF was in charge of the supervision. The MoF collaborated closely with the banks and other financial institutions and exercised moral persuasion to ensure compliance with policy guidelines. The role of the MoF was mere the role of a consultant than that of a controller. There was no explicit legislation concerning supervisory practices and no history of law enforcement. The starting point for *a new supervisory era* was a statement made by the MoF in 1996 on measures to improve banking supervision as a result of the Jusen crises. The MoF's relation to the supervised banks was

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[40] The Law concerning the Financial Supervision Authority 10–12§§.

[41] The Law concerning the Financial Supervision Authority 13–16§§.

modified. The MoF and its successors had to meet demands for authority integrity.[42]

Another area of interest when describing supervision is *the character of FSA data collection*. With regard to *the formal reporting requirements and factual bank reports* aimed at collecting information before 1996 there was no significant difference to means used in the US and many European countries.[43] The legislative base for banks' reports consisted of the Banking Law chapter IV s. 24. The formal reporting requirements and actual bank reporting situation has only partly changed since 1996. In 1998 a "prompt corrective action" scheme (PCA) was introduced to improve identification and monitoring of failing banks. Accordingly, the informational measures have been shaped to improve the identification of variation in capital adequacy. *MoF and FSA inspections* are another central device aimed at receiving information about banks.[44] As a consequence of the new emphasis in supervision after 1996 inspections have concentrated on the internal control structures and functions and to a lesser degree on pure asset value. Originally, the MoF aimed to inspect major banks every three to four years, with smaller banks being inspected every two years. Since 1998 its successors' aim is to inspect problem banks every 12 to 18 months. During the last years, inspections have been pre-announced. An additional, related topic is *the role of the auditors*. Ambitions to use external audit to a greater extent in MoF/FSA assessment of bank status derive from the statement made by the MoF in 1996. The increasing interest in external audit results from the shift in FSA supervision from the examination of loan books to validation of banks' self-assessments. For the external audit to fulfil its aims the auditing should meet several requirements. The decision taken in 1997 (revoked in 2001) to allow banks to choose between acquisition cost or market value when valuing investment securities did not promote the quality of external audit.

The formal *measures to monitor banks* in Japan do not significantly differ from other jurisdictions. The Japanese Banking Law chapter IV ss. 26–29 lists the variety of authority measures. First, the FSA is entitled to request a plan for improvement to secure healthy operations for the bank, and to order revisions of the plan. Second, the FSA may on a temporary base, suspend a bank's business partly or totally, order a bank to deposit its assets and order such other supervisory

[42] The formal aims of regulation and supervision have not changed since the beginning of the 1990's. The Banking Law chapter I s. 1 states that. "The law shall have as its objective… together with the maintaining of trustworthiness and the securing of the protection of depositors… *the smooth facilitation of finance*… via the fixing of healthy and appropriate operations in the banking business and thus the promotion of the healthy development of the national economy."

[43] Measures were applied and reports made in order to assess capital adequacy (the Banking Law chapter II s. 14–2), liquidity, loan exposures, licenses (the Banking Law chapter I s. 4) and deposit insurance fees.

[44] The Banking Law chapter IV s. 25.

measures that it finds necessary.(!) Third, directors and auditors may also be ordered to resign and the bank's licence may be recalled on certain grounds. Fourth, a special means may be applied to protect the interest of depositors or the public interest, ie the ordering of a bank to hold its assets in Japan. Additionally, penalties in the form of penal servitudes, penal fines or non-penal fines may be linked to the above-mentioned orders. – The introduction of *the PCA-scheme* in 1998 was by far the most important single factor concerning supervisory procedures against banks for a long time. It was also a cornerstone in the sense that it constituted an objective scheme for action that did not take into account other than certain specified quantitative data. For the FSA it was not only an entitling scheme but also an obligating one.[45]

3 The banks' creditors and bank exit in the US, UK, Germany, Finland and Japan

3.1 Bank reorganisation and liquidation in the US[46]

> The US bank exit regime is unique in many senses. General insolvency laws do not apply. Both the initiative for starting the proceedings as well as the administration of the insolvency procedures rest entirely with the supervisory authorities. Two proceedings exist, ie conservatorship and receivership. Conservatorship corresponds to reorganisation and receivership to liquidation. The conservator's goal is to reorganise the bank while securing its "going-concern" value. The receiver's aim is to maximise the return of realised assets and minimise any loss to the Deposit Insurance Fund. The procedures are quite similar – the only thing distinguishing them is the fact that receivership enables liquidation. In practice, conservatorship is rarely used. Organisationally, the Federal Deposit Insurance Corporation (FDIC) handles the reorganisation and liquidation of US national deposit banks.

[45] The Banking Law chapter IV article 26. Benchmarks for action comprised both BIS standards on capital adequacy as well as national Japanese standards. Levels generating supervisory action include the situation when a bank's capital adequacy ratio falls below eight percent (BIS standard, or four percent national standard), four percent (two percent) and zero percent. Suspension of operations is required when the capital adequacy level reaches zero. Ratings are not public. – Other supervision related factors that may be relevant to bank stakeholders are the restrictions on bank activities in the Banking Law chapter II. Though several risk-motivated restrictions have existed for banks to engage in ancillary business most of the restrictions have been abolished.

[46] This study concentrates on federal US legislation, ie legislation applicable to US national (federal) and (deposit) insured banks. Though state banks primarily are regulated by state legislation most of the legislation presented here invariably applies when insured state banks face reorganisation or liquidation.

The legislation concerning the reorganisation and liquidation of US national banks identifies two formal procedures, one relating to the reorganisation and the other connected to the liquidation of a bank. Reorganisation of a bank is executed through *conservatorship*, a procedural means originally created during the Great Depression by the Emergency Act of 1933.[47] Liquidation of a national bank is carried out through *receivership*.[48] In the US, the initiative for both commencing insolvency proceedings and the administration of the insolvency rests with the banking supervisory authorities. If not satisfied with the actions taken by the authorities creditors may, on certain narrow grounds, appeal to the court.[49]

Conservatorship as a procedure may be described by referring to the 12 U.S.C. chapter 16 s. 1821d. According to these regulations a conservator appointed by the Office of the Comptroller of the Currency (OCC) may a) take over the assets of and operate the insured bank with all the powers of the shareholders and the directors, b) collect all obligations and money due to the bank, c) perform all functions of the bank in the name of the bank and d) preserve and conserve the assets of the bank. The above-mentioned measures are taken in order to put the insured bank in a sound and solvent condition.[50] – *Criteria for the appointment* of a conservator are several and quite varied. Grounds for appointment may be characterised as status-related, environmental, violations-oriented and consensual. *Status-related grounds* comprise capital adequacy (insufficient assets, losses and under-capitalisation), liquidity (inability to meet obligations) and cessation of insured status. *Environmental aspects* consist of unsafe or unsound conditions to transact business. *Violations-oriented criteria* for appointment include violations of cease and desist-orders or legislation, money laundering offences and concealment. *Consensual grounds* refer to the consent of the bank's board of directors or its shareholders in appointing a conservator.[51] In practice, the "Prompt Corrective Action" (PCA) scheme and the CAMELS-risk classification system are linked to the commencement of conservator- and receivership. Critically undercapitalised banks must be placed under conservatorship or receivership within 90 days unless the FDIC concur that other action would better achieve the purposes of PCA. A ratio of tangible equity to

[47] 12 U.S.C. chapter 2 ss. 201–213 and chapter 16 s. 1821.

[48] 12 U.S.C. chapter 2 ss. 191–200 and chapter 16 s. 1822.

[49] For additional analyses of the US bank exit regime see Spong 2000 p. 138ff, Hüpkes 2000 p. 64ff and Macey, Miller & Carnell 2001 chapter 10.

[50] Secured creditors are protected as a result of the fact that security interests in the assets of the problem bank should be respected by the conservator/receiver pursuant to 12 U.S.C. chapter 16 s. 1821e. Only under extreme conditions secured creditors are not protected.

[51] The criteria are listed in the 12 U.S.C. chapter 16 s. 1821c and chapter 2 s. 203.

total assets equal or less than two percent constitutes the limit when defining critically undercapitalised banks.[52]

Procedurally, the conservator is appointed by the OCC.[53] Exclusively, the conservator appointed has been the Federal Deposit Insurance Corporation (FDIC). In case of under-capitalisation, the OCC should not appoint a conservator without giving the FDIC the opportunity to appoint a receiver.[54] Moreover, the FDIC may appoint itself as conservator on certain grounds specified in 12 U.S.C. chapter 16 s. 1821c. After consultation with the OCC the FDIC may appoint itself as conservator if this reduces the risk for losses for the Deposit Insurance Fund. The FDIC should also consider providing the bank direct financial assistance before the appointment of a conservator.[55] Not later than 20 days after the initial appointment of a conservator the bank (not the creditors) is entitled to appeal to the court for an order requiring the OCC to terminate the appointment. The OCC's decision to appoint a conservator will be set aside only if the court finds that the decision was arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with the law.[56]

The powers and duties of the FDIC as conservator are regulated in the 12 U.S.C. chapter 16 s. 1821d and s. 1823. First, the FDIC has *administering powers* to carry out the activities of and represent the insured bank. Second, the FDIC has *contractual and supportive powers* to make agreements with the insured bank, eg buying assets or taking over liabilities from the bank. – The regulations concerning *the administering powers* deal with both more general capacities and more specified ones. While the general ones were considered above the most important specific ones relate to the FDIC's right to merge the insured bank or transfer any asset or liability of the bank to third parties. Relating to the administering powers the FDIC as conservator also has the power to request a stay, ie suspension, of legal action against the bank, at the proper court. The stay should not exceed 45 days. – The FDIC's *contractual and supportive powers* in relation to the insured bank mainly stem from 12 U.S.C. chapter 16 s. 1823. The FDIC is authorised to make loans to, make deposits in, purchase the assets or securities of, assume the liabilities of or make contributions to insured banks to restore the bank to normal operation or to lessen the risk for the FDIC in case of systemic instability. In order to facilitate a) a merger or consolidation with another bank, b) the sale of any or all of the assets of an insured bank to another bank, c) the assumption of any or all of a bank's liabilities by another bank or d) the

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[52] 12 U.S.C. chapter 16 s. 1831o.

[53] 12 U.S.C. chapter 2 s. 203.

[54] 12 U.S.C chapter 16 s. 1821c.

[55] 12 U.S.C. chapter 16 s. 1823c. These options should be separated from the lender of last resort channel (LLR) available for member banks of the Federal Reserve System (FRS).

[56] 12 U.S.C. chapter 2 s. 203.

acquisition of the stock of a bank by another bank the FDIC may in turn purchase such assets of, assume such liabilities of, make loans to, make contributions to, make deposits in, purchase securities of or issue guarantees to such another bank. The FDIC may also provide any other person than a bank acquiring control of, merging with, consolidating with or acquiring the assets of an insured bank with such financial assistance as it could provide the insured bank itself. Additionally, there are several provisions regulating FDIC powers relating to contracts entered into before the conservatorship (12 U.S.C. chapter 16 s. 1821e).[57]

The powers and duties of the FDIC as conservator are *restricted* in two significant ways. The regulations concerning the FDIC's disposition of assets require the FDIC to *take certain factors into account* when selling or disposing assets. The FDIC shall conduct its operations in a manner which a) maximises the NPV return from the sale or disposition, b) minimises the amount of any loss realised in the resolution of cases, c) ensures adequate competition and fair and consistent treatment of offerors, d) prohibits discrimination and e) to certain extent promotes the situation for low and moderate income individuals. Before taking any measures as conservator, the FDIC should *carry out a number of impact assessments*. Considerations of local economic impact, actions to alleviate adverse economic impact and analysis of impact on the financial services industry are all required before measures are taken. – The grounds for *reviewing decisions* made by the FDIC are also of interest to creditors. Judicial review of agency decisions is available under the Administrative Procedure Act except in cases where statutes preclude judicial review or agency action is committed to agency discretion by law.[58] The Administrative Procedure Act directs the reviewing court to set aside agency actions, findings and conclusions that are a) arbitrary, capricious, an abuse of discretion or otherwise not in accordance with law, b) contrary to constitutional right, power privilege or immunity, c) in excess of statutory jurisdiction, authority or limitations or short of statutory right, d) without observance of procedure required by law, e) unsupported by substantial evidence or f) unwarranted by the facts to the extent that the facts are subject to trial de novo by the reviewing court.[59]

Conservatorship is a means to introduce a period during which the problems of the bank should be sorted out. In principle, there are no restrictions on the maximum length of conservatorship. Regulations state that in *the termination of conservatorship* two aspects should be considered.[60] According to these

[57] FDIC funds are primarily used to pay off depositors. Direct FDIC support (ie financial assistance) to insured banks has usually taken the form of debt or subordinated debt. Though the provisions enable the FDIC to provide support in the form of contributions to banks such an alternative would not emphasise bank shareholder responsibility.

[58] 5 U.S.C. chapter 7 s. 701a.

[59] 5 U.S.C. chapter 7 s. 706.

[60] 12 U.S.C. chapter 2 s. 205.

provisions termination is possible when this is in the interest of the public and it safely can be done. The OCC decides on the termination of conservatorship. The OCC may a) terminate the conservatorship and permit the involved bank to resume the transaction of its business, subject to such terms and limitations that the OCC may prescribe, b) terminate the conservatorship upon a sale, merger, consolidation, purchase and assumption, change in control or voluntary dissolution or c) terminate the conservatorship upon the appointment of a receiver. The bank is entitled to bring an action in the proper court for an order requiring the OCC to cancel its terms and limitations on the continuance of the bank's activities.[61]

The procedure more often used to deal with the problems of US banks is **receivership**. Contrary to conservatorship, receivership comprises an element of finality, ie compulsory liquidation. In many other senses the powers of the receiver are quite similar to the powers of the conservator. Restricting the analysis to *the general powers of a receiver*, ie powers to act as a successor to the bank (eg take over the rights of shareholders) and powers to operate the bank, the differences in relation to the conservator are few. In addition to these powers the receiver "may place the bank in liquidation and proceed to realise upon the assets of the bank, having due regard to the conditions of credit in the locality".[62] – *The criteria for the appointment* of a receiver are the same that are listed above for the appointment of a conservator.[63] As a supplement, a receiver may be appointed if shareholders do not pay any deficiency in capital within three months of notification by the OCC or if the bank's board of directors consists of fewer than 5 members.[64] – *The procedure* for appointing the receiver differs to some extent from the appointment of the conservator. As for the conservator the OCC is entitled (but not obliged) to appoint the receiver when criteria are met. If the national bank is an (deposit) insured bank the FDIC must be appointed receiver. In this sense significant differences prevail in relation to the appointment of a conservator. The FDIC may appoint itself receiver under the condition that the appointment will reduce the risk for losses for the Deposit Insurance Fund.[65] The FDIC should also, as a more inexpensive alternative, consider providing the bank direct financial assistance before the appointment of a receiver.[66]

[61] The final stage of the conservatorship is the distribution of proceeds to depositors, creditors and shareholders stemming from the sale, merger, consolidation, purchase and assumption, change in control, voluntary dissolution or liquidation of the bank. The conservator shall deposit the proceeds, less any outstanding expenses of conservatorship, in the proper court and cause notice to the above-mentioned parties. The court shall distribute the funds equitably.

[62] 12 U.S.C. chapter 16 s. 1821d.

[63] 12 U.S.C. chapter 16 s. 1821c, see also 1831o.

[64] 12 U.S.C. chapter 2 s. 55 and 12 U.S.C. chapter 2 s. 191 respectively.

[65] 12 U.S.C. chapter 16 s. 1821c.

[66] 12 U.S.C chapter 16 s. 1823c.

As mentioned, most of *the powers and duties* of the receiver resemble those of the conservator. *The powers and duties* of the receiver are regulated in the 12 U.S.C. chapter 16 ss. 1821d-w, 1822, 1823 and chapter 2 ss. 197–198. The most significant differences in relation to the conservator's powers and duties are the following. – The receivership of an insured bank often involves the organisation of either a "new bank" or a "bridge bank".[67] Establishing a new bank may be done if it is advisable and in the interest of the depositors or the public. In case a new bank is established it should assume the insured deposits of the bank in default and otherwise perform those temporary functions provided in law. Unless the stock of the new bank is sold to or its assets taken over and liabilities assumed by another bank, the FDIC should wind up the new bank within two years after the date of its organisation. – The purpose of a bridge bank is less formal and detailed. The establishment of a bridge bank is based solely on the FDIC's discretion and usually bridge banks are founded in order to take over the operations of a failed bank and preserve its "going-concern" value while the FDIC seeks to arrange a permanent resolution of the bank failure. Bridge banks are national banks and should be chartered by the OCC. Bridge banks shall terminate upon merger, consolidation or sale of the bank or the assumption of certain of its assets. If such measures are not taken the status of a bridge bank shall terminate at the end of the two-year period following the date it was granted a charter. The FDIC may extend the status of the bridge bank for three additional one-year periods. – In case of receivership the receiver may request a suspension of legal action against the bank for a maximum of 90 days, ie twice the time compared to conservatorship. The proper court will grant the suspension.[68]

A separate regulative entity relating to the receivership is the regulations concerning *the determination and payment of claims*.[69] In general, the FDIC may, as receiver, determine the claims held by creditors and corresponding parties against the insured bank (determination authority). The FDIC may also prescribe regulations regarding the allowance or disallowance of claims, the providing for administrative determination of claims and the review of such determination (rulemaking authority). There are two types of procedures for the determination of claims. In both cases the receiver is obliged to notify the claimants about the forthcoming liquidation. In turn, the claimants shall provide the receiver information about the claims and proof hereabout. According to the main procedure the FDIC shall, in 180 days from receiving information and proof, determine whether to allow or disallow the claim and notify the claimant of the determination. The applicability of the expedited procedure for the determination of claims is quite narrow. Expedited determination is possible for claimants who

[67] 12 U.S.C. chapter 16 s. 1821m and 1821n, respectively.

[68] 12 U.S.C. chapter 16 s. 1821d.

[69] 12 U.S.C. chapter 16 s. 1821d.

a) allege the existence of legally valid and enforceable or perfected security interests in assets of the insured bank <u>and</u> b) allege that irreparable injury will occur if the routine claims procedure is followed. The time limit for determination of claims and notification using the expedited procedure is 90 days.[70]

> One aspect significant to US bank creditors is the fact that banks may receive direct financial assistance from the FDIC. This assistance is usually in the form of debt or subordinated debt. Restrictions oblige the FDIC to choose the least-cost alternative (eg paying off depositors rather than giving financial assistance to banks) when faced with bank problems. – Bank creditors are not entitled to initiate or influence bank reorganisation in any way. Reorganisation may not be used to cut creditor claims while improving shareholder position. – The supervision of banks is based on the "prompt corrective action" (PCA) scheme and the CAMELS risk-classification system with yearly onsite inspections.
>
> Creditors have no right to initiate bankruptcy or liquidation. – Critically undercapitalised banks should face receivership (or conservatorship). A ratio of tangible equity to total assets equal or less than two percent constitutes the limit.
>
> Depositors' claims are in priority in relation to other creditors. As a result of the subrogation of depositor rights in the case of depositor pay-off, FDIC claims are also in priority. – The FDIC should protect the "going-concern" value of the bank. Several judicial concepts aiming to secure the "going-concern" value of the bank exist.

Finally, a few words may be said about the restrictions on the receiver's powers and duties, judicial review of the FDIC's decisions and actions and the eventual resumption of the closed bank. What comes to <u>*the restrictions*</u> on the receiver's powers and duties the restrictions are the same as in the case of conservatorship. The FDIC should among other things maximise the NPV return and minimise the costs when administering the assets and liabilities. Moreover, the FDIC should carry out a number of impact assessments in connection with its decisions and actions.[71] <u>*Judicial review*</u> of the FDIC decisions and actions may be characterised as two-dimensional. First, a court may, as mentioned above, review FDIC decisions and actions on grounds specified in 5 U.S.C. chapter 7 s. 706. Second, relating to the determination of claims, the FDIC is obliged to introduce internal procedures for administrative review of the determination.[72] The US legislation

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[70] The receiver handles the payment of claims in accordance with traditional priority principles. The order of priority for non-secured claims comprises a) administrative expenses of the receiver, b) any deposit liability of the institution, c) any other general or senior liability of the institution, d) any obligation subordinated to depositors or general creditors and e) any obligation to shareholders.

[71] 12 U.S.C. chapter 16 s. 1821d.

[72] 12 U.S.C. chapter 16 s. 1821d.

also recognises a procedure for *the resumption of the business* of a closed bank. The OCC may, when certain conditions are met, permit a bank in receivership to resume business. The permission requires that the resumption a) is to the advantage of the depositors and unsecured creditors and b) 75 percent of unsecured depositors and creditors consent to such a retention of liabilities.[73]

3.2 Bank creditors and the administration of problem banks in the EU

In the EU, recommendations and directives with consequences for the reorganisation and liquidation of banks have been issued. In part, recommendations and directives focusing on bank exit have concerned depositors. On the other hand, the recent Parliament and Ministry Council *Directive concerning the Reorganisation and Liquidation of Credit Institutions (Deposit Banks) (2001/24/EEC)* affects all bank stakeholders.[74] The directive does not create a uniform procedure for bank exit. The directive mainly regulates which national jurisdiction should apply to the reorganisation and liquidation of member-state banks with activities in several member-states. Similarly, the directive regulates which jurisdiction should apply to foreign problem banks with activities in one or more member-states. In addition, the directive sets out certain minimum requirements for national legislation and lines to deal with the practical matters generated. The rule states that for member-state banks, the legislation of the bank's home country should apply to the bank as a whole. For foreign banks, the rules state that the authorities starting the reorganisation or liquidation procedure against the foreign bank should inform and co-operate with the authorities of other EEA-countries. The directive should be implemented before May 2004.[75]

3.2.1 London-based banks' creditors and UK laws on bank exit

The reorganisation and liquidation regulations applicable to UK *companies in general* represent several procedural alternatives. Winding ups, administration orders, arrangements and receiverships etc. all reflect different ways to rehabilitate or cease company activities. The regulations concerning companies overall also apply to banks. In the judicial debate, there have been few motives for

[73] 12 U.S.C. chapter 2 s. 197a.

[74] In the EU, the Brouwer-report 2000 concerning financial stability also pointed out the importance of functional bank exit regimes.

[75] For a 1999 review of EU (federal) rules concerning bank insolvency see Clarotti 1999.

deviating from general procedures when confronted with the reorganisation and liquidation of UK banks.[76] – In order to transmit a picture of UK reorganisation and liquidation alternatives for banks there are many ways to proceed. In this section 3.2.1, the analysis is restricted to the procedures regulated in *the Insolvency Act* (and related provisions in *the Financial Services and Markets Act (FSMA) 2000* and *the former Banking Act 1987*). The Insolvency Act is the legislative source that most strongly affects bank creditors. Certain reorganisation and liquidation measures are regulated in the Companies Act and are covered in section 5.2.1. These measures also have implications for bank creditors. The reorganisation and liquidation measures defined in the Insolvency Act comprise *"the proposal", voluntary winding up, compulsory liquidation, the receiverships and the administration order*.[77]

> The UK bank exit regime is characterised by two main features. First, bank reorganisation and liquidation follows the general procedures applicable to all limited liability companies facing financial problems. Second, both reorganisation and liquidation proceedings are court-based, not FSA-administered. In theory, a number of alternatives to handle problem banks exist. The Insolvency Act comprises reorganisation measures in the form of "the proposal" and the administration order. The law also establishes procedures for both voluntary and compulsory liquidation. Certain reorganisation means are included in the Companies Act (but no reorganisation or bankruptcy regime specific to banks exists.) In practice, problem banks have been dealt with using the administration order, creating a moratorium against legal action. During this period, eg sales of the banks' businesses have been negotiated and a solution presented to the market. The fact that the procedure is court-based, ie slow, has resulted in judges cutting corners to secure the "going-concern" value of the banks' assets and eliminate systemic conse-quences.

Following this categorisation, **the proposal** is a reorganisation measure by which creditors may be bound by the decision of the creditors' meeting even without their consent. The aim of the measure is the composition of the bank's debts or the arrangement of its affairs.[78] – The initiative for the proposal is *the directors'*. The

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[76] The UK insolvency regime is systematically covered in Wadsley & Penn 2000 chapters 23–24, in the UK Insolvency Overview / Global Insolvency Law Database at www.worldbank.org/legal and in Phillips and Tamlyn in Oditah (ed.) 1996.

[77] The administration order is the most frequently used means to handle UK bank failures. The functionality of the order as a reorganisation measure was eg shown in the case of Barings Bank. – "Administration also proved its worth in the rescue of Barings Bank. When attempts by the Bank of England to organise a voluntary rescue of the bank failed, it was placed under administration." (Hüpkes 2000, p. 77).

[78] The proposal is regulated by the Insolvency Act part I and the FSMA part XXIV s. 356.

creditors are not entitled to initiate a proposal. The procedure starts with an insolvency practitioner reporting to the court about the forthcoming creditors' meeting. Every known creditor should be summoned to the meeting. The meeting should decide on the directors' proposal. No secured creditor or holder of preferential debt may be harmed by the proposal. The decision should be reported to the court and the creditors affected. A creditor may challenge the decision made by the meeting on two grounds. If the decision unfairly prejudices the interests of the creditor or there has been some material irregularity in relation to the meetings an application to the court may be made. The court may revoke or suspend the proposal or give direction to consider any revised proposal.[79] – In the FSMA the Financial Services Authority (FSA) is given the right *to participate in the proceedings* concerning the proposal. More specifically, the FSA may make an application to the court concerning the proposal and may also attend any hearing held by the court relating to an application.[80]

The liquidation (winding up) of a UK commercial bank may be carried out in two ways. First, the bank may be wound up voluntarily and second, the court may wind up the bank. The latter case is known as compulsory liquidation. **Voluntary winding up** consists of two main alternatives. There is the creditors' winding up and the members' winding up. – Regulations concerning <u>*the creditors' winding up*</u> comprise the Insolvency Act part IV mainly chapter II and IV and the FSMA part XXIV s. 365.[81] The creditors' winding up starts with a resolution passed by the bank at a general meeting. The winding up is deemed to commence at the time of the passing of the resolution. Within 14 days of the resolution a meeting of the bank's creditors should be summoned. The directors are obliged to lay a statement of affairs including the balance sheet data in specified form before the creditors at the creditors' meeting. The creditors and the bank's general meeting may appoint a liquidator for the purpose of winding up the bank's affairs and distribute its assets. Similarly, the creditors may nominate a liquidation committee to supervise the liquidation. On the appointment of a liquidator the directors' powers cease. An account of the liquidation should be presented to the creditors' final meeting prior to the dissolution of the bank.[82] – The FSA is entitled to refer any question arising in the winding up of a bank to the court. The court may entitle the FSA *to exercise the powers of the court* in respect of the voluntary winding up. Moreover, a person appointed by the FSA is entitled to attend any meeting of the bank's creditors.[83]

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[79] The Insolvency Act part I ss. 2, 3, 4 and 6.

[80] The FSMA part XXIV s. 356. – In the case of *"the proposal"* the former Banking Act gave the Bank of England fewer powers. At that time, the Bank of England was not entitled to make any applications to the court or attend any hearings organised by the court.

[81] The members' winding up is covered in section 5.2.1 concerning UK bank shareholders.

[82] The Insolvency Act part IV chapter II ss. 84–87, chapter IV ss. 98–101, 103, 106 and 165–166.

[83] The FSMA part XXIV s. 365 and the Insolvency Act part IV chapter V s. 112. – Under the former Banking Act, the Bank of England had no powers relative to *the voluntary winding* up.

As mentioned above, **compulsory liquidation** means that the court winds up the bank. One of the main types of compulsory liquidation is *bankruptcy*, ie compulsory liquidation on financial grounds (usually initiated by creditors). Regulations concerning compulsory liquidation comprise the Insolvency Act part IV chapter VI and the FSMA part XXIV ss. 367–371. The starting point for the compulsory winding up is the petition to the court. Petitions may be made on several grounds, the most important being a) *the bank's inability to pay its debts* and b) *the court being of the opinion that its just and equitable that the bank should be wound up*.[84] An application for winding up may be presented by *the company, the directors, a creditor or contributory*. The Secretary of State may in specific cases present a petition for the winding up of the bank on grounds of public interest. At the hearing of the petition the court may make a winding up order or any order it thinks fit. In reaching its decision the court may regard the wishes of the creditors and contributories. The court also has the power to appoint a provisional liquidator to prevent the assets being dissipated or to protect a public interest. In compulsory winding ups the commencement of winding up is the time of the presentation of the petition. After the commencement the business ceases, except to the extent required by the winding up of the bank. The official receiver is ex officio liquidator until the liquidator has been nominated. The liquidator may be nominated by the Secretary of State on the initiative of the official receiver or by the creditors' and contributories' meeting. The liquidator has wide powers. During the liquidation the court is entitled to make an order staying or sisting the proceedings on the initiative of a creditor or any other part.[85] – According to the FSMA part XXIV ss. 367–371 *the FSA has a number of powers* relating to the compulsory winding up of a bank. First, the FSA may present a petition to the court for the winding up of a bank. The court may wind up the bank on the above-mentioned two grounds. Second, the FSA has the right to be heard at a hearing of the petition or any other court hearing. Finally, a person appointed for the purpose by the FSA is entitled to attend any meeting of creditors or any meeting of a committee established relating to the liquidation of the bank.[86]

Other means applicable to problem banks comprise *the receiverships* and *the administration order*. – **The receiverships** constitute a right for a secured creditor to enter the bank, realise assets that form the security and pay off the debt. In practice, this is done by the appointment of *a receiver* or *an administrative receiver*. The regulative base for the receiverships is the Insolvency Act part III

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[84] The Insolvency Act part IV chapter VI s. 122.

[85] The Insolvency Act part IV chapter VI ss. 124–125, 129, 135, 137–139, 143, 147, 167 and chapter VIII s. 195.

[86] Formerly, the Banking Act 1987 part VI s. 92 laid the foundation for the Bank of England's (ie FSA's predecessor's) powers to issue a petition to wind up the bank. The rights of the Bank of England in *compulsory winding ups* of banks did not differ significantly from the current FSA rights.

and the FSMA part XXIV ss. 363–364. The laws acknowledge the receivership as an instrument relating to the reorganisation of a company but the rights of the creditor (and the receiver) are to a large extent contractual. The less regulated of the two receiverships is the simple receivership. The administrative receivership gives the administrative receiver such powers that a clearer legislative foundation is needed.[87] UK banks use simple receiverships more often than administrative ones. – The receiver or administrative receiver is nominated by the creditor or by the court.[88] The terms of the debt usually include the criteria for the appointment of the receivers. To receive the right to appoint an administrative receiver the security of the creditor should cover most of the bank's functions. The wider powers of the administrative receiver comprise both a) powers to manage and realise the security and b) powers to run the bank's business. An administrative receiver's powers to manage the bank cease on liquidation. The powers relating more directly to the secured assets are unaffected by the winding up.[89] – According to the FSMA part XXIV concerning liquidation *the FSA has few powers* to affect the activities of the receiver. The most explicit right of the FSA is the right to be heard when the receiver eventually applies to the court for directions.[90] An administrative receiver running the bank is directed by the regulations concerning any person running a bank.[91]

The last of the measures listed in the Insolvency Act a) that a creditor may use to protect his investment or b) that may affect bank creditors is **the administration order**. The administration order is the most frequently used reorganisation measure to handle problem banks. The administration order is designed to help in rescuing ailing companies by giving a breathing space. The breathing space may be used to facilitate the rehabilitation of a company in difficulty or to improve the prospects of beneficial realisation of its assets. The administration order issued by the court places the management of the bank in the hands of an administrator for a certain period. Administration orders are regulated in the Insolvency Act part II and the FSMA part XXIV ss. 359–362. – A petition for an administration order may be made by *the bank, the directors or by a creditor*. The petition and the order freeze most legal steps against the bank, including any resolution to wind up the bank. The bank's activities continue. The administrator has wide powers relating to the ascertainment and investigation of the bank's affairs. The administrator should give a proposal of how to proceed with the bank's financial problems that should be considered at the creditors'

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[87] The Insolvency Act part III chapter I ss. 42–49 and Schedule 1.

[88] The Supreme Court Act 1981 s. 37.

[89] The Insolvency Act part III chapter I s. 44.

[90] The FSMA part XXIV s. 363 and the Insolvency Act part III chapter I s. 35.

[91] Under the Banking Act, the Bank of England had a different role in *the receiverships*. The Bank of England did not have the right to be heard if the receiver applied to the court for directions.

meeting. The proposal should be made in three months' time. In case the creditors' meeting dismiss the administrator's proposal the court may discharge or change the order or make any other order that it thinks fit. The court may also give directions overriding the creditors' views.[92] – *The FSA has some powers* in connection with the issuance of an administration order. The FSA is entitled to present a petition to the court on the making of an administration order.[93] The FSA has the right to attend the hearing of an eventual petition or any other hearing in relation to the bank. The FSA may apply to the court for the discharge of or changes in an already issued administration order.[94] Furthermore, the FSA has the power to appoint a person to attend any creditors' meeting considering the bank's affairs.[95] The issuance of an administration order does not automatically revoke the bank's authorisation, while such a consequence would affect the "going concern" value of the bank and harm creditors. Still, the issuance entitles the FSA to withdraw the authorisation.[96]

As a result of the fact that *the courts have the powers to decide* on the administration proceedings, even by overriding creditor or other stakeholder rights, judges set the factual principles for the reorganisation of UK banks. In a diachronic sense, the courts may be quick in issuing the orders and the FSA fast in identifying eventual buyers of the bank's assets. Today, many bank problems emerge suddenly, eg due to unforeseeable events in the trading rooms. This

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[92] The Insolvency Act part II ss. 9–11 and 21–25.

[93] The FSMA part XXIV s. 359.

[94] The FSMA part XXIV s. 362 and the Insolvency Act part II s. 27.

[95] The FSMA part XXIV s. 362. – The Insolvency Act part II s. 9 entitled the Bank of England to petition an administration order before the introduction of the FSMA. The Banking Act did not establish any other authority powers relative to administration orders.

[96] The criteria for revoking the authorisation for a bank in accordance with the FSMA are general. The FSMA part III s. 33 regulates the withdrawal of an authorisation and states that a ground for withdrawal is the cancellation of permissions to carry out the specified, regulated activities. In turn, criteria for the variation of permissions on the FSA's initiative (ie among other things the cancellation of the permission) is regulated in the FSMA part IV s. 45. The provisions define the conditions for cancellation in the following manner. The FSA may cancel the permission if, a) the bank fails, or is likely to fail, the threshold conditions (see section 2.2), b) the bank fails to carry on a regulated activity for which it has a permission or c) it is desirable to exercise that power in order to protect the interests of consumers. Grounds for revoking the authorisation under the Banking Act were similar.

usually leaves the courts and the FSA with little time to realise the assets or find an alternative solution in the form of arrangements or liquidation.[97]

> Seen from the creditors' perspective, the most apparent feature of the UK bank exit regime is the absence of an authority-directed separate reorganisation procedure for banks. On the other hand, several voluntary and court-based reorganisation procedures exist. In the court-based procedures, the courts may infringe creditor interests. – In case of financial assistance to banks, the UK regime acknowledges only one type of capital transfer. The Bank of England lender of last resort-function may provide banks with liquidity in the form of loans or subsidies. – FSA supervision of banks is based on continuous reporting and ad hoc inspections. Powers have been concentrated to the supervision of risky banks.
>
> The bank's creditors may apply for the winding up of the bank to the court. The court decides on and supervises the liquidation. – The criteria for the initiation of the liquidation comprise a) the bank's inability to pay its debts and b) the court being of the opinion that it is just and equitable that the bank should be wound up.
>
> No priority for deposit claims exists in the realisation of the bank's assets. Payoff of depositors results in Financial Services Compensation Scheme (FSCS) subrogation of depositor claims. – There are no special procedures protecting the "going-concern" value in the reorganisation and liquidation of failed banks.

3.2.2 The reorganisation and liquidation of Frankfurt (German) banks

Several German laws apply to the reorganisation and liquidation of German banks. *The main provisions* of relevance to the banks' creditors are found in *the Banking Act* part III, division 4 concerning "Measures in special cases".[98] Though the legislation in principle distinguishes between reorganisation and liquidation measures the regime has been criticised for not being constructive. Furthermore, banks are not excluded from the associated provisions of *the Insolvency Act* and *the German company laws*. The Banking Act part III, division 1, s. 38 states that the Financial Supervisory Authority (FSA) may issue *general instructions* regarding the liquidation of a bank. Such instructions have not been issued by the

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[97] An additional aspect of interest when discussing the UK bank exit regime is the Bank of England's (BoE) lender of last resort (LLR) role. The procedure concerning financial assistance to banks is not regulated in the law, but the Memorandum of Understanding agreed upon by the BoE, HM Treasury and the FSA specifies the conditions for LLR-assistance. During the years, assistance both in the form of loans and subsidies has been given to eliminate probable systemic market effects.

[98] The German banking provisions are eg found in Deutsche Bundesbank 2000 "Banking Act" (Banking Regulations 2)

FSA. Due to its wide scope, the Voluntary Deposit Protection Scheme administered by the Association of German Banks may also protect creditors of the bank (though they are not depositors) (see section 4.2.2).[99]

> The German bank exit regime is a regime that leaves some questions unanswered. The Banking Act covers the period until the commencement of the liquidation. The exact extent to which the general Insolvency Act should apply to banks is somewhat unclear. The Banking Act focuses on three types of reorganisation and liquidation measures, ie pure protective measures, means with a constructive element and actual liquidation measures. The measures provided by the Banking Act are almost all FSA initiated and administered. In addition to these measures German banks may be reorganised or liquidated pursuant to the German company laws. Overall, the regime has been criticised for creating a standstill. During recent decades Germany has not experienced large bank failures.

In order to receive a picture of the main provisions affecting the bank's creditors a) the Banking Act and b) the Insolvency Act inclusive the acts preceding the Insolvency Act (ie before the year 1999) are discussed below. German company laws are dealt with briefly in section 5.2.2 concerning the shareholders' position in connection with the reorganisation and liquidation of banks.

The provisions of **the Banking Act** applicable to the reorganisation and liquidation of banks may be characterised by focusing upon the provisions' theoretical aims. Contrary to many other jurisdictions, *the protective (prohibitive) element of* the German regime is quite apparent. As a result, there are three categories of procedural provisions controlling the reorganisation and liquidation of German banks. These categories comprise a) pure protective measures, b) means with a constructive element and c) actual liquidation measures. In practice, all measures (regulated in the Banking Act) despite their theoretical aims, are FSA-initiated and -administered.[100] – *Pure protective measures* may be applied to most financially related problems confronting the bank. Pure protective measures are prohibitions and limitations on the activities. Problems confronting the bank include inadequate own funds or liquidity, dangers (for creditors, entrusted assets or efficient supervision) and insolvency. In case of *inadequate own funds or liquidity* the FSA may prohibit or limit withdrawals by the proprietors, the distribution of profits and the granting of loans.[101] The FSA may issue the orders only if the institution has failed to remedy the deficiency within a

[99] For a number of viewpoints concerning the German bank exit regime see Hüpkes 2000 pp. 57 and 117.

[100] The Banking Act part III, division 4.

[101] The Banking Act part III, division 4, s. 45.

period set by the FSA. Measures associated with *danger* also include several prohibitions and limitations on the bank's activities. Under the condition that a) the discharge of a bank's obligations to its creditors and b) especially the safety of the assets entrusted to it are endangered or c) there are grounds for suspecting that effective supervision of the institution is not possible, the FSA may take temporary measures to avert the danger.[102] In particular, the FSA may prohibit the taking of deposits and the granting of loans and prohibit proprietors and managers from carrying out their activities or limit such activities. If the above-mentioned conditions are met the FSA is given even further means (in the form of prohibitions and limitations) to avert *insolvency proceedings*. In this case the FSA may temporarily issue a ban on sales and payments by the bank, or order the bank to be closed for business with customers.[103] Moreover, the FSA may prohibit the acceptance of payments not intended for the discharge of debts to the bank. If the deposit guarantee scheme undertakes to satisfy in full all creditors the bank may enter into certain new transactions during the ban. As mentioned initially, the German Voluntary Deposit Protection Scheme may cover ordinary creditors (not only depositors). Still, the Voluntary Scheme has *no legal obligation* to pay off the bank's depositors (and creditors). The Scheme may decide on its own behalf whether it provides protection or not. During FSA-measures to avert insolvency proceedings judicial enforcement on, seizures of and temporary injunctions against the assets of the bank are not permissible.[104] The Federal Government may (after consultation with the Central Bank) in case of danger to *the national economy* by regulation order that banks be temporarily closed for business with customers. In this situation the banks may neither make nor accept payments and credit transfers connected with such business. The period for which banks are closed may not exceed three months.[105]

Means with a constructive element in the reorganisation of German banks are measures that either a) direct the proprietors or managers of the bank, b) create conditions for the appointment of representatives to administer the bank or c) constitute a buffer against the claimants of the bank. Means with a constructive element are only applicable in case of *danger*. – In case of *danger to creditors, entrusted assets or efficient supervision* the FSA may on a temporary basis as constructive means issue instructions on the management of the bank's business or appoint supervisors.[106] These measures may complement or exclude any prohibitions or limitations made. If managers have been prohibited from carrying out their activities the proper court shall, at the request of the FSA, appoint the

[102] The Banking Act part III, division 4, s. 46.

[103] The Banking Act part III, division 4, s. 46a.

[104] The Banking Act part III, division 4, s. 46a.

[105] The Banking Act part III, division 4, s. 47 and 48, respectively.

[106] The Banking Act part III, division 4, s. 46.

necessary persons to manage and represent the bank. The persons' authority to manage the bank's business, unless the appropriate governing bodies of the bank extend it, is limited to the execution of the measures necessary to avert insolvency proceedings and protect creditors.[107] The Banking Act includes no special provisions on forced mergers or purchase and assumption transactions by persons appointed like its US counterpart. Finally, if *the national economy* is endangered, the Federal Government may by regulation grant a bank extension of time to discharge its obligations and create a judicial buffer for the period in question.[108]

The liquidation of German banks is regulated in the Banking Act to a marginal extent.[109] *Four criteria* to request liquidation of a bank exist. If the FSA revokes the banking license or the license expires the FSA may rule that the bank be liquidated. Similarly, if a bank becomes insolvent or over-indebted the managers shall report this fact immediately to the FSA, which will then initiate insolvency proceedings. The duty to report is sanctioned.[110] No further definitions of insolvency or over-indebtedness are presented in the Banking Act. Another feature of importance is the fact that *the petition for the initiation of insolvency proceedings* over the bank's assets may be filed by the FSA only. In other words, the bank's creditors have no powers to initiate the liquidation of the bank. The FSA or the Court of Registration appoints the liquidators for the bank. Generally, *judicial appeals* may be made to the Administrative Court of First Instance to review decisions and measures made by the FSA.[111] In principle, the appeal may concern the invalidation or the execution of a decision or a measure. The review is restricted to the legality of the decisions and measures. Legality may be a question of the FSA exceeding the bounds of discretion or making wrongful use of discretionary powers.[112]

The provisions concerning the liquidation of banks in the Banking Act mostly cover *the period until the request on liquidation is made*. The provisions concerning liquidation in the Insolvency Act and German company laws mainly cover the period from the commencement of the liquidation onwards. The abovementioned general laws do not exclude banks as possible objects for liquidation. Several individualised provisions of the Insolvency Act also explicitly supplement the liquidation provisions of the Banking Act. Still, there is some uncertainty to what extent the Insolvency Act is applicable to banks. German company laws apply to voluntary liquidation of sound companies and the Insolvency Act applies when a company is unable to meet its obligations or if its

[107] The Banking Act part III, division 4, s. 46a.
[108] The Banking Act part III, division 4 s. 47.
[109] The Banking Act part III, division 1, s. 38 and division 4, s. 46b.
[110] The Banking Act part V, s. 55.
[111] Rules of the Administrative Courts s. 68.
[112] Rules of the Administrative Courts s. 114.

liabilities exceed its assets. – Anyway, a framework for all the later stages of the liquidation of an insolvent bank is provided by **the Insolvency Act**. In particular, principles for a) the classification of creditors, b) identification of steps in the insolvency procedure and c) certain other issues may be concretised by analysing the Insolvency Act.[113]

When it comes to *the classification of creditors* the Insolvency Act recognises three classes of creditors' claims, ie secured claims, unsecured priority claims and unsecured non-priority claims.[114] *Secured claims* are in most cases not part of the insolvent entity since the claims' securities may be realised independently. *Claims secured by moveable or non-moveable collateral* are parts of the insolvent entity but they are objects of a preferential settlement. Secured creditors with preferential settlement may, however, not sell their collateral themselves anymore. This was only possible before 1998 under the former Bankruptcy Act. The appointed trustee is, according to the current main rule, entitled to sell the collateral.[115] Moreover, *unsecured priority claims* are primarily costs of case administration and other credits are classified as *unsecured non-priority claims*. Internal priorities in the classes of creditors' claims are abolished. In the old Bankruptcy Act priorities existed between claims after the costs of case administration had been satisfied. Salaries, pensions and social insurance costs were in priority in relation to ordinary credits.[116]

The liquidation procedure pursuant to the Insolvency Act comprises several stages. *Between the filing and opening of the case* the court has to take all measures appropriate to prevent a decrease of the debtor's assets.[117] Once *a case is opened* the court is required to appoint a trustee and issue an adjudication order. As a consequence of the order civil law suits against the debtor are stayed.[118] In the order the court will schedule two creditors' meetings. In *the validation meeting* the creditors will prove their claims and in the report meeting they will decide upon the objective of the further proceedings. At the first meeting creditors may elect their own trustee. All creditors with proven and accepted claims except the unsecured non-priority creditors are allowed to vote at the creditors' meetings. Decisions at the creditors' meetings require a simple majority. Voting is proportional. Creditors may appoint a creditors' committee to support, advise and monitor the trustee.[119] At *the report meeting* the trustee should make a statement

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[113] For a comprehensive analysis (in English) of business bankruptcy in Germany and the new Insolvency Act see Ziehmann 1997.

[114] The Insolvency Act part II, division 2.

[115] The Insolvency Act part II, division 2, ss. 49–50 and part IV, division 3, ss. 166–169.

[116] The Insolvency Act part II, division 2, ss. 55 and 39, respectively.

[117] The Insolvency Act part II, division 1, s. 21.

[118] The Insolvency Act part II, division 1. s. 27 and the Law for Civil Law Suits (Zivilprocessordnung) part I, division 3, s. 240.

[119] The Insolvency Act part II, division 1, s. 29, division 3, s. 57, ss. 76–77 and s. 69, respectively.

comparing the implications of different alternatives, ie liquidation with total or partial reorganisation, on the repayment to creditors. The creditors should decide on the trustee's statement. The trustee may also, with the permission of creditors, close the debtor's business before the report meeting. Obtaining loans and other measures of extraordinary importance require the consent of the creditors' committee or the creditors' meeting. If liquidation is chosen the trustee should start *the realisation of assets*. All unsecured creditors are paid the same percentage from the asset sales.[120]

Other issues of interest when analysing the provisions of the Insolvency Act and preceding acts relate to the eventual reorganisation of a company. Both the Insolvency Act and preceding acts established separate reorganisation procedures that (at least in theory) applied to banks. – According to *the Insolvency Act* the court-supervised reorganisation process begins when creditors during the report meeting decide that a reorganisation plan should be implemented and consequently the business should continue. Only the debtor and the trustee are entitled to present a reorganisation plan to the creditors. The plan usually consists of a descriptive part, a structural part and an appendix. The descriptive part comprises a description of former and future measures and the structural part reflects the arrangements in the legal relations of the participants. The court will set a hearing during which the plan is discussed and a creditors' meeting for voting on the plan. Adoption of the plan requires confirmation by the debtor and the court. If the failure to reach creditors' approval of the plan is regarded as obstructive, the court may disregard the creditor's vote and confirm the plan. If the plan is not confirmed, the debtor will go into liquidation. After repayment of the allowed claims in an accepted reorganisation plan all the debtor's unsatisfied claims are discharged.[121] – Pursuant to *the former Bankruptcy Act* the debtor was entitled to file a proposal for composition. The composition enabled the debtor to satisfy the creditors by partial discharge or by extension of payment. For the composition to succeed, the majority of non-priority creditors at the creditors' meeting, representing at least two-thirds of the total claims had to support it. – The composition proceeding according to *the old Composition Act* had to result in that at least 35 percent of the claims were paid to creditors. As before, only the debtor was given the powers to initiate such a proceeding. The composition was linked to a courtsupervised reorganisation of the company. The majority of the

[120] The Insolvency Act part IV, division 2, s. 156–158, s. 160 and s. 159, respectively.

[121] The Insolvency Act part IV, division 2, s. 156, part VI, division 1, ss. 218 and 227, part VI division 2, s. 235, s. 245 and ss. 247–248.

creditors at the creditors' meeting and at least three-quarters of the total claims in amount as well as the court had to accept the composition.[122]

> The position of secured creditors of German banks is strong. No authority directed or other measures may infringe their rights. For the unsecured creditors the situation in bank failures is more uncertain. – Still, financial assistance to German banks is possible. There are two avenues for capital injections into banks. First, the Voluntary Deposit Protection Scheme may assist banks directly and second, the Liquidity Consortium Bank (handles the Central Banks LLR-function) may grant loans only to banks of unquestioned soundness. Assistance from the Voluntary Deposit Protection Scheme may be in any form. – Decisions on the reorganisation of banks according to the Banking Act are made by the FSA. Reorganisation measures are mainly conservative and should not endanger creditor interests. – The ongoing FSA supervision of German banks is largely based on reports addressed to the German Central Bank. On site inspections of banks are rare.
>
> The banks' creditors have no rights in initiating liquidation. The decision to start insolvency proceedings is made by the FSA only. – The criteria for initiation of liquidation on financial grounds comprise insolvency and over-indebtedness.
>
> Depositors' claims are not in priority in the realisation of the banks' assets. The same applies to eventual Deposit Protection Scheme subrogation of depositor claims due to the payoff of depositors. – According to the Insolvency Act the court should take all measures appropriate to prevent a decrease in the debtors' assets. On the other hand, measures listed in the Banking Act do not promote the preservation of the banks' "going-concern" value.

3.2.3 The new Finnish procedures for bank exit

During most of the 1990s, the formal (legislative) Finnish bank exit regime did not face any substantial reforms. In the beginning of 2002, the bank exit regime was thoroughly reformed, providing new reorganisation measures and liquidation proceedings. Currently, the reorganisation and liquidation procedures applicable to Finnish banks are regulated in a) *the Law concerning Commercial Banks* (1501/2001), b) *the Law concerning Temporary Suspension of the Activities of a Deposit bank* (1509/2001), c) *the Law concerning Reorganisation of Companies* (47/1993), d) *the Law concerning Limited Liability Companies* (734/1978) and e) *the Bankruptcy Code* (31/1868). In order to analyse the Finnish bank exit regime the presentation below focuses both on *compulsory* and *voluntary* means to handle problem banks. To describe the complexity of means a differentiation is

[122] Of interest to bank creditors is also the fact that the German Central Bank has no explicit lender of last resort (LLR) function. Liquidity assistance to banks is directed through the Liquidity Consortium Bank (LCB). Assisted banks should be solvent and their liquidity needs temporary.

made between a) *suspensive action*, b) *genuine reorganisation measures*, c) *liquidation proceedings* and d) *other actions*.[123]

In case of **suspensive action**, the judicial base for action changed almost totally in 2002. Provisions in the Law concerning Temporary Suspension of the Activities of a Deposit Bank replaced the regulations on suspensive action in the former Law concerning Commercial Banks (1269/1990) 28–31§§. – Due to the new legislation the Ministry of Finance (MoF) was given the right to suspend the activities of a bank if the continuation of its activities would a) *endanger the depositors' or other creditors' position*, b) *risk the stability of the financial markets* or c) *cause severe disturbances on the market*. Suspension is possible for a maximum period of one month. The suspension may be continued, but can never aggregately exceed six months.[124] The Financial Supervision Authority (FSA) should appoint a representative to supervise the bank during the suspension. The suspension creates both *restrictions for the activities of the bank* and *a buffer for legal action against the bank*. During the suspension the bank is not entitled to receive deposits without MoF permission and borrow or lend money or deal in derivatives without the permission of the FSA-appointed representative. During the suspension the bank has to make a plan for recovery or discontinuation of business. If no plan is made or proper measures not suggested, the MoF is entitled to withdraw the bank's licence. During the suspension, the MoF (only) has the right to apply to the court for reorganisation of the bank in accordance with the Law concerning the Reorganisation of Companies. The suspension has to be cancelled if the preconditions for the suspension do not exist anymore, ie if the bank is able to continue its business.[125]

Seen from the bank's creditors' perspective, some *changes relative to the preceding regime* have occurred though this regime provided a similar suspension. *The criteria for action* have been transformed. Before 2002, action was taken when the bank's own capital had diminished to less than half of its book value and the level of capital adequacy was too low or the bank could not fulfil its liabilities. Moreover, it was required that the bank, within the timeframe given, was not able to come up with acceptable means to increase its capital. Now, action may be taken only if the above-mentioned market effects are expected to emerge.[126] – Both suspensions were and are *administered by the MoF*.

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[123] For an analysis of the legal reform (in Finnish) see Government Proposal 180/2001 to the Parliament (Hallituksen esitys 180/2001). – Until the end of 2001 the laws regulating reorganisation and liquidation of banks were restricted to the former Law concerning Commercial Banks (1269/1990), the Law concerning Limited Liability Companies and the Bankruptcy Code.

[124] The Law concerning Temporary Suspension of the Activities of a Deposit Bank 3§.

[125] The Law concerning Temporary Suspension of the Activities of a Deposit Bank 5, 7, 9–11, 13§§.

[126] The starting points for suspension according to the former Law concerning Commercial Banks were listed in the 27§ of the law.

But the suspension according to the new law opens up the possibility of reorganisation of the bank in line with an established judicial scheme. As we will see later, this scheme gives the creditors of the bank certain voting and other rights. On the other hand, the scheme usually cuts creditor claims. Earlier, the whole reorganisation context was the affair only of the authorities and the banks' shareholders. – On a more *detailed level*, the former suspension was restricted to a maximum of four months. For the new suspension the longest period is six months. The former legislation established a time frame of five years for the banks' recovery once the suggested means were accepted and the suspension withdrawn. No such time frame exists anymore.[127]

> The new Finnish bank exit regime (established 1.1.2002) comprises all the basic, common elements that are found in bank exit regimes. A possibility for authorities to suspend bank activities, a separate reorganisation procedure to rehabilitate the bank, a variety of voluntary reorganisation measures, separate procedures for voluntary and compulsory liquidation (including bankruptcy) constitute the regime. – Suspension of bank activities derive from the Law concerning Temporary Suspension of the Activities of a Deposit Bank and it is MoF-initiated and FSA-administered. Only the MoF has the right to initiate court-administered formal reorganisation of the bank pursuant to the general Law concerning Reorganisation of Companies. Voluntary and compulsory liquidation of banks follows the general procedures set up in the Law concerning Limited Liability Companies. Liquidation on financial grounds (bankruptcy) is regulated in the Bankruptcy Code. In practice, Finland has no history of dramatic bank failures. The banking crisis in the beginning of the 1990's resulted in financial assistance to many banks. Currently, a scheme for both private and Government assistance to banks exists.

Another entity of interest to the Finnish banks' creditors is **the measures used for genuine reorganisation**. In principle, there are several types of reorganisation measures. In an economic sense, internal arrangements, mergers, divisions, transfers of activities etc. constitute reorganisation. In a judicial sense, reorganisation of Finnish banks may be carried out on a voluntary basis (ie before the authorities act), as a means to eliminate suspension of the banks' activities and as MoF-initiated reorganisation due to the Law concerning Reorganisation of Companies. Two approaches coherent with this view, a) *voluntary reorganisation* and b) *the reorganisation procedure under the Law concerning Reorganisation of Companies* are looked into below.

[127] The former Law concerning Commercial Banks 31§ listed various criteria when the suspension should be withdrawn. One of these alternatives was decreasing the share capital. A permit to cut the share capital could be issued by the MoF without hearing bank creditors.

One of the most frequently used types of *voluntary reorganisation* is merger. Currently, the new Law concerning Commercial Banks chapter 2 regulates merger. With respect to the status of the merging entities, the law applies to mergers in which a bank or an ordinary limited liability company is merged with a bank. According to the new legislation the merger procedure follows the Law concerning Limited Liability Companies chapter 14. These provisions state that merger requires approval by the register authorities. In turn, a condition for approval is the hearing of creditors.[128] The FSA may object to a merger by informing the register authorities thereof.[129] Earlier, the former Law concerning Commercial Banks and the Law concerning Limited Liability Companies both regulated mergers relating to banks. Only in the case that both merging companies were banks, the Law concerning Commercial Banks was used. In all other cases, the Law concerning Limited Liability companies was applied. The former legislative procedure under the old Law concerning Commercial Banks required MoF (not register authorities) approval for bank mergers. Creditors were not heard at any stage.[130] The procedure under the Law concerning Limited Liability Companies has not changed. Still, the FSA had no right to object to such mergers during that time. – In practice, merger may be carried out in many ways. The Law concerning Limited Liability Companies 14 chapter 1§ recognises two main alternatives, ie the absorbing merger and the combining merger. The absorbing merger indicates that two companies merge in a way that one of the companies endures. The combining merger creates a new company of the two merged companies.

The new provisions for bank *division and transfer of activities* are included in the new Law concerning Commercial Banks chapter 3 and 4, respectively. The law introduces new, deviant definitions on both division and the transfer of activities. Division is defined as an arrangement where the compensation for the assets transferred is made directly to the shareholders of the delivering bank (and the bank's own capital is restructured). The term transfer of activities is restricted to the situation where compensation is paid directly to the delivering bank. As a result of these separate definitions, both division and the transfer of assets may cover a part of the bank or the whole bank. – According to the new Law concerning Commercial Banks 8§ the Law concerning Limited Liability Companies chapter 14a applies to bank divisions. Division requires the approval of the register authorities. The FSA may object to the division. As in merger, creditors should be heard.[131] Despite the definitional differences, the transfer of assets is procedurally similar to division. Only creditors of claims transferred

[128] The Law concerning Limited Liability Companies 14 chapter 13–14§§.
[129] The Law concerning Commercial Banks 5§.
[130] Mergers were formerly regulated in the preceding Law concerning Commercial Banks 25§.
[131] See also the Law concerning Commercial Banks 5 and 9§§.

should be heard. Still, in accordance with the Law concerning Limited Liability Companies, the delivering bank will be liable for the claims transferred on a secondary basis.[132]

Only the MoF may initiate *bank reorganisation due the Law concerning Reorganisation of Companies*. The Law concerning Reorganisation of Companies, originally introduced in 1993, is a general law applicable to ordinary companies. The bank exit reform of 2002 extended the scope of the law to include banks also. Until the end of 2001, no such formal procedure for bank reorganisation existed. Banks were reorganised on a voluntary basis, ie in accordance with shareholder decisions (often requiring authority approval). The Law concerning Reorganisation of Companies applies to banks only in the case that the activities of the banks are suspended.[133] The law provides for *a detailed scheme* for the reorganisation of problem banks. The procedure is court-based, directed by creditor voting and aims to create conditions for the continuance of bank activities by cutting creditor claims. To start the reorganisation procedure, the MoF should apply to the court. The condition for the initiation of the procedure is the threatening or factual lack of ability for the debtor to pay his debts. Alternatively, the bank's and at least two creditors acceptance, whose claims represent at least one fifth of the bank's known obligations, is required. The procedure should be closed if lasting improvement of the bank's affairs is not reached.[134] The procedure generates a buffer for legal action against the bank for obligations preceding the initiation of the procedure. As soon as possible, a plan for recovery should be made. The plan may affect both unsecured and secured creditors of the bank. The plan may result in changes of the repayment schedule for claims against the bank, the decrease in costs payable to creditors or the decrease in the borrowed amount repayable to creditors. Still, secured creditors always receive their capital in full. Organisationally, an administrator and a creditors' committee should be appointed in order to administer the procedure and represent creditors. The FSA appoints the administrator and the MoF, the FSA, the Bank of Finland and the Depositor Guarantee Fund should be represented in

[132] Law concerning Commercial Banks 12–13§§. – Before 1.1.2002 division and the transfer of activities were both regulated in the former Law concerning Commercial Banks 25§ and the Law concerning Limited Liability Companies 14a chapter. In a definitional sense, the term division earlier corresponded both to the situation where the total assets and liabilities of a bank were handed over to two or more receivers and where a part of the assets and liabilities were handed over to one or more receivers (transfer of activities). All divisions of banks required a permit by the MoF according to the former Law concerning Commercial Banks 25§ and the Law concerning Limited Liability Companies 14a chapter 4§. When dividing banks, the legislation did not call for a hearing of creditors.

[133] Law concerning the Temporary Suspension of the Activities of a Deposit Bank chapter 4.

[134] The Law concerning Temporary Suspension of the Activities of the Bank 13§ and the Law concerning Reorganisation of Companies 6–7§§.

the creditors' committee.[135] The court should confirm the plan for recovery. One of the following three criteria should be met in order to make the confirmation of the plan possible. First, the plan may be confirmed if all creditors approve the plan. Second, the plan may be confirmed if the majority of each group of creditors approve the plan or third, the plan may be confirmed if certain specified conditions are met. These conditions focus on the internal relations between creditors. Moreover, factors hindering the confirmation, if eg the plan infringes creditors' rights, are listed in the law's 53 and 55§§.[136]

The reform of the Finnish bank exit regime also had a significant impact on **the eventual liquidation** of Finnish banks. In case of liquidation, the Finnish bank exit regime acknowledges three types of liquidation, ie *voluntary liquidation, compulsory liquidation and bankruptcy*. As a result of the 2002 bank exit regime, voluntary and compulsory liquidation is regulated in the general Law concerning Limited Liability Companies chapter 13. Certain provisions in the new Law concerning Commercial Banks chapter 6 only specify the procedures when applied to banks. The differences between voluntary and compulsory liquidation appear by focusing on definitions used. If the conditions for liquidation specified in the law or in the articles of the association are met, then that is defined as *compulsory liquidation*. Liquidation that is not compulsory is *voluntary*. Due to the main rule, the shareholders' meeting decides on the liquidation of the company. In certain cases or if the criteria for compulsory liquidation exist, and the shareholders do not act, then the court or the register authority should decide on liquidation.

There are three main types of *grounds for compulsory liquidation* specified in the Law concerning Limited Liability Companies. *First*, if shareholders have misused their position in the bank, the court may if grave reasons exist, decide on the liquidation of the bank. *Second*, if the bank does not have competent governing bodies, the register authority should decide on the liquidation. *Third*, if the bank has not delivered its financial statement to the register authority in one year's time starting from the end of the bank's financial year, this establishes an obligation for the authority to decide on liquidation.[137] According to the Law concerning Commercial Banks 19§ the MoF should request liquidation of a bank, if the bank's licence is withdrawn. There are several grounds for the withdrawal of a banking licence. From the bank creditors' perspective the most important ones are the ones concerning the financial condition of the bank. On this point, the

[135] The Law concerning Reorganisation of Companies 8–28, 39–48 and 57–66§§ and the Law concerning Temporary Suspension of the Activities of a Deposit Bank 14§.
[136] See also the Law concerning Reorganisation of Companies 49–52§§ and 54§. – Until the end of 1992 the Finnish jurisdiction also provided for composition pursuant to the Composition Law (148/1932) and compulsory composition due to the Bankruptcy Code.
[137] The Law concerning Limited Liability Companies chapter 13 3–4a§§, respectively.

Law concerning Credit Institutions (1607/1993) 80§ comprises provisions on capital adequacy for banks. These provisions entitle the FSA to set a timeframe during which the bank has to restore its solvency level or initiate the withdrawal of the bank's licence by the MoF. If the bank's licence is whitdrawn by the MoF, it should initiate the bank's liquidation. – In short, *the implications of a started liquidation procedure* are that administrators will be appointed to administer the affairs of the bank, realise its assets and pay its debts. The different stages will follow the principles set out in the Law concerning Limited Liability Companies. The Law concerning Commercial Banks 20§ states that for banks, the MoF should appoint the administrators. – The bank itself or its creditors may also initiate *the bank's bankruptcy* pursuant to the Bankruptcy Code (31/1868) at the court. The main criterion for the initiation of bankruptcy proceedings is "other than temporary inability to pay one's debts". In the case bankruptcy is initiated by a creditor, the court has to inform the MoF about the petition. The MoF may eg decide on a temporary suspension of the bank's activities based on the Law concerning Temporary Suspension of the Activities of a Deposit Bank if the bank or a creditor initiates bankruptcy.[138]

Earlier, alternative routes for the liquidation of Finnish banks existed. Liquidation was possible both according to the previous Law concerning Commercial Banks and the Law concerning Limited Liability Companies. The laws established two totally different liquidation procedures for banks. Moreover, bankruptcy as a liquidation alternative was regulated in the Bankruptcy Code. The liquidation rules in the former Law concerning Commercial Banks only recognised the procedure as a *compulsory* one, whereas the Law concerning Limited Liability Companies recognised both *obligatory* and *voluntary* liquidation procedures. In sum, this meant that the bank was confronted with four alternative liquidation procedures.[139]

[138] The Law concerning Commercial Banks 20–22§§.

[139] According to the former Law concerning Commercial Banks, there were only a few situations that *initiated the liquidation procedure*. The first situation was when the bank had not succeeded in taking certain reparative measures. The other situation was when the bank had not responded to interim actions taken by the MoF. The third situation was when the bank's licence had been withdrawn. – The *decision about entering the liquidation procedure* was made by the shareholders' meeting. If the bank had not called for a shareholder's meeting or the shareholder's meeting had not fulfilled its obligations according to the law the MoF was entitled to start the liquidation procedure on the initiative of the FSA.

The reform of the Finnish bank exit regime affected the position of bank creditors. The introduction of a formal reorganisation scheme created a procedure that may cut creditor claims and affect also secured creditors to a marginal extent. – In case of financial assistance to banks there are two actual channels that may provide the bank with capital. First, an eventual membership in a guarantee fund may result in assistance. Second, banks endangering the stable functioning of financial markets may receive assistance direct from the Government's Guarantee Fund. – Only the MoF decides on the commencement of compulsory, court-based reorganisation. – The supervision of Finnish banks includes both extensive reports and onsite inspections. Technically, regulations on supervision do not deviate much from international standards.

Creditors may initiate debtor bankruptcy pursuant to the Bankruptcy Code. – In practice, the MoF may request compulsory liquidation if the banks' capital adequacy is too low.

Depositor claims and claims received through the subrogation of depositor rights are not in a priority in the realisation of debtor assets. – No explicit constructions securing the "going-concern" value of the bank during the reorganisation exist.

Finally, there are a group of **other actions** that are not listed above and may sometimes be used for the reorganisation of the bank. These are decreasing the share capital, bank-initiated withdrawal of the licence and changing the terms of the licence. The provisions concerning *the decreasing of share capital* partly changed as a result of the reform of the bank exit regime. Currently, decreasing the share capital follows the general procedure set up in the Law concerning Limited Liability Companies chapter 6. No special rules apply to banks anymore. Shareholders decide on the decrease. Depending on the aim of the decrease, the register authority's permit may be required. Conditions for the issuance of a permit is the hearing of creditors. In the case creditors oppose, the register authority may issue the permit if the creditors have received court-approved payment or security for their claims.[140] The reform also introduced *bank-initiated withdrawal of the licence* as a new reorganisation measure. The MoF decides on the withdrawal. The register authority's permit is needed and a creditors' hearing should be summoned.[141] The provisions applicable to an eventual *change of the terms of the banking licence* were not amended by the reform. Changing the terms of the banking licence may be seen as an extreme alternative for the

[140] Earlier, decreasing banks' share capital was regulated in the former Law concerning Commercial Banks 8 and 31§§ and the Law concerning Limited Liability Companies chapter 6. In most cases, decreasing the share capital required MoF approval. The decision on decreasing the share capital could be made to cover losses. Similarly, it may have been a means to eliminate the preconditions for authority action against the bank. As an exception, decreasing the banks' share capital in order to cover losses did not require MoF approval or hearing of the bank's creditors.

[141] The Law concerning Commercial Banks chapter 5 14 and 16§§.

reorganisation of a bank. By restricting the bank to exercise certain activities the authorities may in some situations create preconditions for the redevelopment of the bank. Still, the terms may be changed only if the prevailing conditions when the license was issued have altered in a significant way.[142]

3.3 The reorganisation and liquidation of banks in Tokyo (Japan)

> The Japanese bank exit regime has gradually been reformed as the crisis in the Japanese financial sector has continued. Since the beginning of the 1990's, more than ten bank specific or general laws have directed bank reorganisation and liquidation. Large amounts of capital have been injected into the financial system. Originally, the Ministry of Finance (MoF) was in charge of the supervision of Japanese banks but further on, the Deposit Insurance Corporation's (DIC) mandate in administering bank exit was increased and the FSA established. The most important measures taken to improve the bank exit regime have comprised various types of reorganisation means. In 1986, the DIC was entitled to provide financial assistance to banks on certain grounds. In 1997, the DIC was given the right to initiate both reorganisation and liquidation procedures. In 1998, new DIC administered reorganisation measures were introduced. These measures include the appointment of a financial administrator to the bank, the establishment of "bridge banks" and temporary nationalisation of failed banks.

The legal framework for the reorganisation and liquidation of Japanese banks has been characterised by fundamental changes since the beginning of the 1990's. In short, it is possible to identify three periods of varying reorganisation and liquidation procedures for banks. The changes in the procedures are consequences

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[142] The change of the terms of the banking license is regulated in the Law concerning the Financial Supervision Authority (503/1993) 16§. – An additional aspect of interest when discussing bank exit is the eventual lender of last resort (LLR) function that the national Central Bank may have. In Finland, the new Bank of Finland Law (214/1998) states that loans to banks require collateral. This was not the situation before 1998. Problem banks are usually short of collateral, a fact limiting the Bank of Finland's LLR function. Capital injections into the banks are made through the Voluntary Guarantee Funds (requires membership) or through the Government's Guarantee Fund. Capital injections from the Voluntary Funds may be in the form of loans or subsidies. The Voluntary Funds may also issue guarantees for bank borrowing. Capital injections from the Government's Guarantee Fund may be made only to banks facing problems that endanger the stability of financial markets. This latter type of assistance may be in the form of subscribing bank shares, issuing guarantees for bank loans or other financial assistance (ie traditional loans and subsidies).

of the crises confronting the Japanese financial markets. Furthermore, the changes are linked to a continuing enhancement of the powers of the Deposit Insurance Corporation (DIC) provided in the Deposit Insurance Law. One could say that the response of the Japanese government to the financial sector problems has been largely two-fold. Considerable amounts of public funds have been injected into the system and the reorganisation and liquidation legislation has been renewed according to US standards.[143] – In order to transmit a picture of the reorganisation and liquidation principles of interest to the banks' creditors provisions are analysed *diachronically*. First, the period up to 1996 is described. Then the period from 1996 to 1997 is assessed. Finally, the situation after the 1998 legislation is covered.

The aspects of importance to the bank's creditors **in the period up to 1996**, can be presented in a number of ways. As a result of the fact that the possibilities for the authorities to handle bank problems were improved during the period without deteriorating creditor rights the following aspects should receive closer attention. Moreover, all aspects significantly affected bank creditors' position. The aspects are a) the authorities changed mandate, b) applicable reorganisation and liquidation procedures and c) the injection of public funds into the financial system. – When it comes to *the authorities' changed mandate* the authorities involved comprise the DIC and the Ministry of Finance (MoF). For many years the DIC was a minor office with 10 employees largely subsumed within the operations of the Bank of Japan (BoJ). The MoF's supervisory approach, ie the "convoy" style of banking administration, the BoJ "lender of last resort" functions and existing general rehabilitation and bankruptcy legislation were seen as sufficient guarantees for eventual crises. Following the recommendations of the Committee for Financial System Research (CFSR) the Deposit Insurance Law that had been enacted in 1971 restricted DIC's powers to *the pay off of insured deposits* in the event of bank failure. In other words, the DIC had no mandate to initiate or administer the reorganisation or liquidation of banks. Reorganisation and liquidation of banks were possible under a) the Banking Act chapter V and VI covering voluntary mergers/acquisitions and voluntary liquidation, b) the Law concerning Amalgamation and Conversion of Financial Institutions and c) the general reorganisation and liquidation laws applicable to any company. Following further deliberations of the CFSR, the Deposit Insurance Law was amended in 1986 to reflect the more important role deposit insurance was likely to have in the future. As a result, the powers of the DIC were increased *to provide financial assistance* to facilitate mergers or acquisitions of failed institutions.[144] Financial assistance involved money grants, lending and debt guarantees when a bank

[143] For analyses of the Japanese bank exit regulations and financial crisis see Kanaya & Woo 2001, Bhala 1999, Milhaupt 1999 and Hall 1998 (a) and (b).

[144] The Deposit Insurance Law s. 64.

became or was likely to become insolvent and another healthy financial institution merged with it, bought its business, obtained its shares or otherwise took over its assets and liabilities. The amount of financial assistance was limited to the hypothetical cost of paying off depositors, ie authorities should choose the least cost alternative. Financial assistance to banks required MoF approval.

The other main element in the system before 1996 was *the existing reorganisation and liquidation procedures* applicable to banks. As a result of DIC's increasing powers and the possibility of giving banks financial assistance the relevance of these (mainly general) provisions steadily decreased. Still, they were and are an alternative for the resolution also of Japanese banks. – In principle, reorganisation of a bank is possible pursuant to the Corporate Reorganisation Law, the Commercial Code and the Composition Law. In addition, banks may reorganise outside these procedures through voluntary mergers, acquisitions etc. Liquidation of a bank is regulated in the Japanese Bankruptcy Law and the Commercial Code. Certain supplementary provisions are found in the Banking Law. While reorganisation means and other types of liquidation are covered in section 5.5 the kind of liquidation that mostly concern bank creditors, ie *bankruptcy*, is analysed below. In the case of bankruptcy, there are three criteria that should be met in order to initiate the proceedings. These are a) the debtor should be unable to pay his debts, b) the debtor has suspended payments of his debts and c) the debtor's liabilities exceed his assets. When it comes to the procedure, both creditors and debtor may file a petition for bankruptcy. When a petition for bankruptcy is filed, the court can render adjudication on the petition by examining the documents submitted. Additionally, a court can order preservative measures at the time the petition is filed. In any case, measures do not block action by secured creditors. When the court declares the debtor bankrupt, the court appoints a trustee. The trustee takes over the management of the debtor's affairs. The trustee's job is to convert all of the debtor's assets into cash and then distribute the proceeds to the creditors.[145]

In addition to supervision and laws concerning reorganisation and liquidation of banks the Japanese banks' creditors were also affected by other measures taken by the authorities. These measures, aiming to secure the stability of financial markets, comprised *injections of public funds* into the banks and other financial institutions. From 1991 until 1996, based on the 1986 amendment of the Deposit Insurance Law, the Bank of Japan Law and the Financial Stabilisation Law funds were injected into banks, credit co-operatives and jusen companies (housing loan corporations, ie bank subsidiaries, not banks themselves). Capital provided by the DIC to *banks and credit co-operatives* rose to JPY 2,2 trillion during the period. Moreover, the Bank of Japan supported the banks and credit co-operatives with

[145] For a coverage of Japanese general company rehabilitation and bankruptcy laws see Bhala 1999 part III.

JPY 1,4 trillion in temporary finance. Local governments and other financial institutions also gave support. *The jusen crisis* was a separate chapter. Starting in 1991 and ending in 1995 with many companies insolvent the final cost to taxpayers was approximately JPY 1,0 trillion. In this case, the financial sector shared the losses to at least the same amount.[146]

The period from 1996 to 1997 constitutes another era of distinct bank reorganisation and liquidation measures in Japan. During this period judicial conditions for authority-initiated and -administered reorganisation and liquidation measures were further improved. The changes in procedures were a result of the Law concerning Special Treatments to Reorganisation Procedures for Financial Institutions and amendments to the Deposit Insurance Law in 1997. – As for *the reorganisation* of Japanese banks, the introduction of the new legislation established a possibility for the DIC to initiate reorganisation procedures. Procedures concerned were regulated in the above-mentioned general company rehabilitation laws. In detail, the new legislation entitled the DIC to initiate the reorganisation procedures and represent depositors, ie exercise depositor rights, during reorganisations. The amendments to the Deposit Insurance Law in 1997 expanded the powers for the DIC by enabling it to provide financial assistance for bank mergers between two ailing banks. According to the previous amendment to the Deposit Insurance Law in 1986 financial assistance to merging banks was possible only to assist the merger of a troubled bank into a healthy one. Of importance to the reorganisation of banks was also the statement made by the Japanese Government in 1996 to protect *all* deposits for the next five years (extended to 2002 in 2001). This commitment was given in the light of the inadequate information disclosure made by banks and the current fragility of the financial system. In 1986 the amendments to the Deposit Insurance Law had introduced financial assistance by the DIC to problem banks as a new reorganisation measure. Initially, the amount of financial assistance was limited to the potential pay off cost to depositors. As a result of the Government's commitment in 1996 the former limit was abolished. Financial assistance to problem banks could now equal the total stock of deposits.[147]

From 1998 onwards the problems of the Japanese financial sector have continued, despite major injections of public funds and substantial changes of the legislation. In 1998 two major laws were introduced, the Financial Reconstruction Law and the Financial Function Early Strengthening Law. In 2001 these temporary laws were incorporated into the Deposit Insurance Law. – *The*

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[146] Hall 1998 (b) pp. 2–9 and Milhaupt 1999 pp. 19–23.

[147] The new legislation also changed the procedures for *the liquidation* of banks. As a consequence of the law DIC-initiated procedures for the compulsory liquidation of banks were established. In practice, the existing liquidation procedures according to the general company liquidation laws remained, mainly the grounds for applying them were re-developed.

Financial Reconstruction Law was formulated to provide principles for compulsory liquidation of financial institutions, concrete measures for the reorganisation of institutions and certain organisational reforms. – In case of *compulsory liquidation* the law set out the principle that insolvent financial institutions (including banks) are to be liquidated.[148] The law also provided information on aspects that should be considered in the settlement of financial institution liquidation. These aspects included the disclosure of bad loans, clarification of the responsibilities of shareholders and the management and protection of deposits etc.

The law went on, however, to provide that various mechanisms to handle *the reorganisation* of banks should be established to support the credit system and protect depositors. In practice this meant the introduction of new authority administered reorganisation measures, means mainly constructed in accordance with US standards. Three types of measures were introduced for failed banks or banks in danger of failing. These were a) the appointment of a financial reorganisation administrator, b) the establishment of a "bridge bank" and c) temporary nationalisation of failed banks. – When it comes to the appointment of a financial reorganisation administrator, the main duties of the administrator were to operate and manage assets of the failed bank and transfer the bank's business to other banks. The current law lists the criteria for the appointment of the administrator.[149] These comprise the situations when the assets of the bank are insufficient to satisfy obligations or the condition of the bank is such that it has ceased or will cease to repay against deposits. Furthermore, two alternative conditions should be met. The first one is that the business operations of the bank should be seriously impaired. The other is that without a merger, the discontinuation of the business operations in their entirety or the dissolution of the institution would have a serious negative effect on the normal supply of funds in the region or pose a serious inconvenience to customers. The law also sets out the duties of the administrator more precisely.[150] According to the provisions the administrator shall have the same authority as the president of the bank with respect to its business operations and assets. The administrator shall conclude management of a bank by effecting a transfer of business operations or implementing other measures within one year from appointment. Upon occurrence of unavoidable circumstances the time limit may be extended by an additional year. – Another reorganisation measure applicable to banks constituted the establishment of a "bridge bank" to carry on the operations of the failed bank. The idea of a bridge bank is to take over certain healthy functions of the failed bank in order to smoothly continue these functions and sell the healthy business

[148] The Financial Reconstruction Law s. 1.
[149] The Deposit Insurance Law s. 74.
[150] The Deposit Insurance Law ss. 77–90.

when a candidate appears. Bridge banks are mostly needed when a succeeding buyer bank does not appear within a prescribed period. – As a final reorganisation measure for banks temporary nationalisation was also introduced. This latter option meant that the DIC obtained the bank's shares and placed it under special public management. Two criteria were introduced to enable for the DIC to purchase the shares of the troubled bank. First, the bank should be insolvent or nearly insolvent. Second, the authorities should determine that a systemic risk is posed by the bank's failure. If both of these conditions were met the DIC might be given the powers to acquire the shares of the bank, at a price determined by the authorities. Public management of the bank was to be terminated when the bank was rehabilitated and a private successor was found (eg through merger or acquisition of the business) or the bank's shares were reprivatised.

The Financial Reconstruction Law also brought about *organisational changes* in the administration of the reorganisation and liquidation of banks. The organisational changes dealt with the main decision making process and more practical matters. To decide on the reorganisation measures the Financial Reconstruction Commission (FRC) was established in 1998. The FRC was established under the Prime Minister's Office and its decisions in reorganisation matters were required to consider FSA examinations of banks. In 2001, FRC activities were transferred to the Prime Minister's Office. To handle practical matters in connection with the reorganisation of banks the Resolution and Collection Corporation (RCC) was founded in 1998. The RCC was created through the merger of former resolution and collection banks. The RCC is a subsidiary of the DIC and it was given the right to purchase assets (ie non-performing loans) from troubled banks in order to improve the banks' condition.[151]

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[151] The Bank of Japan (BoJ) has a limited role in the bank exit context. The BoJ is not a supervisory body per se, but it conducts inspections to secure the stability of financial markets. Moreover it has the role of a lender of last resort (LLR). Collateral for BoJ loans to banks is not required in all cases.

The position of the Japanese banks' creditors may be seen as being fairly strong, resulting from the continuing flow of assistance into the banking system. Though the Japanese bank exit regime recognises liquidation, in practice it seems to be an option only for small banks. – In reality, the specific reorganisation procedures for banks are authority-initiated. The procedures are developed in a way that interests of bank creditors are not endangered. Mainly shareholders are affected by the reorganisation measures. – Banking supervision is the responsibility of the FSA. Until 1998, the Ministry of Finance (MoF) was in charge of the supervision. Supervision is characterised by ambitions to get away from the former "convoy" style of bank sector administration.

In theory, bank creditors may request liquidation of a bank pursuant to the general Bankruptcy Law. The debtor being unable to pay his debts, the debtor suspending payments on his debts and the debtor's liabilities exceeding his assets constitute criteria for liquidation.

Depositors are not in priority in the realisation of the debtor's assets. In the case of a pay-off of depositors, subrogation of rights will occur. The Deposit Insurance Corporation (DIC) may also otherwise represent depositors in the reorganisation of a bank. In a sense, bridge banks and the nationalisation of banks may be seen as measures aimed to protect the "going-concern" value of the banks. Such measures will mostly benefit bank creditors.

The Financial Function Early Strengthening Law introduced emergency measures to re-capitalise banks and other financial institutions not necessarily insolvent. Public funds were used to accelerate the disposal of bad loans by enabling the banks to further write off bad loans and provide sufficient reserves in a capital adequacy sense. The law places banks in four categories according to their capital adequacy levels. Pursuant to the legislation, the Prime Minister's Office (from 2001) may, upon banks' applications, decide on the purchase of stock or subordinated bonds from or the grant of subordinated loans to banks. In practice, the purchase or loan is administered by the RCC. The re-capitalisation system lists the different capital adequacy levels, the specific re-capitalisation measures applicable to each level and further conditions that the bank should meet. All recapitalisation measures require a "plan for restoring sound management" detailing how business will be streamlined and accountability established. The banks are also required to furnish and publish reports on their implementation of the plan. – Since 1996 to 1997, under the former Financial Stabilisation Law, *funding to banks* was lower than during the previous years. Capital injections to banks from 1998 to 2001 based on the Financial Function Strengthening Law

exceeded JPY 10 trillion. Still, the legislation contemplated the use of larger sums to protect depositors and the health of the Japanese banking sector.[152]

4 Bank depositors and various national deposit protection schemes

4.1 The protection scheme applicable to New York banks

The aim of the 12 U.S.C. chapter 16 concerning the Federal Deposit Insurance Corporation (FDIC) is to protect the depositors of an insured bank. In accordance, the reorganisation and liquidation of a bank in financial distress is directed in a manner that considers the interests of the depositors and the FDIC. The US Deposit Protection Scheme is the most important of the means aimed to secure the interests of the depositors in problem situations. In sum, the scheme includes the activities of four parties. The protection scheme constitutes the Bank Insurance Fund (BIF), is financed by the banks, administered by the FDIC and guaranteed by the Federal Government. In order to receive a general picture of the scheme four topics are considered below. These are a) *the scope and level of cover*, b) *the pay-out mechanism*, c) *the funding of the scheme* and d) *resolution of disputes*.[153]

As for **the scope and level of cover**, the term deposit is defined in 12 U.S.C. chapter 16 s. 1813l. According to the main rule, *deposit* is defined to mean "the unpaid balance of money or its equivalent received or held by a bank for which it is obliged to give credit". *Insured deposit* is in turn defined as "the net amount due to any depositor for deposits in an insured bank".[154] The US federal insurance cover is not restricted to certain types of depositors, eg private persons and small businesses. The 12 U.S.C. chapter 16 s. 1821a states that the FDIC is obliged to insure the deposits of all insured banks as provided in the act. *The net amount payable* to any depositor of an insured bank should not exceed USD 100.000.

[152] Another issue concerning creditors of Japanese banks is *the availability of data* concerning the condition of the banks. To sum up, the Japanese regime is not in the forefront on disclosure issues. Recently, the possibility for banks to choose other options in annual reports, than marking to market value, was abolished for certain financial assets. Similarly, the Japanese banking supervision has no history of transparency.

[153] For overviews of the regulations and practices relating to the US deposit insurance system see Spong 2000 chapter 5 and Dale in Goodhart (ed.) 1998 pp. 561–580. FDIC administered merger and acquisition related measures to deal with US bank failures are analysed by Hüpkes 2000 pp. 90–92. Moreover, the Office of the Comptroller of the Currency (OCC) has published an evaluation study of factors contributing to the failure of US national banks in 1988.

[154] 12 U.S.C. chapter 16 s. 1813m.

When determining the maximum amount payable, the FDIC should aggregate the amount of all deposits of a person in the insured bank.

The payment of insured deposits consists of several stages. – First, as mentioned in section 3.1, payment of insured deposits is *only one of the options* the FDIC may choose. The FDIC may protect depositors by a) paying off deposits, b) arranging for them to be transferred to or assumed by another bank, c) administering the bank and/or d) assisting the bank financially. In choosing which of these options to use, the FDIC is required to use the method that will result in the least cost to the insurance fund.[155] Moreover, the FDIC is specifically prohibited from taking any steps to protect uninsured depositors if such actions would increase losses to the insurance fund. The only exception to these least cost provisions is in emergency situations where compliance with the provisions "would have serious adverse effects on economic conditions or financial stability". Several stringent formal criteria for deciding on such an exception exist. – Second, according to 12 U.S.C. chapter 16 s. 1821f concerning *chronological aspects*, "payment of deposits in an insured bank shall be made by the FDIC as soon as possible". This means that there are no explicit time limits in the legislation for the payment of insured deposits. – Third, the 12 U.S.C. chapter 16 s. 1821d introduced in the mid 1990's states that any depositor claim against the insured bank is *a priority claim* in relation to unsecured creditors. Such a provision represents a remarkable transfer of funds from unsecured creditors to depositors. Furthermore, any financial assistance by the FDIC to the bank may be subordinated in relation to the rights of depositors and other creditors.[156] – Fourth, *the subrogation of depositor rights* to the FDIC is another important feature in the payment of insured deposits. As a consequence of the FDIC's payment of insured deposits all rights of the depositors will be transferred to the FDIC. The FDIC will have a priority position in relation to unsecured creditors in the realisation and distribution of the bank's assets.[157]

The funding of the deposit protection scheme was thoroughly reformed by the Federal Deposit Insurance Corporation Improvement Act (FDICIA) of 1991. The FDICIA required the FDIC to establish *a risk-based deposit insurance assessment system*.[158] Under this system, rates were to be linked to the probability that the insurance fund would incur a loss from a particular bank. In its risk-based assessment system, the FDIC puts individual banks into one of nine risk categories, based on a bank's placement into one of three capital subgroups and one of three supervisory subgroups. The three capital subgroups correspond to whether a bank is well capitalised, adequately capitalised or undercapitalised

[155] 12 U.S.C. chapter 16 s. 1823c.
[156] 12 U.S.C. chapter 16 s. 1823c.
[157] 12 U.S.C. chapter 16 s. 1821g.
[158] 12 U.S.C. chapter 16 s. 1815d.

according to the current capital standards. The three supervisory subgroups are based on a bank's last examination rating, other relevant supervisory and financial information and emerging risk characteristics. In practice, FDIC assessment rates have ranged from 0 percent for banks in the top capital and supervisory subgroups to 0,27 percent of total assessable deposits for banks in both the bottom capital and supervisory subgroups. *The borrowing authority* of the FDIC is regulated in the 12 U.S.C. chapter 16 s. 1824. These provisions state that avenues for refinancing comprise borrowing from the Treasury, borrowing from the Federal Financing Bank and borrowing from BIF members. Borrowed capital required for insurance purposes should not at any time exceed USD 30 billion. In any case, *the US Government guarantees insured deposits* to the above-mentioned USD 100.000 limit.[159]

The 12 U.S.C. chapter 16 s. 1821f states that the FDIC may establish internal procedures for **the resolution of disputes** relating to insured deposits. More specifically, claims relating to any insured deposit or any determination of insurance coverage with respect to any deposit may be covered by these procedures. Regardless of the fact whether the FDIC has established such procedures, final determination of deposit claims made by the FDIC shall be reviewable by the court in accordance with 5 U.S.C. chapter 7.

Depositors of insured US banks are well protected. – The US Deposit Protection Scheme covers deposits to USD 100.000 per depositor and insured bank. The provisions do not distinguish between different types of depositors. Large companies, small companies and private persons are in this respect all equal under the law.

The Federal Deposit Insurance Corporation (FDIC) should pay off insured depositors of failed banks as soon as possible. No other time limit exists. In principle, the payment of deposits is only one of the FDIC's options. The FDIC may, as an alternative, arrange for a merger or an acquisition, take control of the bank or provide the bank with financial assistance. When depositors are paid off, subrogation of depositor rights to the FDIC occurs. Depositor claims have priority relative to unsecured creditor claims.

The Deposit Protection Scheme requires the banks to finance the scheme. Capital is placed in the Bank Insurance Fund (BIF). The Federal Government guarantees the insured deposits in case the fund becomes insolvent.

[159] 12 U.S.C. chapter 16 s. 1828a.

4.2 Principles for depositor protection in certain EU financial centres[160]

4.2.1 London (UK)

In the UK, the current Financial Services and Markets Act (FSMA) part XV sets out the principles for *the Financial Services Compensation Scheme* (FSCS). This scheme comprises sub-schemes concerning deposits, investments and insurance. The FSMA obliged the FSA to establish a scheme manager and regulations for the scheme.[161] The scheme manager established was the Financial Services Compensation Scheme Limited (FSCS Ltd). Regulations for the compensation scheme were recently published. The FSA still has the administering role in the conduct of operations in response to problem banks. In forming a view of the UK deposit protection scheme a) *qualifying conditions for compensation*, b) *limits for and implications of payments* and c) *certain related issues* are considered below.[162]

Qualifying conditions for compensation may be analysed by focusing on a number of features of the provisions in question. Rules concerning the scope of FSCS Ltd activities, eligible claimants, protected claims, definitions of bank default etc. all constitute conditions. On the whole, the FSCS Ltd will only *pay claims* if a bank is unable or likely to be unable to meet claims against it because of financial circumstances. The more frequent term used in the legal text is *"banks in default"*. Compensation is paid due to application. Regulations also recognise criteria that should be met for a claimant to be considered as *an eligible claimant*. Eligible claimants are claimants that are not large firms, collective investment schemes, directors or managers of the bank, owners or auditors of the bank etc. For *the deposit to be protected*, the deposit should be made in the UK or at a branch of a UK bank in an EEA state. Moreover, the deposit should not be a bond issued by a bank, a secured deposit or a non-nominative deposit, ie a deposit made without disclosing the depositor's identity. When considering the fact whether *a bank is in default*, the regulations provide certain guidelines. *First*, a

[160] The foundation for the EU member-states' national legislation on this matter is the EU Parliament and Ministry Council Directive concerning Deposit Insurance Systems (94/19/EEC) and the former Commission Recommendation concerning the Introduction of Deposit-Guarantee Schemes in the Community (87/63/EEC). The directive had to be implemented before July 1995. Minimum requirements established by the directive concerned the existence of an independent national deposit guarantee scheme, a compensation of EUR 20.000 and 90 percent of deposits and a three month time-frame for the actual payment of compensation.

[161] The FSMA part XV ss. 212–217.

[162] The FSA regulations are found at www.fsa.gov.uk – The Memorandum of Understanding between HM Treasury, the Bank of England and the FSA sets out the responsibilities for the various authorities in case of bank failures and also affects FSCS Ltd action.

bank is in default when the FSCS Ltd has determined it to be in default. *Second*, the FSCS Ltd may determine a bank to be in default when it is, in the opinion of the FSCS Ltd or the FSA unable to satisfy protected claims against it or it is likely to be unable to satisfy protected claims against it. *Third*, the FSCS Ltd may also determine a bank to be in default if it is subject of UK proceedings concerning a) creditors' voluntary winding up, b) appointment of a liquidator or an administrator, c) compulsory winding up or administration or d) approval of a company voluntary arrangement.[163]

Claims meeting the qualifying conditions for compensation will be subject to further regulations concerning **the payment of compensation**. These provisions comprise both *limits for* and *implications of compensation*. The most important features of the deposit protection scheme in this respect are the following. Outer limits for FSCS action is set by the fact that the FSCS Ltd is required to use its resources in the most efficient and economic way. The scheme states that the FSCS Ltd may pay compensation, it does not oblige the FSCS Ltd to pay compensation. Payment of compensation is linked to FSCS Ltd subrogation of depositor rights according to FSCS Ltd judgement. In other words, the FSCS Ltd may make any compensation conditional on the depositor assigning the whole or any part of his rights to the FSCS Ltd on such terms that the FSCS Ltd thinks fit. The FSCS Ltd must pay a claim *as soon as reasonably possible* after it is satisfied that the qualifying conditions have been met and it has calculated the amount of compensation due to the claimant. In any event, payment should be made within three months of the above-mentioned date, unless the FSA has granted the FSCS Ltd an extension. In this case, payment must be made no later than six months from that date. The FSCS Ltd may also postpone paying compensation on certain narrow grounds specified in the regulations.[164] *The amount of compensation* for deposits (ie net claims) is limited to 100 percent of deposits up to GBP 2.000 and 90 percent of the next GBP 33.000. For the excess deposit (over GBP 35.000) no compensation will be provided. This indicates that the maximum compensation payable is GBP 31.700. If the FSCS Ltd is satisfied that compensation is payable, but considers that immediate payment in full would not be prudent because of uncertainty as to the amount of depositors net claims, the FSCS Ltd may decide to pay a lesser sum or to make payment on account. The FSCS Ltd may also decide to make a payment on account or to pay a lesser sum if depositors will receive compensation in respect of the claim from a (any) third party. When it comes to the payment of interest, the FSCS Ltd may pay interest on the compensation sum in such circumstances that it considers appropriate. A depositor's claim is the sum of the protected claims of that person against the bank as an independent judicial entity (ie despite the number of deposit accounts in different branches). A

[163] See FSA Regulations on compensation chapter 1 and 3–6.

[164] FSA regulations chapter 9.2.2.

depositor's net claim is the claim less the amount of any liability that the bank may set off against the claim. If two or more persons have a joint beneficial claim against the bank, and there is no satisfactory evidence as to their respective shares, the FSCS Ltd must regard each person as entitled to an equal share.[165]

Finally, there are some **other related issues** of interest when considering the position of depositors under the UK protection scheme. *Banks finance the FSCS* in accordance with the principles set out in the regulations (chapter 13). These regulations entitle the FSCS Ltd to impose two types of levies. A management expenses levy, and a compensation costs levy. In the first three full years of the operation of the scheme, the FSCS Ltd may impose an establishment levy as part of the management expenses levy. The FSCS Ltd has discretion as to the timing of the levies imposed. Another central feature of the FSCS is the fact that *the role of the FSCS* Ltd is restricted to paying off depositors only. FSCS funds may not be used to assist banks. Similarly, the FSCS Ltd has no role in administering problem banks.[166] In comparison with the US scheme significant differences exist on this point. In the US, the FDIC has several options to handle bank failure. Moreover, *the UK Government does not provide any guarantee for deposits*. In principle, compensation for deposits is planned to be limited to collected FSCS funds. The FSCS compensation fund consists of a number of sub-funds covering deposits, investments and different types of insurance. The regulations allow division of sub-funds into smaller entities covering banks with similar kinds of activities. In addition to depositor compensation, compensation for investments may actualise in connection with bank failures. This occurs if the bank has handled the investment and there is a claim on the bank stemming from the investment at the time of the bank failure. Currently, investments are compensated entirely up to GBP 30.000 and to 90 percent for the next GBP 20.000. Procedures for judicial review of FSCS Ltd decisions on compensation to depositors also exist.[167]

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[165] FSA regulations chapter 2–3, 7 and 9–12.

[166] A special characteristic of the FSCS scheme is the fact that though the FSCS may not provide banks with financial assistance as an alternative to paying off depositors, it may provide assistance to an insurance undertaking in order to enable it to continue insurance business (FSA regulations chapter 3.1.3.).

[167] The previous UK deposit protection scheme was regulated in the former Banking Act part III ss. 50–66. Organisationally, the deposit protection system consisted of the Deposit Protection Board and the Deposit Protection Fund. The main functions of the system did not differ very much from the functions of the current deposit protection system. The system was established only to pay off depositors in the case of bank insolvency. No Government guarantee existed. Deposits were compensated to 90 percent up to a limit of GBP 20.000. In other words, the total amount payable was GBP 18.000.

The UK deposit protection scheme is a part of the UK Financial Services Compensation Scheme (FSCS) and partly exceeds EU standards. – The deposit protection coverage is dependent on the character of the depositor, ie the cover applies to private persons and small companies. The compensation to be paid is 100 percent of deposits up to GBP 2.000 and 90 percent of the next GBP 33.000.

The FSCS Ltd should pay claims as soon as reasonably possible in the case of bank default. Subrogation of depositor rights against the bank may be a condition (due to FSCS Ltd discretion) for the payment of compensation. The UK deposit protection scheme does not enable the FSCS Ltd to assist banks financially. Funds may be used only for the pay off of depositors.

The banks finance the UK deposit protection scheme. The deposit protection scheme constitutes a sub-fund under the FSCS. In principle it is possible to further divide the sub-fund into smaller entities comprising similar banks. The UK Government does not guarantee the depositor protection scheme.

4.2.2 Frankfurt (Germany)

Depositors of German banks are currently protected by two deposit protection schemes. With the coming into force of the Deposit Guarantee and Investor Compensation Act on August 1st 1998, a statutory and compulsory **Deposit Guarantee and Investor Compensation Scheme** was introduced for the banks. Hitherto, depositors, and certain other creditors, of German banks were protected by the voluntary **Deposit Protection Scheme** set up by the Association of German Banks. Since 1998 the voluntary Deposit Protection Scheme has been *complementary* to the statutory scheme. In detail this means that not only the deductions made by the statutory scheme to each depositor are compensated by the voluntary scheme. Deposits exceeding the limits in the statutory scheme and various depositors not entitled to compensation from the statutory scheme will receive compensation in accordance with the provisions of the voluntary scheme.[168] – In order to cover both schemes the analysis will focus on certain features of the schemes. These features comprise a) the scope of compensation, b) the compensation procedure and c) resources available to the compensation schemes.

The scope of compensation for **the German statutory scheme** may be described by concentrating on the definition of the term deposit, the depositor's character and the amount of compensation. – According to the Deposit Guarantee and Investor Compensation Act s. 1 *the term deposit* means any credit balance which results from funds left in an account or from temporary situations deriving

[168] The Deposit Guarantee and Investor Compensation Act is found at www.bundesbank.de and the By-laws of the Deposit Protection Fund of the Association of German Banks are found at www.german-banks.com.

from normal banking transactions of an institution and which it must repay under the legal and contractual conditions applicable. These also include debts evidenced by a certificate issued by an institution, but not bearer or certain other bonds and liabilities in respect of own bills. – In the statutory scheme *the character of the depositor* is central for the right to compensation. No right to compensation is granted to credit or financial institutions, insurance enterprises and investment companies and foreign UCITS.[169] Similarly, government, land and local authorities as well as managers, certain owners, auditors and creditors of and enterprises within the same group of companies are excluded from compensation. Moreover, relatives of the above-mentioned persons, creditors with advantageous contracts that have caused the bank's financial difficulties and creditors of claims relating to money laundering will not receive compensation. The claim of the person entitled to compensation scheme is barred under the Statute of Limitations after five years. Disputes about the reasons and amount of the claim to compensation may be settled under the Code of Civil Procedure. – *The amount of compensation* shall take into account any set off and counterclaims of the bank.[170] There is no claim to compensation to the extent that deposits or funds are not denominated in EUR or the currency of an EEA-state. The amount of the claim to compensation is limited to 90 per cent of the deposits and the equivalent of EUR 20.000. The claim to compensation includes also the interest accrued until settlement of the claim. The limit to compensation shall apply to the creditor's aggregate claim on the institution, irrespective of the number of accounts and the location where the accounts are held. In the case of joint accounts the limit provided shall be based on each account holder's share. If the creditor has acted for the account of a third party, the limit provided shall apply to the third party.

Provisions concerning *the compensation procedure* require the Financial Supervisory Authority (FSA) to act not later than 21 days after receiving notice that a bank is unable to repay its deposits.[171] The FSA shall determine that compensation is payable immediately. The depositor receives *a direct claim on the compensation scheme*. The ruling shall be notified and made public. Objections to and appeals against the ruling have no postponing effect. The compensation scheme shall immediately notify the creditors of the bank that compensation is payable and take appropriate measures to compensate the creditors within three months of the date when it was determined that compensation is payable. The claim to compensation shall be submitted in writing to the compensation scheme within one year from the date of notification that compensation is payable. The compensation scheme shall immediately check the claims submitted and pay them *not later than three months* after the establishment

[169] The Deposit Guarantee and Investor Compensation Act s. 3.
[170] The Deposit Guarantee and Investor Compensation Act s. 4.
[171] The Deposit Guarantee and Investor Compensation Act s. 5.

of eligibility and the amount of claims. In special cases the period may be extended by up to three months with the approval of the FSA. To the extent that the compensation scheme pays the claim to compensation of an eligible person, the latter's *claims on the bank are transferred* to the compensation scheme (subrogation of depositor rights).

In practice, the Deposit Guarantee and Investor Compensation Scheme comprises two schemes, one concerning deposits and the other concerning investments. – Currently, *the one concerning deposits* is administered as an entrusted scheme by the Association of German Banks and the Association of Public Banks under the supervision of the FSA. There are two types of *resources available to the statutory scheme concerning deposits*, ie contributions and loans. The funds for paying compensation are raised by contributions from the banks.[172] Banks must cover their deposits through membership of the scheme. The banks are required to pay annual contributions and the scheme may set a non-recurring payment for banks paying contributions for the first time. If funds available for paying compensation suffice contributions may be lowered or suspended. The funds accumulated for compensation shall be invested, with a view to diversifying the risk, in a way that ensures the maximum security and adequate liquidity of the assets while earning a reasonable yield. The scheme shall collect special contributions and take up loans if this is necessary to carry out the compensation procedure. The Ministry of Finance (MoF) regulates the details of the scheme. The Federal Government does not guarantee the scheme. – *The scheme concerning investments* has been set up at the Reconstruction Loan Corporation (Kreditanstalt fur Wiederaufbau, KfW). In line with the EU Investor Compensation Directive compensation is paid for unpaid claims rising from investments in the event of the institution's (including banks) default that handled the investments. Compensation is limited to 90 per cent of the liabilities arising from investment business and the equivalent of EUR 20.000.

As mentioned initially, **the voluntary Deposit Protection Scheme** for the banks at the Association of German Banks will continue to be operated alongside the statutory scheme. The voluntary Deposit Protection Scheme constitutes the voluntary Deposit Protection Fund. The purpose of the fund is to give assistance, a) in the interest of depositors, b) in the event of imminent or actual financial difficulties of banks, c) particularly when the suspension of payments is imminent, d) in order to prevent the impairment of public confidence in private banks.[173] All measures likely to be of assistance may be used. – As for *the scope of compensation*, the voluntary scheme will protect all liabilities of banks to non-banks for each creditor up to a protection ceiling of 30 per cent of the liable

[172] The Deposit Guarantee and Investor Compensation Act s. 8.

[173] By-laws of the Deposit Protection Fund s. 2.

capital of the bank concerned.[174] The liable capital consists of the total sum of core capital and additional capital measured at the time of the last published annual accounts. Liabilities in respect of which the bank has issued bonds payable to bearer and certain other liabilities are not protected. Also not protected are liabilities to managers of the bank, certain owners, relatives to or third persons acting on the account of the above-mentioned persons. In computing protected liabilities all liabilities to one creditor are added together and counterclaims of the bank are deducted even if these are not yet due. Within the limits of the protection ceiling, payments also cover interest claims. However, the Fund makes payments only for interest at market rates.

The By-laws of the Deposit Protection Fund comprise few provisions on *the compensation procedure*, ie the actual payment of the compensation to depositors and other creditors. No time limits for payment of compensation are defined in the By-laws. Specific provisions exist concerning the absence of any right to enforce intervention or payments by the Fund.[175] Furthermore, the Fund may only provide compensation insofar as deposits are not covered by another protection scheme as provided for under the Deposit Guarantee and Investor Compensation Act. – Participation in the voluntary Deposit Protection Fund is linked to membership of the Association of German Banks. According to the main rule, banks that are members of the Association are obliged to participate in the Fund.[176] There are several conditions for the participation in the Fund (sufficient liable capital, A-rating according to the Association's own rating procedure, membership of the Auditing Association of German Banks etc.) as well as specified criteria for the exclusion of a bank from participating in the Fund. *The Fund's resources* stem from participation fees.[177] The banks pay a yearly contribution to the Association depending on certain balance sheet items and the banks' ratings. In addition, newly admitted banks make a non-recurrent payment. The Association may suspend the payment of the annual contribution if the assets of the Fund have reached a reasonable level. The By-laws of the Fund do not include any provisions on the refinancing of the Fund. There is no Government guarantee for the Fund.[178]

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[174] By-laws of the Deposit Protection Fund s. 6.

[175] By-laws of the Deposit Protection Fund s. 6.

[176] By-laws of the Deposit Protection Fund s. 2a.

[177] By-laws of the Deposit Protection Fund s. 5.

[178] There are two other features of relevance to the depositor (and especially to the deposit protection schemes). The first is the fact that claims against German banks arising from deposits are not priority claims in an eventual realisation of the bank's assets. The second is the establishment of the Liquidity Consortium Bank (Liquiditäts-Konsortialbank) in 1974. In order to prevent liquidity crises in the wake of bank failures, the Central Bank and all groups in the German banking industry joined forces to set up the bank. The bank grants, as and when necessary, liquidity assistance to banks of unquestioned soundness.

The German deposit protection system consists of two different schemes. There is the statutory scheme and the voluntary scheme. The voluntary scheme is complementary. If the funds of the voluntary scheme are sufficient, the voluntary scheme will provide far better terms for compensation than the statutory one.

The statutory scheme is required to compensate non-financial institution depositors for 90 percent of their deposits up to a limit of EUR 20.000. The scheme is to pay compensation in three months from the establishment of the claims. As a result of compensation paid, subrogation of depositor rights will occur. The statutory scheme may not provide banks with direct financial assistance. The funds collected may be used only to pay off depositors. The statutory scheme is refinanced through contributions by the banks and eventual borrowing. The German Government does not guarantee the statutory scheme.

The Association of German Banks operates the voluntary scheme. Compensation is paid only to member bank depositors and creditors. The scheme may compensate depositors and non-bank creditors of banks up to 30 percent of the liable capital of the bank in question. Claims in the forms of bonds are not protected. No time limits for payment exist. The detailed use of scheme funds is not regulated. In principle, funds may be used for paying off depositors, assisting banks directly, financing mergers etc. The voluntary scheme's resources stem from participation fees. The Government does not guarantee the voluntary scheme either.

4.2.3 Helsinki (Finland)

The Finnish depositor-related rules may be analysed in many ways. One way to handle the dilemma is to choose the risks that confront the depositors as a starting point. As a result, one may distinguish between three aspects when analysing the regulation, ie a) *the risk of depositor's capital loss*, b) *the liquidity aspect* and c) *the level of uncertainty* confronting the depositor.[179]

The risk of depositor's capital loss may be estimated by analysing the regulations concerning cash reserves and depositors' capital loss. These provisions are included in the Law concerning Credit Institutions (1607/1993) chapter 7 and 6a, respectively. The regulations state that a deposit bank has to have a cash reserve that amounts to 10 percent of its liabilities and be a member of a deposit guarantee fund.[180] The deposit guarantee fund guarantees each depositor's deposits up to *EUR 25.000 per deposit bank* (FIM 150.000). In case when the deposits relate to the selling of depositors' dwellings, the deposit is, if certain criteria are met, guaranteed to its full amount. The obligation for the

[179] The Finnish bank exit-reform in 2002 only resulted in minor changes for the depositors of Finnish banks. The Law concerning Credit Institutions (1607/1993), directing the Finnish deposit insurance system, was mostly unaffected by the reform.

[180] The Law concerning Credit Institutions chapter 7, 67§ and chapter 6a, 65§.

deposit guarantee fund to guarantee the deposits emerges if the deposit bank has not returned deposits as a consequence of the bank's liquidity or other financial problems and the problems are not (according to the FSA) temporary.[181] The deposit guarantee fund refinances its activities by supportive fees collected from deposit banks. The deposit guarantee fund may borrow capital if its own assets are not sufficient to cover its liabilities. The rules of the deposit guarantee fund should include provisions on the members' obligation to lend capital to the deposit guarantee fund when capital is needed to cover the liabilities of the fund. The assets of the deposit guarantee fund are independent of the member banks' assets.[182]

Another aspect of importance to the depositor is **the liquidity aspect**. The moment when the depositor may receive his money if the bank is faced with problems is of concern to the depositor. In this case the Law concerning Credit Institutions differentiates between a) commencement of the fund's liability to pay out the funds and b) payment of the funds. *The commencement of the fund's liability* to pay out the funds is dependent on the FSA's decision. The initiative for the decision may come from depositors, the bank in question or any other source. The FSA has to decide whether the criteria for the commencement of the deposit guarantee fund's liabilities are met. The provisions concerning *the payment of the funds* state that the guarantee fund should make an announcement to the depositors and pay out the capital in three months time from the date of the FSA decision. As an exception, if the bank's liquidation has started earlier, the period should be calculated from this earlier date. In the case of special conditions, the FSA is entitled to postpone the pay out of funds on the initiative of the guarantee fund. Postponement may be granted three times, a maximum of three months each time. If payment has not been made in due time, the depositor receives *a legal claim* against the guarantee fund.[183]

Still, there is **some uncertainty** affecting Finnish depositors. This uncertainty may be analysed by constructing a number of *scenarios*. In principle, there are three scenarios representing uncertainty for Finnish depositors. The EUR 25.000 limit and also the fact whether the bank is a member of *a guarantee fund* (not the deposit guarantee fund) are relevant when making assumptions about the uncertainty. First, there is the situation of *the deposit exceeding the limit and the bank being a member* of a voluntary guarantee fund. In this case the regulations concerning voluntary guarantee funds in the Law concerning Credit Institutions chapter 6 are applied. According to these regulations the guarantee fund may grant supportive loans or subsidies to a deposit bank in financial distress, if the loans or subsidies are necessary to uphold the activities of the bank. The decision

[181] The Law concerning Credit Institutions chapter 6a, 65i and 65j§§.

[182] The Law concerning Credit Institutions chapter 6a 65c–h and 65n§§.

[183] The Law concerning Credit Institutions chapter 6a 65i and 65k§§.

must have Ministry of Finance (MoF) approval. The guarantee fund's assets consist of the fees that the member banks have paid the guarantee fund.[184] If needed, the guarantee fund may in turn receive supportive loans and guarantees from *the Government's Guarantee Fund* according to the Law concerning the Government's Guarantee Fund (379/1992). An additional requirement is that the supportive loans and guarantees are necessary to secure the stable functioning of the financial markets. The Government's Guarantee Fund may refinance itself to a total balance of EUR 3,5 billion. The Finnish Government decides on supportive loans and guarantees from the Government's Guarantee Fund. – In other words, the risk for capital loss to the extent that the deposit exceeds EUR 25.000 may be smaller when the deposit bank is a member of a guarantee fund.[185]

The second scenario is the situation where *the deposit exceeds the limit and the deposit bank is not a member* of a guarantee fund. In this case no supportive loans or subsidies can be issued by an eventual guarantee fund. In order to secure the activities of a deposit bank and the stable functioning of the financial markets *the Government's Guarantee Fund* may directly invest in the bank's shares, issue guarantees for the bank's loans or give subsidies to the bank.[186] The bank's financial distress is not a sufficient motive for support as was the case with voluntary guarantee funds. In this second case support may be granted only if the bank's problems affect the stable functioning of financial markets. This means that the risk for the loss of the deposit to the extent it exceeds EUR 25.000 increases. The third scenario is when *the deposit is below the limit and the deposit guarantee fund is not sufficient* (despite its borrowing) to cover the total amount of deposits. Until 1998, the statement made by the Finnish Parliament in 1993 to guarantee the functioning of the banking system in any situation would have resulted in supportive action by the state to protect depositors. The statement was revoked in 1998. No legal obligation to act exists for the state anymore. It is difficult to estimate how such a situation would be handled in practice.

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[184] The Law concerning Credit Institutions chapter 6 59 and 61§§.

[185] The Law concerning the Government's Guarantee Fund 11, 14 and 15§§.

[186] The Law concerning the Government's Guarantee Fund 1§.

The Finnish deposit insurance system is fairly straightforward. Depositor protection is provided through deposit guarantee funds. Fund membership is compulsory for banks. The deposit guarantee funds should not be mixed up with voluntary guarantee funds aiming at securing the activities of banks by providing financial assistance. – The Finnish deposit insurance system covers avista and time deposits up to EUR 25.000 per depositor and bank. When a bank faces financial problems that are not classified as temporary by the FSA the depositor receives a legal claim against the deposit guarantee fund.

The time limit for the payment of compensation to depositors is calculated from the FSA's above-mentioned decision. Payment of compensation should be made in three months from that date. Payment results in fund subrogation of depositor rights. As in other EU countries, depositor claims are in no priority relative to other claims. Deposit guarantee funds may not be used to assist banks.

Deposit guarantee funds are refinanced through supportive fees from the banks. Funds may borrow capital if assets are insufficient to cover liabilities. Deposit guarantee funds are not explicitly guaranteed by the state.

Though the provisions directing the Finnish deposit insurance system were mostly unaffected by the bank exit-reform in 2002 some *consequences of the reform* for depositors may be detected. First, the new Law concerning Commercial Banks (1501/2001) excludes depositors from the creditor hearing during voluntary reorganisation of banks (in accordance with the Law concerning Limited Liability Companies 734/1978). Second, the new law prohibits a depositor, who should be fully compensated by a deposit guarantee fund, to initiate bankruptcy for the bank. Moreover, depositors do not have to lodge their claims in bank bankruptcy and pursuant to the Law concerning Temporary Suspension of the Activities of a Deposit Bank (1509/2001) a bank is not entitled to receive deposits during the suspension without MoF approval.[187]

4.3 The depositor and the reorganisation and liquidation of banks in Tokyo

As described in section 3.3 the role of the Deposit Insurance Corporation (DIC) has steadily increased as the crisis in the Japanese financial sector has continued. Still, *DIC's original mandate* was limited to collecting insurance premiums and paying off insured depositors of failed banks. Ironically, insured depositors have never been paid off in Japan. Problem banks have always been dealt with in some other manner. Anyway, as a "backup" legislation diminishing systemic risk the provisions concerning deposit insurance are important. Eventually, one could

[187] The Law concerning Commercial Banks chapter 2 6§ and chapter 6 22–23§§.

claim that they are so fundamental that the authorities have never dared to apply them. – In order to analyse the provisions in the Japanese Deposit Insurance Law to the extent that these concern *the payoff of insured deposits* the text below is structured in the following way. First, main characteristics of the system are covered. Then, the question how payment is made in practice is looked into more closely. Finally, the resources that constitute the system are considered.[188]

Describing **the main characteristics** of the Japanese deposit insurance system, there are some important aspects that should receive attention. These characteristics relate to the extended scope of compensation and DIC's role as a representative of depositor rights. – The question of *the extended scope of compensation* is a characteristic of the Japanese system that distinguishes it from most other deposit protection schemes. The extension was made in 1996. The extended scope of compensation means that the DIC not only pays insurance money to the depositors up to the specified level, it also *purchases principal and interest in excess of that specified level*. Purchase of excess principal and interest will be made at a prorated value. The prorated value is the amount of deposit on the day of the bank's failure multiplied by a rate determined in light of the expected amount to be repaid from bankruptcy procedures. In other words, the DIC assumes the role of the depositor (subrogation of depositor rights) also in excess of the amount of the deposit insured. In strategic terms this means that the problem concerning the future of the bank, ie the liquidation of the bank, more clearly becomes the problem of a narrow group of insiders, the DIC, the bank's traditional creditors and the shareholders. Another factor of relevance when considering extensions of the scope of compensation relates to *the changes in the level of compensation*. In the Japanese legislation the term deposit refers to yen-denominated deposits, time deposits, instalment contributions, funds receivable under money trust agreements and funds receivable through the issuance of securities.[189] As a result of JPY inflation, the level of deposit cover has been increased. In 1971 the level of cover was set at JPY three million per depositor. The 1986 amendments to the Deposit Insurance Law led to an increase of the level up to JPY 10 million.[190] In 1996, due to the financial sector crisis, the

[188] The Deposit Insurance Law, introduced in 1971, was amended in 1986, 1996, 1998 and 2001. The 1986 and 1996 amendments resulted in changes for the payment of insured depositors. – As referred to above the original mandate of the Japanese DIC was limited to the pay off of insured depositors of failed banks. As a consequence of the reforms of the legislation concerning reorganisation and liquidation of financial institutions the powers of the DIC were steadily increased and it became one of the main players in the administration of the crisis in the Japanese financial sector. This development did not weaken the DIC's role as a protector of the depositors in the eventual pay off of insured depositors. The transformation of DIC's role towards an active administrator of crises only made its possible role as a pure payer more unlikely.

[189] The Deposit Insurance Law s. 2.

[190] The Deposit Insurance Law s. 54.

Japanese government promised to protect the full value of all deposits for a five-year period. In 2001 this period was prolonged to 2002.

In principle, *DIC's role as a representative of depositor rights* may be analysed in many ways. To sum up, there are three dimensions that one should focus on when describing DIC's role. From 1971 to 1996 DIC received, in the hypothetical case of a pay-off of insured depositors, the depositors' rights against the debtor bank to the extent payment based on insurance was made to the depositor (traditional subrogation rights). Pursuant to the 1996 amendment of the Deposit Insurance Law the subrogation rights also covered principal and interest in excess of the level of compensation (transferred rights in connection with extended cover). Finally, according to the 1996 amendment the DIC was allowed to exercise depositor rights (represent depositors) in the reorganisation of banks. This last amendment was also significant because the transfer of rights to the DIC did not require the pay off of insured depositors nor final documentation of the bank's insolvency.[191]

The question **"How is payment made in practice to insured depositors?"** is another central issue when considering the Japanese deposit insurance system. The most important aspects relating to this issue concern the criteria for the initiation of payment, the time period during which payment to depositors should be made and measures taken in order to strengthen depositors position in the case of a pay-off. One of the main *criteria for the initiation of payment* to depositors, ie the establishment of DIC's obligation to pay, is the inability of a bank to refund deposits. Inability to refund may be the consequence of the bank's inadequate liquidity or insolvency. Inability to pay may in some circumstances be difficult to prove. In theory, the fact that the bank does not meet its obligations to depositors is only an indication of inability. Another feature of the Japanese deposit insurance system concerns the formal opening of bankruptcy proceedings. The Japanese Deposit Insurance Law states that the initiation of bankruptcy proceedings generates an obligation for the DIC to pay off insured depositors. This automatic mechanism has been criticised. One tendency in the development of bank exit legislation has namely been to secure conditions for the continuance of bank activities. This has been done to protect the value of the bank while searching for an appropriate solution to the bank's problems.

The time period during which payment to depositors should be made is defined in the Deposit Insurance Law.[192] According to the current legislation the

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[191] Another feature of the Japanese system is the common fact that financial institutions engaged in investment services in accordance with the Securities and Exchange Law are required to participate in an investor protection scheme. Consequently, banks offering investment services should maintain a parallel protection scheme covering losses that stem from the default of the bank (ie broker) handling the investments.

[192] The Deposit Insurance Law ss. 53 and 56.

DIC shall make a determination whether to pay claims within one month of claim occurrence. This period may be extended by one additional month by the Prime Minister's Office. Before the 1986 amendments to the Deposit Insurance Law determination was to be made within one month from claim occurrence without possible extensions. Several *measures to improve the position of the depositor in the case of a pay-off* have also been taken. In 1986, pursuant to the major reforms of the law, payment procedures were improved by simplifying the a) *depositor identification process* and b) *introducing a suspense payment system* allowing for payments of up to JPY 200.000 to meet living expenses. In 1996, the position of the depositor was further improved. The launch of the above-mentioned deposit purchase system under which the DIC would provide depositors with the amounts of money (above the JPY 10 million limit) which were expected from the bank's bankruptcy improved the liquidity of bank depositors. Depositors did not have to wait for the conclusion of court procedures anymore.

The resources that constitute the deposit insurance system are the final main element of the system. As for *the DIC's role*, DIC was established as a special corporation in 1971 in accordance with the Deposit Insurance Law for the purpose of administering the deposit insurance system. The DIC had an initial capital of JPY 5,5 billion from the Japanese Government, the Bank of Japan (the BoJ) and private financial institutions. A Management Committee administers the DIC and as referred to above the duties and obligations of the DIC have steadily expanded since 1971. When considering the resources of the DIC, two factors should be taken into account. First, DIC finance to the financial sector comprises both financial assistance and depositor pay-off. Second, assistance to the financial sector has been and may also be directed through other channels than the DIC. Many banks have used BoJ lender of last resort-capital to defeat liquidity problems. Moreover, in the former crises banks have eg been partly rescued by creditors (mainly other banks) relinquishing claims.

The role of the Japanese deposit insurance system has changed significantly over time. All banks are obliged to take part in the system. The Deposit Insurance Corporation's (DIC) original mandate was limited to the paying off of depositors. As a result of crises DIC powers have been increased. – The limit for depositor compensation has been JPY 10 million since 1986. Still, the Japanese Government has currently promised to protect the full value of deposits under all circumstances.

The DIC shall decide whether to pay compensation to depositors within one month of claim occurrence. The condition for payment is the fact that the bank is unable to refund deposits. Payment to depositors is followed by DIC subrogation of depositor rights. Depositor claims do not have priority in the realisation of the bank's assets. As an alternative to paying off depositors, DIC may provide banks with financial assistance.

Membership fees, borrowing and injections of public funds have been used to finance the deposit insurance system.

The refinancing of DIC financial assistance to banks and eventual pay-off of depositors has been handled by different kinds of contribution fees and borrowing with and without government guarantees. – The level of *contribution fees* payable by the banks to the DIC has been raised several times.[193] In 1986 the fees were raised from 0,008 percent to 0,012 percent and in 1996 from 0,012 percent to 0,048 percent. An additional temporary fee was introduced in 1996 as the Japanese Government guaranteed all deposits for the coming five years. This fee rose to 0,036 percent of deposits. Internationally, the ratio of insurance fund reserves to covered deposits has been low in Japan. – Another avenue to secure the refinancing of the DIC's mandate is *borrowing*. The DIC may borrow with or without government guarantee. DIC borrowing has been restricted in several ways over the years. In 1986, borrowing from private financial institutions was explicitly sanctioned. As a result, borrowing limits from the BoJ were raised from JPY 50 billion to 500 billion. The current limit is JPY four trillion. Unfortunately, in 1997 the DIC was forced to borrow from private financial institutions to repay BoJ capital. Today, the DIC may borrow from the BoJ, financial institutions or other parties on certain grounds listed in the Deposit Insurance Law ss. 42,68 and

[193] Contribution fees are currently calculated as an average of the deposit stock during the previous fiscal year. Before 2001 fees were calculated based on the amount of deposits at the end of March each year.

126. In 1998 DIC received the right to issue bonds and obtained government guarantees for its borrowing.[194]

5 Bank reorganisation and liquidation relative to bank shareholders

5.1 Bank exit in the USA

Contrary to many other financial centres the distinction between voluntary and compulsory reorganisation and liquidation measures in the US is very apparent. When it comes to *compulsory* action, the initiation of conservatorship and receivership constitute a clear abolishion of *all administrative rights* of the shareholders. But the reorganisation and liquidation of US banks may also be carried out on *voluntary* grounds. Solvent banks and banks that do not meet any judicial criteria for conservatorship or receivership may reorganise or dissolve voluntarily. In these situations, the shareholders decide on what measures to take, if necessary with the co-operation of parties involved.[195] – In order to analyse the reorganisation and liquidation of US national banks from *the shareholders' perspective* a) *voluntary alternatives for the reorganisation and liquidation* of US banks will be studied after which b) *the position of the shareholders under conservatorship and receivership* is considered.

There are several **voluntary measures for the reorganisation and liquidation** of banks that US shareholders may use in a discretionary sense. The main alternative means for reorganisation comprise a) changes in the bank's share capital, b) consolidations and mergers and c) acquisitions and transfers. Liquidation may in turn be put into effect through voluntary dissolution. – *Changes in the share capital* of a national bank are frequently used measures for the rehabilitation of US banks.[196] 12 U.S.C. chapter 2 s. 57 deals with *the increase of capital*. The capital stock of banks may eg be increased in order to strengthen the capital adequacy of banks and prevent banks becoming undercapitalised. In conformity with the regulation, the banks' capital may be increased by the vote of shareholders owning two thirds of the stock of the bank. To be valid, the

[194] To handle DIC activities a large number of *financial entities* have been established in connection with the DIC. The Resolution and Collection Corporation (RCC, mentioned in section 3.3.), a subsidiary bank of the DIC and responsible for several of DIC's detailed duties, is the best-known example of such an entity. Several funds have also been founded to deal with individual crises.

[195] For a comprehensive presentation of the US bank exit regime see section 3.1.

[196] Changes in the share capital are regulated in the 12 U.S.C chapter 2 ss. 55, 57 and 59.

strengthening of capital requires that the capital is paid in, the increase is registered and approved by the Office of the Comptroller of the Currency (OCC). The 12 U.S.C chapter 2 s. 59 regulates *the reduction of share capital* by vote of shareholders. The share capital of banks may eg be reduced in a situation where losses have generated a deficit in the banks' own funds and the regulations force banks to act. In principle, section 59 identifies two stages in the decision-making process. The decision on reducing the capital is separated from the decision on distributing the assets stemming from the reduction. Both decisions require the vote of shareholders owning two thirds of the bank's capital stock and OCC approval. The US federal banking regulation does not call for the consent of bank creditors when reducing the capital stock. Another feature associated with the change of banks' share capital is *the payment of any deficiency in the capital stock*.[197] Usually the deficiency is a result of repeated losses. The provisions state that the deficiency should be paid by the shareholders on a pro rata basis and in proportion within three months after receiving notice thereof from the OCC. If no payment is made during this time, the bank should go into liquidation or a receiver should be appointed. The neglect or refusal of any shareholder to fulfil his obligation may lead to the sale of the stock of such a shareholder at a public auction.

Other voluntary measures to reorganise banks include *consolidations and mergers*.[198] On the whole, the provisions concerning voluntary consolidations and mergers by national banks are fairly complex. Relevant regulative dimensions when estimating the applicability of legislative provisions include a) the type of conversion, ie consolidation or merger, b) the status of the delivering institution or institutions and c) the character of the receiving or continuing institution. As for the type of conversion a consolidation of banks may be defined as a measure whereby a bank is consolidated with another bank without creating a new judicial entity. The owners of the delivering bank usually receive shares in the receiving bank. A merger may be described as a measure whereby banks merge into a new bank, ie a new judicial entity replacing the old banks. Consolidations and mergers usually require the vote of the shareholders owning at least two thirds of the institution's capital stock for each institution involved together with OCC approval.

Acquisitions and transfers differ from consolidations and mergers in that these are generally based on traditional purchase or exchange transactions. Acquisitions and transfers may include assets, liabilities or activities of banks. Acquisitions are regulated in the 12 U.S.C. chapter 2 s. 215c to the extent they result in national banks receiving control of other banks. In these cases OCC approval is needed.

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[197] 12 U.S.C. chapter 2 s. 55.

[198] The most important regulations concerning consolidations and mergers of US national banks comprise the 12 U.S.C. chapter 2 ss. 215–215c and chapter 16 ss. 1831u and 1828c.

The 12 U.S.C chapter 16 s. 1828c concerning acquisitions made by insured banks and transfers from insured banks is more comprehensive. Most cases require OCC approval. Acquisition of stock (of banks or other companies) is separately regulated and may also at some stage involve the provisions concerning holding companies. – *Voluntary liquidation* is another measure that shareholders may use to wind up the affairs of banks.[199] In principle the legislation constitutes two routes for the liquidation of national banks. Insured banks may follow *the receivership procedure* when dissolving on voluntary grounds. As a result the interests of the depositors are well protected. According to the provisions, an insured bank may by resolution of its board of directors or its shareholders decide on the appointment of a receiver. The provisions in 12 U.S.C. chapter 2 also create an OCC-supervised *voluntary liquidation scheme*. No explicit rights are given to the creditors. Voluntary liquidation requires the vote of bank shareholders owning two-thirds of the bank's stock.

Finally, a few words may be said about **the shareholders' position under conservator- and receivership**. The consequences of conservatorship and receivership for the shareholders may be illustrated by focusing on the conservator's or receiver's a) administering powers, b) contractual powers and c) supportive powers. – In case of *administering powers* the 12 U.S.C. chapter 18 s. 1821d states that the FDIC shall, as a successor to the bank, succeed to all rights, titles, powers and privileges of the bank's stockholders and take over the assets of and operate the bank with all the shareholders' powers. As a result, all the administrative powers of the shareholders' are transferred to the conservator or receiver. In case of conservatorship the withdrawal is temporary whilst in case of receivership it is final. In both cases *the financial rights* of the shareholders remain. Assets will be distributed by the receiver to the shareholders in accordance with the priority principles directing the dissolution of the bank. – *Contractual powers* are here defined to mean the powers of the conservator or receiver to make contracts with the insured bank or its representatives. Certain restrictions concerning this type of agreements are included in the 12 U.S.C. chapter 16 s. 1823c. These provisions state that the FDIC may not use its authority to purchase the shares of an insured bank. In other words, the whole risk for the bank's problems should be carried by the shareholders. – The regulations concerning the conservator's or receiver's *supportive powers* are also coherent with these latter provisions. 12 U.S.C. chapter 16 s. 1823c states that eventual financial assistance to insured banks may be subordinated in relation to other claims against the banks. Still, financial assistance may only be subordinated in

[199] Voluntary liquidation of US national banks is regulated in 12 U.S.C. chapter 2 ss. 181–182 and chapter 16 ss. 1821c.

relation to depositors' or creditors' claims. Financial assistance may not be subordinated in relation to shareholders' share capital based claims.[200]

> The position of US bank shareholders under conservator- and receivership is relatively weak. Shareholders lose all their administrative rights when the compulsory reorganisation and liquidation procedures start. – When the bank faces financial problems, OCC/FDIC action is not dependent on shareholder opinion or decision. The authorities should choose the least-cost alternative (for the Deposit Insurance Fund) of the following options, ie financial assistance to the bank, paying off depositors, reorganisation or liquidation. – Under adequate conditions, the shareholders may voluntarily initiate reorganisation or liquidation of a US bank.
>
> Financial assistance to banks does not abolish shareholder value. Usually, financial assistance to banks takes the form of subordinated or ordinary debt. In a priority sense, FDIC assistance must not equal or be below the rights that the shares of the bank represent in an eventual realisation of the bank's assets. – In theory, the criteria for the initiation of compulsory reorganisation and liquidation are very detailed. According to the "Prompt Corrective Action" (PCA) scheme, a ratio of tangible equity to total assets equal or less than two percent entitles/obliges the authorities to act. – Provisions also oblige the FDIC to protect the "going-concern" value of the bank during reorganisation and liquidation.

5.2 EU bank exit from the shareholders' perspective – the case of UK, Germany and Finland[201]

5.2.1 UK

In analysing aspects of the UK bank reorganisation and liquidation legislation of interest to *bank shareholders* there are many potential elements that may or should receive attention. Concentrating on the procedures not analysed in section 3.2.1 the focus inevitably will be on voluntary measures initiated by the bank and its shareholders. Still, some further viewpoints will cover shareholder position pursuant to the compulsory reorganisation and liquidation measures presented in section 3.2.1. – The voluntary measures comprise a) *business transfers* according

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[200] *Judicial review* of agency decisions relating to the interests of shareholders is possible under and on general grounds specified in the Administrative Procedure Law (5 U.S.C. chapter 7).

[201] Concerning the provisional administrator's powers in compulsory reorganisation of problem banks the verdict by the European Court of Justice (ECJ) in the "Panagis Pafitis" case ((C-441/93):1996 2 CMLR 551) is central. The ECJ confirmed that art. 25 of the Second Company Law Directive 77/91 disallowed a (Greek national) regulation that permitted an appointed administrator to increase a bank's (in the form of a stock company) capital without the decision of the sharehold-ers' meeting.

to the Financial Services and Markets Act (FSMA) part VII, b) *arrangements and reconstructions* based on the Companies Act 1985 part XIII, c) *the reduction or increase of share capital* in accordance with the Companies Act part V chapter I and IV and d) *the members' voluntary winding up* pursuant to the Insolvency Act part IV chapter II and III.[202]

As mentioned, **banking business transfers** are regulated in the FSMA part VII. According to the main rule, the provisions apply independent of the judicial form of the transfer of banking business. A banking business transfer scheme is a scheme where the transfer of assets includes *the accepting of deposits*. The regulations state that the banking business transfer requires different kinds of acceptances. First, a certificate as to financial resources for the transferee issued by the Financial Services Authority (FSA) is needed. Furthermore, an order by the court for the banking business transfers scheme to have effect is required. If the transferee is not a financial service provider or a bank, authorisation and permission are also required. In the case *the provisions in the Companies Act* part XIII s. 427a concerning mergers and divisions of public companies (see below) apply to the business transfer in question, the transfer is excluded from the specific provisions in the FSMA part VII.[203]

The regulations concerning **arrangements and reconstructions** in the Companies Act part XIII establish a separate procedure for the reorganisation of banks. *The procedure* involves the bank, bank shareholders, bank creditors and the court. The bank, any bank creditor or bank shareholder may initiate a compromise or an arrangement. The compromise or arrangement is a proposition concerning the relation between *the bank and its creditors*. Initiation of a compromise or an arrangement is made to the proper court. If a compromise or an arrangement is proposed, the court should order a meeting of bank creditors or shareholders to be summoned.[204] If a majority, representing *three-fourths in value of creditors or shareholders*, agree to any compromise or arrangement, the measures, if sanctioned by the court, will be binding. In case the bank is in course of being wound up the measures will also bind the liquidator. The compromise or arrangement requires the bank to inform shareholders and creditors about the consequences of the measures before the meeting is summoned.[205] If the measures a) *relate to the reconstruction of the bank or the amalgamation of companies* or b) *include the transfer of any part of the undertaking or property of the bank to*

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[202] Discussing liquidation on shareholder initiative, one should also recall the shareholders' right to initiate a compulsory winding up pursuant to the Insolvency Act part IV chapter VI (and relating provisions in the FSMA part XXIV ss. 367–371).
[203] For detailed provisions, see the FSMA part III, IV and VII ss. 106 and 111 and Schedule 12 part II.
[204] The Companies Act part XIII s. 425.
[205] The Companies Act part XIII s. 426.

another company the court may make certain provisions directing the measures.[206] The court is entitled to make provisions concerning the transfer of properties or liabilities, the allotting or appropriation of shares or other interests of the receiving company, the dissolution of the bank etc.

The special character of the arrangements and reconstructions in the Companies Act part XIII *in relation to other reorganisation and liquidation* means is evident. This fact may affect the position of shareholders (and creditors). Comparing arrangements and reconstructions and *"the proposal"* regulated in the Insolvency Act part I (presented in section 3.2.1.) differences appear. The bank, bank shareholders or bank creditors may propose arrangements and reconstructions according to the Companies Act, while directors initiate "the proposal". "The proposal" was originally introduced as a simpler and less expensive alternative compared to the measures in the Companies Act. – The relation between arrangements and reconstructions and *the administration order* as another reorganisation measure is also of interest to bank stakeholders. The administration order was intended to give banks a breathing space, ie buffer against legal action, during which different alternatives for handling the banks' problems were considered. In bank failures, the administration order has been frequently used. The relation between the measures may be described as follows. First, the need for arrangements and reconstructions constitute criteria for the issuance of an administration order.[207] Second, it is explicitly pointed out that an administration order should not prevent arrangements and reconstructions under the Companies Act.[208] The relation between arrangements and reconstructions and *liquidation measures* is also of special interest to bank shareholders (and creditors). In compulsory liquidation procedures the shareholders would most certainly lose their capital. In both voluntary and compulsory winding ups, a compromise or an arrangement proposed between the bank and its creditors entitles the court to arrange a meeting of company stakeholders to discuss the company affairs in a manner directed by the court. The implications of the discussions may be company reorganisation (ie securing the continuance of bank activities) by cutting creditor claims. Such an option is highly valued by shareholders.[209] Pursuant to the FSMA part XIV ss. 365 and 362 the FSA is

[206] The Companies Act part XIII s. 427.

[207] The Insolvency Act part II s. 8.

[208] The Insolvency Act part II s. 27. – If during an administration order, a compromise or an arrangement is proposed between a bank and its creditors, the FSA also receives the right to petition the court due to the Companies Act part XIII s. 425.

[209] The Companies Act part XIII s. 425.

entitled to petition the court in both types of winding ups when arrangements and reconstructions are proposed.[210]

Another question of importance to bank shareholders is the possibilities that **reducing or increasing the share capital** may offer in a reorganisation sense. *Reducing the share capital* as a means of reorganisation is most often used in situations when as a result of losses own funds are not sufficient. Considering *grounds for the reduction*, the duty of the directors on serious loss of capital is regulated in the Companies Act part V chapter V s. 142. According to these provisions the directors shall, where the net assets of a public company are half or less of its called-up share capital, duly convene an extraordinary general meeting for the purpose of considering what steps should be taken to deal with the situation. *The procedure for reducing the share capital* is regulated in the Companies Act part V chapter IV. These regulations state that a bank may, subject to confirmation by the court and if authorised by the articles of the bank, reduce its share capital by special resolution. In case the reduction of share capital involves either the payment to a shareholder of any paid-up share capital or if the court so directs, every creditor of the bank should be contacted and may object to the reduction of the capital. If a creditor does not approve to the reduction, the court may, if it thinks fit, dispense with the consent of that creditor if the bank is willing to secure the creditor's claim in accordance with the court's directives. As a result, the court should, if satisfied with respect to every creditor, make an order confirming the reduction. On certain grounds, the court may object to the reduction of capital.[211] *Increasing the share capital* may be used as a reorganisation measure when there is a need of additional own funds. Some aspects of the alteration of share capital, including the increasing of capital, are regulated in the Companies Act part V chapter I. The general meeting of bank shareholders should decide on the increase of the bank's share capital. Specific provisions on the decision making and announcement of the increase are included in the law.[212]

The members' voluntary winding up differs from the creditors' corresponding alternative in respect of the solvency of the bank.[213] Similar to the creditors' voluntary winding up, the members' (ie shareholders) winding up starts

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[210] In general, receiverships as means to secure creditors are unaffected by arrangements and reconstructions. – Another interesting aspect concerning arrangements and reconstructions is the fact that eventual arrangements establish a right for the FSA to withdraw or restrict the banking license. The perspective on the term arrangement has been wide in these situations. Arrangements have covered both arrangements and reconstructions under the Companies Act part XIII and "the proposal" pursuant to the Insolvency Act part I.

[211] The Companies Act part V chapter IV ss. 135–137.

[212] The Companies Act part V chapter I ss. 121–123.

[213] The members' voluntary winding up is regulated in the Insolvency Act part IV chapter II and III and the FSMA part XXIV s. 365.

with a resolution passed by the bank at a general meeting. The winding up is deemed to commence at the time of the passing of the resolution. Contrary to the creditors' winding up, the members' winding up requires solvency of the bank, ie the assets should exceed the obligations. In accordance with this condition, the legislation states that a members' winding up should be preceded by *a statutory declaration of solvency* made by the directors. Such a declaration should embody a statement of the bank's assets and liabilities as at the latest practicable date before the making of the declaration. The bank's general meeting should nominate a liquidator to wind up the bank's affairs and distribute its assets. If the liquidator is of the opinion that the bank's assets are not sufficient to cover its obligations the liquidator should summon *a meeting of creditors*. Consequently the member's voluntary winding up is transformed to a creditors' winding up. In case the assets are sufficient, the liquidator should make up an account of the winding up, showing how the bank's property has been disposed, and call a general meeting of the bank to consider the account.[214] In a members' voluntary winding up, the FSA is entitled to refer any question arising in the winding up of a bank to the court. The court may entitle the FSA *to exercise the powers of the court* in respect of the winding up.[215]

Another entity of importance to bank shareholders is **the position of bank shareholders under compulsory reorganisation and liquidation measures**. Though the main characteristics of the compulsory means were presented in section 3.2.1, a few words may be said in order to describe consequences of the measures for shareholders. Focusing on reorganisation, shareholders' role in *"the proposal"* is secondary. Formally, "the proposal" is the affair of the bank's management, the creditors and the court. Shareholders may direct the management, but only the court can overrule decisions made by the creditors' meeting.[216] Shareholders may make a petition for *an administration order* creating a buffer for legal action against the bank. During this time an adequate solution to the bank's problems may be presented. There is a risk that such public actions affect the "going-concern" value of the bank.[217] Under *receiverships and compulsory liquidation* the position of the shareholders is fairly straightforward. There are no actual means for the shareholders to affect the procedures other than the abovementioned arrangements and reconstructions. – On the whole, the arrangements and reconstructions in accordance with the Companies Act part XIII are the procedural alternatives most valuable for the shareholders of the failed

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[214] The Insolvency Act part IV chapter II ss. 84–87, 89–91 and 94–96.

[215] The FSMA part XXIV s. 365 and the Insolvency Act part IV chapter V s. 112. – The Companies Act also establishes a scheme for the winding up of companies registered under the Companies Act. The scheme is comprehensive and comprises court-administered liquidation, voluntary liquidation and court-supervised liquidation (the Companies Act part XX).

[216] The Insolvency Act part I and the FSMA part XXIV s. 356.

[217] The Insolvency Act part II and the FSMA part XXIV ss. 359–362.

bank. Though both shareholders and creditors vote on arrangements and reconstructions, the court determines what will be done.[218]

> Shareholders of UK banks are confronted with a bank exit regime that leaves the important decisions to be made by the courts. Independent of the type of compulsory reorganisation measure taken, the courts set the limits for action. In theory, the FSA has no central, decisive role in the reorganisation and liquidation of banks. In practice, the FSA may affect court behaviour through its right to initiate and attend the court proceedings. – There are few possibilities for bank shareholders to influence a compulsory liquidation of the bank. Only, the commencement of certain reorganisation measures listed in the Companies Act may temporarily stop the proceedings. – Reorganisation measures require the creditors' vote and court approval to become valid. The measures may imply cutting creditor claims in order to secure the continuance of the bank's activities.
>
> Financial assistance to banks is based on the Bank of England's lender of last resort (LLR) role only. Financial assistance to banks may take several forms. The implications of the assistance on shareholder value are not given. – Compulsory liquidation/bankruptcy should be initiated in case a) the bank is unable to pay its debts or b) the court is of the opinion that the bank should be wound up. – No explicit provisions protecting the "going-concern" value of the bank in reorganisation and liquidation are included in the legislation.

5.2.2 Germany

Considering the German bank exit legislation from the shareholders' perspective the structure of the study can follow the logic set up in previous sections. Consequently, one group of interesting aspects relates to the shareholders' position under *the formal (FSA-administered) reorganisation and liquidation measures* pursuant to the Banking Act (and Insolvency Act). Another group of aspects is linked to *the voluntary means* through which a bank, not faced with financial problems, may reorganise or liquidate its business. On the whole, one could say that in some senses the position of the shareholders of German banks is relatively strong. Criteria for intervention by the Financial Supervisory Authority (FSA) are fairly narrow. On the other hand, there are factors creating uncertainty especially in the case of liquidation of a bank.[219]

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[218] Analysing the situation for bank shareholders in the case of reorganisation and liquidation under the former Banking Act relative to current provisions in the FSMA no significant differences appear. On the other hand, the powers of the FSA (pursuant to the current FSMA) in relation to former Bank of England powers (due to the former Banking Act) in the reorganisation and liquidation of banks have marginally increased (see section 3.2.1). – For viewpoints on financial assistance to UK banks, see section 3.2.1.

[219] For a more detailed analysis of the various FSA-administered reorganisation and liquidation measures see section 3.2.2.

Considering the shareholder’s position relative to **the formal (FSA-administered) reorganisation measures** according to the Banking Act, a distinction between the different means should be made. As defined in section 3.2.2 the formal reorganisation measures consist either of pure protective measures or means with a constructive element. – In a general sense, *the protective measures* applicable when the bank is confronted with inadequate own funds or liquidity, dangers and insolvency primarily constitute *prohibitions*. These prohibitions affect the present and future capital flows of the bank, indicating a decrease in shareholder value. Moreover, at a detailed level, some of the protective measures directly *restrict actions by the owners* of the bank. The Banking Act part III, division 4, s. 45 states that in case of inadequate own funds or liquidity the FSA may prohibit or limit withdrawals by the owners as well as the distribution of profits. Protective measures against the shareholders in the case of danger include the prohibition of owners from carrying out their activities and the limitation of these activities.[220] *Means with a constructive element* create, at least in theory, conditions for the protection of shareholder value. Means with a constructive element only apply to banks *in danger* or confronted by *insolvency*. More precisely, danger is defined in respect to the banks’ creditors. Danger entitles the FSA to *issue instructions on the management and to appoint supervisors*. Supervisors are entitled only to take measures in order to avert insolvency proceedings and protect creditors. Further measures require the approval of the banks’ governing bodies. For banks confronted by insolvency, a judicial stay on actions against the bank may be introduced, ie a moratorium creating a breathing space. During this temporary stay the shareholders may in co-operation with creditors and authorities decide on how to proceed. The legislation does not include any provisions on forced mergers etc.[221] *Another question* linked to the formal reorganisation of banks concerns the shareholders’ rights in case of financial assistance. *First*, the Liquidity Consortium Bank (LCB) may grant banks liquidity assistance. The assistance is in the form of loans. Loans generate a claim against the bank without affecting the judicial status of the shareholders. *Second*, the By-laws of the Voluntary Deposit Protection Scheme administered by the Association of German Banks do not exclude direct financial assistance to banks in whatever form. The By-laws do not include provisions on any explicit conditions or implications for such assistance.[222]

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[220] The Banking Act part III, division 4, s. 46.

[221] The Banking Act part III, division 4 ss. 46 and 46a.

[222] By-laws of the Deposit Protection Fund s. 2. – Deposit guarantees according to the Deposit Guarantee and Investor Compensation Act are paid directly to the depositors resulting in the subrogation of depositor claims against the bank and no further effects on bank shareholders. Moreover, according to the German legislation, the Government does not back banks in the case of default. Consequently, there is no need to write down the shareholder value of banks.

The provisions concerning **the liquidation of banks** in the German Banking Act affect the bank's shareholders in many ways. To describe the matters that arise one could concentrate on three main issues, ie a) restrictions in the powers for shareholders to decide on liquidation, b) the absence of further FSA-regulations on the liquidation procedure and c) the level of accuracy of existing insolvency criteria. – *The restrictions in the powers for shareholders to decide on liquidation* are a concrete result of the current law. According to the provisions the petition for the initiation of *insolvency proceedings* may be filed by *the FSA only*, excluding both the bank's shareholders and creditors from initiating the proceedings. Shareholder initiated liquidation (due to the German company-laws) as a means to cease the bank's activities and realise its assets may be used only for sound banks.[223] – Pursuant to the Banking Act the FSA may issue general *instructions regarding the liquidation of a bank*. No such instructions have been issued. As a consequence, there is some uncertainty about the procedure following the initiation of liquidation proceedings. The chosen procedure will have some effect on the shareholders' position. The possibility of reorganising the bank according to the provisions of the Insolvency Act (ie after initiating the insolvency proceedings) would be a valuable alternative for the shareholders, because in the event of compulsory liquidation the shareholders would most certainly lose their capital. In such reorganisation, creditor claims would be cut in accordance with the creditor voting procedures provided.[224] – As mentioned, the German Banking Act acknowledges two *grounds for the FSA to request the liquidation of the bank* that relate to the bank's financial problems. These are *insolvency* and *over-indebtedness*. As the terms are not further defined, some uncertainty on the criteria for initiating insolvency proceedings exist. The separation of insolvency and over-indebtedness as criteria for liquidation indicate that a liquidity aspect is linked to the term insolvency. In other words insolvency means inability to fulfil any obligation. In turn, over-indebtedness follows a balance-sheet logic. One would anticipate that German over-indebtedness covers the situations where the amount of foreign capital exceeds the assets of the bank. The base for calculations would presumably be market values.[225]

Finally, there are a number of different means that may classify as **voluntary reorganisation and liquidation measures**. These measures are applied to banks without financial problems. They may be used by the banks themselves in beforehand to avoid more formal, FSA-administered measures. In short, the voluntary reorganisation measures consist of altering the share capital, mergers and acquisitions. Voluntary liquidation may be carried out in accordance with the

[223] The Banking Act part III, division 4, s. 46b.

[224] The Banking Act part III, division 1, s. 38. – For an overview of the procedures under the Insolvency Act and the preceding Bankruptcy Act and Composition Act see section 3.2.2.

[225] The provisions are included in the Banking Act part III, division 4, s. 46b.

liquidation rules in the German company-laws. – The applicable legislation for reorganisation measures and dissolution is dependent on *the type of the company* (the commercial bank). The Law concerning Limited Liability Companies division 5 regulates the liquidation of GmbH-companies and the Stock Corporation Act part I, division 8 directs AG-companies.[226] *Alterations of the share capital* are not regulated in the Banking Act. Depending on the type of company the Law concerning Limited Liability Companies division 4 and the Stock Corporation Act part I, division 6 apply to alterations. Still, the provisions are quite similar. An increase in the share capital for both types of companies normally requires a majority of three-quarters of the shareholders voting in favour of the increase. In addition, a reduction of the share capital requires that all creditors' claims are satisfied or secured or the creditors consent to the reduction. *Mergers and acquisitions* of banks are regulated to achieve a variety of aims in the German jurisdiction. The Banking Act introduced restrictions on bank engagements (purchase of shares, assets or other engagements) in non-financial companies to manage risk. Competition law, ie the Act against Restraints on Competition applies to mergers between enterprises including acquisitions of assets or shares to protect functioning markets.[227] Company-laws comprise regulations to protect creditor interests in relation to an eventual sale of debtor-assets.

[226] Gesetz betreffend die Gesellschaften mit beschränkter Haftung (GmbHG) and Aktiengesetz, (AktG), respectively.
[227] Gesetz gegen Wettbewerbsbeschränkungen (GWB).

The position of German bank shareholders during bank exit is quite strong. – The powers of the appointed administrator during formal reorganisation only comprise measures to avert insolvency proceedings and protect creditors. Further measures require the approval of the bank's governing bodies. Most Financial Supervisory Authority (FSA) administered reorganisation measures constitute prohibitions and limitations for bank activities. – On the other hand, the shareholders (or creditors) have no right to initiate insolvency proceedings. The decision is made by the FSA only. – The extent to which the Insolvency Act applies to bank liquidation is somewhat unclear. The Insolvency Act includes certain reorganisation procedures that may improve shareholder position and infringe creditor rights.

The Liquidity Consortium Bank (LCB) and the Voluntary Deposit Protection Scheme may provide German banks with direct financial assistance. LCB-assistance is possible for solvent banks and it takes the form of loans only. Assistance from the voluntary scheme may be given to any member bank in any form. No provisions concerning implications of assistance on shareholder value exist in the by-laws of the scheme. – Insolvency and over-indebtedness constitute the criteria for the commencement of insolvency proceedings against banks. The terms are not further defined. – Ambitions to protect the "going-concern" value of the bank in reorganisation and liquidation are more easily detected in the provisions of the Insolvency Act compared to the Banking Act.

5.2.3 Finland

Focusing on the Finnish bank exit regime from *the shareholders' angle*, one would assume that, as anywhere, the degree to which the regulations secure the capital invested is a central feature appreciated by the shareholders.[228] Consequently, one would estimate that procedures for the reorganisation of problem banks that do not require additional investments or abolish shareholder-value are highly valued by the proprietors. As a result of this, the Finnish bank exit regime is presented below categorising measures due to the potential requirements that these reflect relative to shareholders. First, a) *reorganisation means not requiring additional capital* are analysed. Then, b) *rehabilitation*

[228] The theoretical framework in this paper is based on the assumption that the security aspect is two-dimensional. For bank shareholders the security aspect concerns both the security that the law and authorities provide (supervision, financial assistance, etc.) and the amount of powers that the law transfers to shareholders in order to protect their investment.

measures requiring additional capital are covered, where after c) *the actual closing steps* of banks are considered from a shareholder perspective.[229]

When it comes to **reorganisation means not requiring additional capital**, these mainly comprise authority-initiated reorganisation of a bank and certain voluntary reorganisation measures. In theory, *the temporary suspension of the activities of a deposit bank* (regulated in the Law concerning Temporary Suspension of the Activities of a Deposit Bank (1509/2001) also constitute a means for reorganisation. Still, the bank shareholders' judicial position is not significantly altered during the suspension. The Financial Supervision Authority (FSA) is entitled to appoint a representative to supervise the bank during the suspension. Moreover, the suspension restricts the bank's activities and creates a buffer for legal action against the bank. In other senses, the bank shareholders' position is not directly affected. Major problems may arise for bank shareholders only if the bank is unable to present a plan for recovery during the suspension. In this case, the Ministry of Finance (MoF) may withdraw the bank's licence. The net worth of the bank will decrease, harming creditors and shareholders.[230] – *MoF-initiated reorganisation measures* may be seen as the shareholders' lottery ticket. These formal reorganisation means follow the procedure set out in the general Law concerning Reorganisation of Companies (47/1993). When the reorganisation procedure is started the net worth of the bank is presumably low, ie the value of bank shares are marginal or negative. By renegotiating or cutting creditors' claims, conditions for the rehabilitation of the bank are created. The procedure is based on voting and it is court-supervised. If the reorganisation is a success the shareholders will benefit and the creditors will receive the cut claims. If the reorganisation is a failure (ie a later bankruptcy occurs) the creditors may loose parts or all of the cut claims. If no reorganisation had taken place, the shareholders would have lost all of their capital in the bank's bankruptcy.[231] – The legal foundation for *the voluntary reorganisation* of a bank changed to a large

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[229] One of the main aims of the 2002 reform of the Finnish bank exit regime was to enhance the framework of shareholder responsibility in the restructuring of problem banks. During the Finnish banking crisis in the early 1990's substantial amounts of taxpayers' money were injected into Finnish banks without any negative consequences for the banks' shareholders. (For an analysis of the Finnish banking crisis see Nyberg & Vihriälä 1994.)

[230] The former Law concerning Commercial Banks (1269/1990) 28–31§§ also established a similar suspension for banks. Still, there were differences between the two suspensions. First, the criteria for the initiation of the suspensions have changed (see section 3.2.3). Second, an authority initiated formal reorganisation procedure was introduced as an extension to the new suspension. Third, the former law set a time frame of five years for the implementation of shareholder-initiated reorganisation measures. This time frame is abolished in the new legislation.

[231] Before 1.1.2002 the Finnish legislation did not provide for an authority-administered reorganisation scheme (with direct and compulsory implications for bank creditors). The reorganisation of banks was the task of bank shareholders, mainly using traditional voluntary reorganisation means.

extent as a result of the bank exit reform. Mergers, divisions, transfers of activities and the decrease of share capital may be seen as reorganisation measures not requiring additional capital from bank shareholders. Still, the terms of the mergers, divisions and transfers of activities determine the success of the measures and their effect on bank shareholders. – The principles for the regulation of *mergers* before and after the Finnish bank exit reform are presented in section 3.2.3. Earlier, two decisional procedures existed. The procedure applied depended on the character of the merging entities. Today, only one procedure exists. From a shareholder perspective, the reform did not change the main characteristics of the decisional procedure. Shareholders decided and decide on mergers in accordance with similar voting rules. Mergers under the former Law concerning Commercial Banks 25§ required MoF approval. Current mergers require (and former mergers under the Law concerning Limited Liability Companies (734/1978) required) the register authority's approval. A condition for approval is the hearing of creditors. Pursuant to the present legislation the FSA may object to a merger. – The provisions concerning *division and the transfer of activities* are also presented in section 3.2.3. According to the current legal definition, division is an arrangement where the compensation for the assets transferred is made directly to <u>shareholders</u>. Division may concern the whole bank or parts of the bank. When activities are transferred the compensation is paid directly to the bank. The procedure for deciding on division and the transfer of activities are similar to merger. The register authority's approval is needed and the FSA has the powers to object to the division or the transfer.[232] The judicial frame *for the decrease of share capital* as a reorganisation measure also changed due to the reform. As for any company, the bank's shareholders decide on the decrease. The decision about decreasing the share capital is usually made by simple majority. If the decision violates the interests of any shareholder or group of shareholders, the acceptance of each of these shareholders is needed. The way the decrease of share capital is made may have some effect on the redevelopment of the bank and the future capital flows to shareholders. Still, one has to remember that decreasing the share capital may often remain a temporary measure. Success may require constructive structural action. Depending on the aim of the decrease, the register authority's permit is required.[233]

The second best choice for shareholders of a troubled bank is **the reorganisation measures requiring additional capital**. In principle, these alternatives comprise two main options: *a traditional increase of the share capital and the possibility of capital injections more generally*. In practice, capital

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[232] Earlier, division required MoF acceptance. The former definition of division also comprised the transfer of activities.

[233] Applicable provisions concerning an eventual decrease of share capital before and after 1.1.2002 are listed in section 3.2.3. Formerly, MoF approval was required for certain decreases.

injections into Finnish banks (given that they are not in the form of ordinary or subordinated debt) will most probably have the judicial form of an increase (or bargain) of share capital (shares). – *The traditional increase of share capital* is regulated in the Law concerning Limited Liability Companies chapter 4. Increasing the share capital may be used to *prevent* authority action or as *a response* to authority action taken against the bank. The decision about increasing the bank's own capital is made by the shareholders' meeting. There are two alternatives to carry out the increase: by issuing new shares or increasing the value of old shares against payment by old or new shareholders. In theory, company funds may also constitute an increase. The decision about increasing the share capital is made by simple majority. If the decision changes the shareholders' relative position or requires a change of the articles of the company a 2/3 majority is needed. The appropriateness of this measure from the shareholders' angle is partly dependent on the terms for increasing the bank's own capital.[234]

The other measures involving additional capital in order to solve banks' problems are capital injections more generally. To sum up, troubled Finnish banks may receive capital from the voluntary guarantee funds and from the Government's Guarantee Fund. Voluntary guarantee funds are regulated in the Law concerning Credit Institutions (1607/1993) chapter 6. Assistance from the Government's Guarantee Fund to banks or banks' guarantee funds is in turn directed by the Law concerning the Government's Guarantee Fund (379/1992). – In principle, the assistance to banks from *voluntary guarantee funds* may take the form of supportive loans, subsidies or guarantees. Implications for bank shareholders depend on the form of the assistance. Membership of the fund is a condition for assistance. Other criteria for assistance are that the bank is in financial distress and the assistance is needed to continue bank activities.[235] – Assistance from *the Government's Guarantee Fund* differs due to the receiver of the assistance. The Government's Guarantee Fund may issue supportive loans or guarantees to voluntary guarantee funds. Conditions for aid are that the assistance is needed to secure the activities of banks, the stability of the financial markets and that guarantee fund resources are insufficient. The Government's Guarantee Fund may also assist banks directly. The Government's Guarantee Fund may invest in bank shares, issue guarantees for banks' loans and give subsidies to secure the stable functioning of financial markets. The assistance may include

[234] The Law concerning Limited Liability Companies chapter 4 1–2§§ and chapter 9 13–14§§. – Increasing banks' share capital was formerly regulated both in the preceding Law concerning Commercial Banks 28–31§§ and the Law concerning Limited Liability Companies chapter 4. According to the former Law concerning Commercial Banks the increase of own funds could be used as a reparative measure (28§), as a response to authority suspension of bank activities (29–31§§) and as an exit from an already started liquidation procedure (54§).

[235] The Law concerning Credit Institutions 61§.

conditions both for the voluntary guarantee funds and the assisted banks.[236] According to the current Law concerning the Government's Guarantee Fund 12a§, if capital injections into banks are made through subscription of shares issued, the banks' losses should be covered by the old share capital before support is given. The law's 12b§ provides an alternative in the form of nationalising the shares against full payment to the shareholders.[237]

> The reorganisation of Finnish banks is linked to the general procedure specified in the Law concerning Reorganisation of Companies. Under this formal procedure, bank creditors and the court should approve action taken by a provisional administrator to rehabilitate the bank. The aim of the procedure is to secure the continuance of bank activities by cutting bank creditors claims. Implications for bank shareholders are marginal. – What comes to liquidation, bank shareholders may decide on voluntary liquidation of a solvent bank. The MoF may order a bank whose licence has been withdrawn, into compulsory liquidation. Several grounds for register authority-initiated and court-initiated compulsory liquidation also exist. Moreover, Finnish banks may face bankruptcy. – The MoF may decide on the reorganisation of a bank if the bank's activities have been suspended, as an alternative to liquidation. The probability that the MoF would take such steps against a failed bank is quite high.
>
> From 2002 onwards, bank losses should be covered by old share capital before Government assistance is given. An alternative is to nationalise banks against full payment to shareholders. Banks may also receive assistance in the form of subsidies from voluntary guarantee funds. – Financial criteria for the initiation of compulsory liquidation procedures do not exist. The solvency level, i.e. capital adequacy, is linked to the withdrawal of bank licenses and an eventual liquidation. The main criterion for the initiation of bankruptcy is "other than temporary inability to pay one´s debts". – On the whole, the Finnish bank exit legislation is not very concerned with the "going-concern" value of the bank.

The actual closing of Finnish banks may be carried out through *voluntary or compulsory liquidation or bankruptcy*. The legal framework for the different liquidation procedures is presented in section 3.2.3. According to the main rule bank shareholders decide on liquidation. In certain cases or if criteria for compulsory liquidation are met, the court or the register authority should decide

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[236] The Law concerning the Government's Guarantee Fund 1, 11 and 12§§.

[237] The provisions concerning these types of reorganisation means was slightly different under the previous Law concerning Commercial Banks. First, financial assistance to banks required a decision by the bank shareholders' meeting in several cases (29–31§§). Second, the issuance of a guarantee to cover eventual loss of own capital was separately regulated in the former law. Any party could issue the guarantee. The issuance of a guarantee to cover the loss of own capital required a decision by the shareholders. Third, during the old regime shareholders' judicial position was not affected by capital injections from the Government's Guarantee Fund.

on liquidation. There are no explicit financial criteria for compulsory liquidation of a bank in the current legislation. Still, as a result of insufficient own funds, the banking licence may be withdrawn. If the licence is withdrawn, the MoF should order the bank into liquidation. In turn, grounds for bankruptcy are well defined and both the bank and its creditors may file a petition for bankruptcy.[238]

5.3 Reorganisation and liquidation of problem banks in Japan

Though the reforms of the Japanese financial sector have been substantial and the powers have been expanded for the Deposit Insurance Corporation (DIC) to deal with the reorganisation and liquidation of banks the position of the Japanese banks' shareholders has been *fairly well protected*. This is particularly true in comparison with the US regime. On the other hand, certain subsequent amendments to the legislation have altered the strong tradition of shareholder protection. The best-known example of a major change in values was the introduction of temporary nationalisation as a reorganisation measure in 1998.[239] – To receive a picture of the implications of the varying Japanese legislation on the banks' shareholders position one should distinquish between the period *before and after 1998*. Similarly, one may distinguish between *compulsory* (ie authority or creditor initiated) rehabilitation and liquidation measures against the bank and *bank-initiated* reorganisation and liquidation. Considering these terms, the analysis may be structured in the following way. First, a) *compulsory action before 1998 is described* where after b) *compulsory action from 1998 onwards* is covered. Then, c) *bank-initiated reorganisation and liquidation* are analysed.[240]

Starting with **compulsory action before 1998**, eventual measures affecting the banks were initially taken by the bank's creditors, not the authorities. This was due to the fact that the Japanese Deposit Insurance Law provided the DIC with no means to reorganise or liquidate banks confronted with financial problems. Similarly, no other legislation provided such powers to any authority. As referred to above in section 3.3. DIC's original functions were restricted to the pay-off of depositors in the 1971 version of the Deposit Insurance Law. In principle, the pay-off of insured depositors did not affect the bank's shareholders. The DIC only

[238] For viewpoints on the rules concerning bank liquidation at the time before the bank exit reform see section 3.2.3.

[239] For viewpoints on shareholder structure and corporate governance issues relating to Japanese banks see Kanaya & Woo 2001 p. 23ff.

[240] The Japanese Bankers' Association (Zenginkyo) 2001 pp. 44–73 lists the most important legal reforms directing Japanese banks and also covers the general implications of the reforms on bank shareholders.

received subrogation rights relative to paid off depositors. In other words, compulsory action against banks at that time was a question of *creditor initiated measures*. As reorganisation, according to the Japanese legislation, required the consent of the bank, only creditor-initiated liquidation (ie bankruptcy proceedings) constituted compulsory action. Creditor initiated bankruptcy proceedings for commercial banks under the Japanese jurisdiction were possible due to *the Bankruptcy Law* and *the Commercial Code*. The shareholders' position in both procedures was straightforward. The number of criteria for the initiation of the proceedings was three. The criteria comprised a) the debtor's lack of ability to pay his debts, b) the debtor's suspension of payments of his debts and c) the excess of debtor's liabilities over his assets. In most cases the result of bankruptcy proceedings for the banks' shareholders would have been clear giving the criteria for the initiation of the proceedings. The shareholders would not have received any funds in the realisation of the bank's assets and distribution of the proceeds. The only means left for the shareholders before and under the bankruptcy procedures would have been creditor-binding reorganisation and composition. In theory, this would have been possible due to *the Corporate Reorganisation Law, the Composition Law* and as compulsory composition under *the Bankruptcy Law*. – In practice, Japanese problem banks were dealt with quite differently during this period. Problem banks were merged with healthy entities on conditions developed by the Ministry of Finance (MOF) and the financial sector. This meant that the shareholders' position depended on the terms of the mergers.[241] – In 1996, when the Deposit Insurance Law was amended, *DIC was entitled to apply to the court* for the initiation of both compulsory bank *reorganisation* and *liquidation proceedings*. The fact that DIC was given the right to initiate reorganisation increased the possibility for problem banks to reorganise. DIC initiated reorganisation might have been seen as a signal to bank creditors to approve the reorganisation scheme and accept cuts in their claims. From a shareholder perspective, the reorganisation of an insolvent bank would have been a valuable option, since Japanese reorganisation did not endanger the position of shareholders.

In 1998, the theoretical position of the Japanese banks' shareholders partly changed. *The Financial Reconstruction Law* affected the bank shareholders' position. – The law established *the financial reorganisation administrator-scheme* to deal with failed banks or banks in danger of failing. Financial reorganisation administrators were appointed to banks that met certain criteria. Assessment was based on Financial Services Agency (FSA) examinations. The criteria for the appointment of the administrators are (since 2001) listed in the Deposit Insurance Law s. 74. The main duties of the administrator comprised the operation and

[241] For a more comprehensive analysis of the period in question see Milhaupt 1999 pp. 11–16 and 23–24.

management of assets of the failed bank and the transfer of the bank's business to other banks.[242] Provisions stated that the administrator was given the same authority as *the president* of the bank with respect to its business operations and assets. According to the main rule measures should be taken within one year of the appointment of the administrator. However, the fundamental measures required for reorganisation of the bank were mainly the responsibility of the board and the shareholders' meeting. As a consequence the administrator was forced to co-operate. The outcome of co-operation with the shareholders of a bank that is in danger of failing is easily estimated. As the shareholders would lose their money in the case of bankruptcy, they all vote for reorganisation. – While the administrator-scheme in some senses reflected a continuity of shareholder protection, *temporary nationalisation of failed banks* (also introduced in 1998) may be interpreted as the end of Japanese shareholder protection. Temporary nationalisation meant that the DIC obtained the bank's shares and placed it under special public management. The fact that the bank was insolvent or nearly insolvent and there was a systemic risk posed by the bank's failure constituted the conditions for action. Initially, the Financial Reconstruction Commission (FRC) set the terms for the nationalisation, ie the FRC decided on the price payable to shareholders. Since 2001, decisions have to be taken by the Prime Minister's Office. Especially in cases when the bank is nearly insolvent problems may arise. From a judicial perspective, the rights of the shareholders may easily be infringed in the determination of share value.[243]

Furthermore, the implications of **bank-initiated means** (ie bank or shareholder-initiated or -approved reorganisation and liquidation measures) on shareholder rights are an interesting subject. It is clear that few threats to shareholders may appear through measures that are initiated or approved by the shareholders. On the other hand, the voluntary means represent several avenues for *improving the shareholders' position*. Very often, the possibility to improve the bank's status through reorganisation is connected with an increased *risk for the bank's creditors* to suffer capital loss. In order to analyse the effects of bank-initiated means on shareholder position the different means are listed below. First, reorganisation measures that do not infringe creditor rights are addressed. Second, reorganisation measures affecting the bank's creditors' position are described. Finally, the main characteristics of voluntary liquidation are presented. – In case of *bank-initiated reorganisation measures not infringing creditor rights* applicable means comprise a) voluntary mergers and acquisitions, b) changing the share capital, c) reorganisation according to the Commercial Code, d) DIC financial assistance and e) DIC purchase of stock and subordinated bonds.

[242] Deposit Insurance Law ss. 77 and 90.

[243] A presentation of the Japanese legal reforms in 1998 is found in Hall 1998 (b) pp. 12–14 and Milhaupt 1999 pp. 25–28.

Voluntary mergers and acquisitions by banks are regulated in the Japanese Banking Law chapter V and require the approval of the MoF. In addition, the Law concerning Amalgamation and Conversion of Financial Institutions and the Antimonopoly Law (competition law) are applicable to voluntary bank mergers and acquisitions. *Alteration of share capital* is covered by the Commercial Code. Increasing the share capital improves the creditor position but capital decrease may harm creditors. While creditors consent is required pursuant to the Japanese Commercial Code creditors' rights are not infringed. *Reorganisation pursuant to the Commercial Code* (company arrangements) also requires the consent of all creditors. Consequently it does not endanger creditor rights. In 1986 DIC's mandate was enlarged to comprise also *financial assistance* to problem banks in order to facilitate mergers or acquisitions. Assistance was in the form of subsidies, loans or guarantees. In the case assistance covered subsidies no special requirements in relation to the banks' shareholders existed. As a result, a foundation was laid for the transfer of substantial amounts of taxpayers' money to bank shareholders. Still, the detailed conditions under which the mergers or acquisitions were made determined how shareholders were affected. The Financial Function Early Strengthening Law of 1998 introduced capital injections to banks in the form of *DIC's purchase* of common and preferred stock and subordinated bonds. The terms according to which purchase was made were dependent on a scheme based on the level of the banks' capital adequacy. The capital was supplied upon application by the banks. In practice, all purchases improved the position of bank shareholders, creating at least temporary conditions to continue the banks' activities. The Financial Function Early Strengthening Law also enabled DIC to grant banks subordinated loans, not only purchase subordinated bonds.

There is also a number of *bank-initiated reorganisation measures affecting creditor rights*. By limiting creditor rights the possibility of rehabilitating the bank was increased. Creditors' rights were mainly infringed by accepting majority votes in deciding on rehabilitation. Certain reorganisation measures also blocked the action, ie realisation of assets, by secured creditors. – *The Japanese Reorganisation Law* introduced court-based reorganisation as a rehabilitation alternative. This type of reorganisation automatically prevented secured creditors from realising the security. Secured and unsecured creditors and preferred and regular shareholders were required to vote on the reorganisation plan through a "cram down" procedure. The requisite majority for approval varied with each class. After creditor and shareholder acceptance, the court had to approve the plan. – *The Composition Law* introduced a composition procedure (ie creditors relinquishing parts of their demands) as an avenue for promoting the future existence of the bank. This procedure did not affect the secured creditors' position and they were able to possess the same rights of separation that they could in debtor bankruptcy. Japan's Composition Law does not contain detailed criteria for

the acceptability of the composition plan. Still, unsecured creditors holding at least three-fourths in amount of the allowed claims must approve the plan. Similarly, more than one-half in number of unsecured creditors who attend the creditors' meeting should support the plan in addition to the court. – "The compulsory composition" offered by *the Bankruptcy Law chapter IX* broadened the arsenal of creditor-binding rehabilitation means. In other words, compulsory composition was compulsory in relation to the bank's creditors. A bankrupt debtor may propose a compulsory composition at any time during bankruptcy. Creditors' majority as well as the court's support is required for the approval of the composition. Companies seldom use compulsory composition. In this sense, filing for bankruptcy is seen as final.[244]

Japanese bank shareholders' position is not as strong as it used to be. – Currently, authority-initiated reorganisation of Japanese banks is carried out in accordance with the financial reorganisation administrator-scheme. The scheme gives the administrator the powers of the bank's president. The administrator is forced to co-operate with bank shareholders and creditors. – Japanese banks may be liquidated on a voluntary or compulsory basis. The bank itself, its creditors and the Deposit Insurance Corporation (DIC) may initiate the liquidation or bankruptcy. – Experience indicates that reorganisation is a very probable alternative to bank liquidation in Japan.

Earlier, financial assistance had no effect on bank shareholder position. DIC was entitled to facilitate mergers between the bank in question and other banks. Only the terms of the mergers directed the outcome for bank shareholders. The introduction of temporary nationalisation as a reorganisation means clearly weakened the position of bank shareholders. The authorities set the price to which the bank was purchased. – The criteria for the initiation of bankruptcy proceedings against the bank were three: the inability to pay debts, the suspension of debt-payments and the excess of liabilities over assets. – The introduction of the "bridge bank"-scheme to handle bank mergers and acquisitions may be seen as the best example of provisions aiming to secure the "going-concern" value of the bank. Securing the bank's "going-concern" value in the realisation of bank assets is important also to bank shareholders.

[244] In principle, *the voluntary liquidation* (dissolution) of a Japanese bank is possible only due to MoF sanction. To be effective, the bank's shareholders decision in accordance with the provisions of the Commercial Code has to be approved by the authorities (the Banking Law chapter VI s. 37). General criteria for the dissolution of a company in the Commercial Code are not applicable to banks. On the other hand, Japanese banks that have lost their license should be dissolved in accordance with the Banking Law chapter VI s. 40.

6 Conclusions

In principle, concluding remarks on the viewpoints presented in this paper could reflect several aims. Still, since this paper is restricted to a comparison of the legal rules and practices of bank exit, the conclusions drawn here will be legally oriented. The concluding remarks concentrate on extreme alternatives in the security and the powers that the bank exit regimes provide the different bank stakeholders in the various financial centres. In other words, *a selective summarisation* of the security and powers received by bank creditors, depositors and bank shareholders is presented below.

Analysing **bank creditor** security and powers, the variation represented by the different regimes is high. The most central *security and power issues* relate to the fact that a) banks are supervised differently, b) they may or may not receive financial assistance, c) the bank exit regimes eventually comprise means aimed to preserve banks "going-concern" value during reorganisation and liquidation, d) bank creditors may or may not initiate bankruptcy and e) creditor claims may be cut in bank reorganisation in many financial centres. – What comes to *banking supervision*, the one extreme is the New York/US (and Tokyo/Japanese) "Prompt Corrective Action" scheme (PCA) combined with risk-classification systems. The scheme obliges the authorities to act. Before carrying out on-site inspections the authorities should identify the particular risks of the bank in question. Accordingly, the areas inspected should relate to the risks identified. On the other hand, the jurisdictions of most European financial centres only entitle the supervising agencies to act. The means applied to failing banks are to a larger extent subject to authority discretion. – According to the various bank exit regimes, *financial assistance to banks* derives from several sources. One feature of the deposit insurance system in the EU is that deposit insurance funds may not be used to assist banks, only to pay off insured deposits. Both Helsinki/Finland and Frankfurt/Germany have some kind of formal or informal channels to support banks. In London/UK, the procedures to support banks are largely undefined. In New York, the Federal Deposit Insurance Corporation (FDIC) may provide insured banks with assistance from the insurance fund. The FDIC has to choose the least cost alternative (ie assistance relative to paying off insured deposits) for action. Moreover, US creditors (only) are worse off in the realisation of the bank's assets since their claims are subordinated depositor claims. The Tokyo regime resembles the New York regime. In Japan, funds from the banking industry, the Bank of Japan (BoJ), local governments etc. have also been used to aid ailing banks.

The most developed formal *means to protect banks' "going-concern" values* are found in the US bank exit regime. In addition, the US jurisdiction announces the aim of conservatorship (ie reorganisation) to be the protection of the bank's

"going-concern value". Bridge banks and new banks constitute such means. These measures are most important for bank creditors. The European and Japanese perspective on failing banks is quite contrary. In Europe and Japan the emphasis is on the continuance of bank activities. – Another area of interest when analysing differences in the position of bank creditors in various financial centres is *creditor powers in the initiation of bank bankruptcy*. Though one would consider this to be an option for any bank creditor, this is not possible pursuant to the laws applied in Frankfurt and New York. In Germany insolvency proceedings against banks may be initiated by the Federal Banking Supervisory Office (FBSO) only. In the USA, both reorganisation and liquidation are authority-initiated and administered. Creditors have no rights to influence the procedures, and grounds for judicial review of authority decisions and actions are restricted. In London, Helsinki and Tokyo, creditor-initiated bankruptcy is an option (at least in principle). – The last main feature of the bank exit regimes relevant to bank creditors is *the eventual cutting of creditor claims* in the reorganisation of problem banks. In Helsinki, this was not a realistic alternative until the 2002 bank exit reform. Due to the reform, formal procedures for cutting creditor claims were introduced. The procedures aim to create conditions for the continuance of bank activities and do not affect shareholder position. The London court-based system opens up the possibility of similar measures. The Frankfurt and Tokyo regimes have no history of such measures taken, though in theory they include such means. The system in New York stresses shareholder responsibility for the bank failure and does not allow for creditor rights to be infringed in such a manner.

The second group of bank stakeholders affected by an eventual bank exit is **the depositors** of the banks. In order to describe the variety of security and powers provided by the bank exit regimes to depositors, the following main topics are looked into. These are a) the amount of compensation provided by the deposit protection schemes, b) eventual scheme requirements concerning depositor character, c) time limits for the pay-off of depositors, d) the type of scheme manager powers relating to the pay-off, e) eventual depositor claim priority over ordinary creditor claims in the realisation of bank assets and f) the eventual existence of government guarantees for the schemes' obligations. – In case of *the amount of compensation provided* to depositors the differences between the schemes are significant. The voluntary German scheme may provide cover up to 30 per cent of the liable capital of the ailing bank in question. US depositors are protected in full up to USD 100.000. In Europe, EU-directives create minimum standards for national protection. The amount protected should be at least EUR 20.000. The compensation for the amount protected should not be below 90 per cent. In Japan, the actual protection limit is JPY 10 million (~ EUR 87.000). Compensation is paid up to 100 per cent. In addition, the Japanese scheme may pay off deposits exceeding the limit to the extent that funds will be available from the liquidation of the bank. In 1996, the Japanese Government promised to protect

the full value of deposits under all circumstances. This promise is still in effect. – Some deposit protection schemes also comprise *requirements concerning depositors* as conditions for the pay-off of deposits. In the event of failure of London banks, deposits made by larger companies, certain persons linked to the bank in question, other financial institutions etc. are not protected. In New York, a depositor being a company does not constitute or abolish deposit protection. Still, the judicial form of the claim against the bank is central when estimating the scope of deposit cover anywhere. – In some financial centres there are *time limits for the pay-off* of depositors, in others payment is based solely on authority discretion. EU-directives establish a time frame of three months for the payment of compensation to depositors calculated from the decision concerning the compensation. This time frame may be extended. In New York, payment should be made "as soon as possible" by the FDIC. In Tokyo, specific procedures that enable the Deposit Insurance Corporation (DIC) to pay immediate compensation to meet living expenses have been introduced.

Regarding *scheme manager powers*, the regulatory regimes of certain financial centres enable scheme managers to pay compensation, whilst other oblige managers to pay once the authority decision concerning the bank's insolvency has been made. EU-directives require that national procedures for the judicial review of decisions on the payment of compensation will be established. In those financial centres where direct financial assistance from deposit insurance funds to banks is an alternative to the pay off of depositors (ie New York and Tokyo) scheme managers are entitled to pay compensation to depositors. The German voluntary scheme is extraordinary in the sense that it explicitly poses no obligation for the scheme manager to pay off depositors (or provide any other support direct to banks or others) under any circumstances. – Of importance, especially to depositors whose claims exceed the compensation limits, is the fact whether *depositors are in a priority relative to ordinary creditors* in the realisation of the debtor bank's assets. On this point, only the US bank exit regime represents such a set up. All the other jurisdictions consider depositors and ordinary creditors equal under the law. The payment of compensation also results in scheme manager subrogation of depositor claims in all financial centres. In the US, claims transferred to the FDIC are likewise in priority relative to ordinary creditors. – Finally, only in New York (and for the time being in Tokyo) *deposits are guaranteed by the Federal Government.* In New York, deposits are guaranteed for deposit fund insolvency up to the compensation limit. As mentioned, the Japanese Government currently guarantees all deposits. In EU financial centres, the deposit cover is (at least in theory) restricted to deposit insurance funds.

The last group of bank stakeholders whose position has been analysed in this paper is **the bank shareholders**. The security and powers provided by the bank exit regimes for bank shareholders may be analysed by focusing on three areas.

These are a) the probability of the bank receiving subsidies, b) the possibility of cutting creditor claims in order to secure the continuance of bank activities and c) the powers of the provisional administrator in bank reorganisation. In all areas the jurisdictions of the various financial centres represent quite varied arrangements. – *The probability of the bank receiving subsidies*, ie such financial assistance that would directly benefit bank shareholders, is the most valuable option for the shareholders. In most financial centres, financial assistance is usually considered to be in the form of ordinary or subordinated debt. Eg in New York, shareholder responsibility for the bank's condition is emphasised in all situations. This fact has restricted such financial support to banks that would directly increase shareholder value. In Tokyo and Helsinki, banks have received subsidies, though the new reorganisation means involving public funds are constructed to promote shareholder responsibility. In London and Frankfurt, the forms for public bank assistance are not defined. – The second best option for bank shareholders is *the cutting of creditor claims* in order to create conditions for the continuance of bank activities. This alternative is usually executed through a formal reorganisation procedure. From a shareholder perspective, this type of reorganisation may be seen as a lottery ticket, since without reorganisation the bank would most certainly be liquidated and the shareholders would lose their investments. The jurisdictions of all financial centres, except for New York, comprise such measures. The motives not to introduce such measures are the same as for restricting direct subsidies to banks. – The last area significant to bank shareholders is the eventual *powers of the provisional administrator* during bank reorganisation. This has been a hot topic in the European context as a result of the Panagis Pafitis-verdict by the European Court of Justice (ECJ). To sum up, the powers of the US authorities in relation to bank shareholders are extensive in comparison with European standards. The integrity of bank shareholders is emphasised in the EU and is currently strongest in Germany. The powers of Japanese provisional administrators resemble the ones of German administrators.

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