

DEPOSIT INSURANCE REFORM IN CANADA

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I. Introduction

The plight of the deposit insurance system has been obscured by the larger debate surrounding the restructuring of the financial services industry. Yet most observers recognize that the integrity of the deposit insurance system is crucial to the future health of that industry.

The first section of this paper will outline and analyze various proposals for reforming the present system of deposit insurance by reviewing the reports of the Wyman, Senate, Dupré and House of Commons committees. The second section will set forth the author's views as to the changes which must be made if the system is to be satisfactorily rebuilt. The perspective informing the whole of the discussion is that certain features of the deposit insurance system are inherently destabilizing and that only those measures which address these destabilizing influences in a meaningful way are likely to prove useful.

II. The Wyman Committee Report¹

In January of 1985 the Minister of State for Finance announced the formation of a committee (the "Wyman Committee"²) to study the operations and structure of the Canada Deposit Insurance Corporation (hereinafter "CDIC").³ The Committee's final report was released to the public and referred to the House of Commons Standing Committee on Finance, Trade and Economic Affairs some five months later.

In light of the private sector backgrounds of the members of the Committee, it might have been expected that a call for less regulatory intervention would issue forth from it. In fact, as will become evident below, implementation of the Committee's recommendations would result in a significant broadening of the CDIC's responsibilities and authority. While the final report does contain numerous affirmations of belief in the virtues of "market discipline", only a very limited degree of such discipline would be introduced to the system were the Committee's recommendations to be followed. It appears that, in the final analysis, the impulses of the Committee members in the direction of a deregulated marketplace were overwhelmed by the impetus towards re-regulation which has been generated by the recent problems in the deposit-taking sector.

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1. Canada, *Final Report of the Working Committee on the Canadian Deposit Insurance Corporation* (CDIC) (Ottawa: Minister of Supply and Services Canada, 1985) (Chair: W.R. Wyman).

2. The committee's chairman was W. Robert Wyman. Its other members were Andre Bedard, Hugh M. Brown and J. L. A. Colhoun.

3. Specifically, the Committee's terms of reference required it to examine and make recommendations on the following topics: objects of deposit insurance; possible reforms of deposit insurance; funding; supervision and monitoring of member institutions; lessons from recent member institutions failures; rehabilitation and liquidation of member institutions; organization and staffing; and, the public relations of the corporation.

A. The Role of CDIC

1. Insurance

The Wyman Committee would grant to CDIC significantly greater discretion than it currently possesses with respect to the granting, renewal and termination of insurance coverage. Specifically, the Committee recommends that all companies be required to apply for insurance,⁴ that the contract of insurance be subject to annual renewal, that CDIC be empowered to terminate a federally-incorporated member's insurance for cause,⁵ and that CDIC have the right automatically to review a member institution's contract of insurance upon any transfer of ownership control. In addition, the Committee suggests that in individual cases CDIC be authorized to amend the contract of insurance, the terms of which are currently statutorily prescribed.

2. Monitoring of Member Institutions

The report advocates a far more active role for CDIC in this area, recommending that all member institutions be required to report to CDIC on at least a quarterly basis and advocating the adoption of the "Uniform Bank Reporting System" used by the Federal Deposit Insurance Corporation in the United States. The Committee favours, as well, empowering CDIC to impose special charges on those member institutions whose behaviour results in the incurring of additional surveillance costs.

3. Regulatory powers

As noted above, one of the most striking features of the Wyman Committee Report is the extent to which it would accord new powers to the CDIC.⁶ The expressed reasons for doing so are four-fold: to achieve better coordination between CDIC and primary regulators; to cause regulated institutions to "pay more attention to CDIC than has sometimes been the case in the past";⁷ to ensure that CDIC has authority commensurate with its responsibilities; and, to assure that appropriate action is taken quickly and effectively in the event of an insolvency.

4. Under the current legislation, chartered banks and federally incorporated trust and loan companies receive deposit insurance automatically, while provincially incorporated institutions receive insurance on application. See the *Canada Deposit Insurance Corporation Act*, R.S.C. 1970, c. C-3, ss. 14 and 16 [hereinafter *CDIC Act*].

5. CDIC has the power to terminate only provincially-incorporated members' insurance for cause under the current Act. See *CDIC Act*, s. 25.

6. The new powers which would be accorded to CDIC by the Wyman Committee are as follows: i) power to order a member to either cease doing any act or pursuing a course of conduct deemed by the regulators to be contrary to the Act under which it is operating or which may be prejudicial to the well-being of the member; ii) power to work out a voluntary compliance program with a member; iii) power to put conditions on a member's license to carry on business subject to being removed when the reason for the conditions is corrected; iv) power to hold hearings which would give rise to the program or the conditions contemplated above; v) power to require a member institution to cease conducting a particular type of business and, if this business is being conducted in a subsidiary, power to restrict the downstreaming of funds to the subsidiary; vi) power to alter the leverage ratio of a member institution; vii) power to require a change in the management of a member institution; viii) power to take possession and control of the assets of a member institution carrying on unsound business practices and in these circumstances appoint managers and deal with its business; and ix) power to require the winding up of a member institution and to become its liquidator if it so chooses.

It should be noted that CDIC would be limited to acting in circumstances in which it was concerned that necessary action was not being taken by the responsible regulator.

7. *Supra*, note 1 at 18.

B. Market Discipline

The conventional view, articulated in the Wyman Committee Report, is that the current structure of the deposit insurance system, combined with the tendency of governments to compensate uninsured depositors, have caused the "natural disciplines" of the financial marketplace to disappear, with resultant reductions in efficiency and increased risk to the insurer. While the report professes adherence to the goal of restoring these disciplines to the system by imposing discipline on depositors and on the shareholders and management of financial institutions, the recommendations made do not, in fact, address the perceived problems in a meaningful or systematic fashion.

1. Co-Insurance

The only participants in the deposit-taking sector who would be subject to a meaningful degree of "market discipline" under the Wyman Committee recommendations are depositors. In order to provide an incentive to depositors to make informed judgments about the institutions with which they deal, the report recommends the phasing in over three years of a system of first-dollar co-insurance, under which 90 percent of a deposit between zero and \$100,000 would be insured.

2. Multiple Accounts

Under the current system, insurance coverage far in excess of the nominal \$60,000 limit can easily be obtained, either by maintaining deposit accounts with different institutions or by maintaining separate accounts in one institution.⁸ The report rejects,⁹ for reasons of cost and complexity, a system of coverage which would impose a ceiling on the amount any depositor could receive from the deposit insurance fund in respect of deposit accounts with all insured institutions.¹⁰

3. Brokered Deposits

A deposit broker places deposit funds with a financial institution on behalf of a depositor, often receiving a commission from the institution for doing so. This practice has implications for the stability of the deposit insurance system for two principal reasons: first, large deposits are frequently parcelled out among various institutions for the express purpose of maximizing insurance coverage; and second, the practice of paying commissions may create incentives on the part of brokers to select a depository without regard to its solvency.¹¹ The Wyman Committee's view is that the problems associated with deposit brokering can best be addressed by adopting a co-insurance system and by according new powers to CDIC.¹²

8. The potential for multiplication of coverage through the maintenance of separate accounts in one institution is more limited and arises through the use of trust and joint accounts.

9. *Supra*, note 1 at 32.

10. *Ibid.* The committee preferred reliance on a system of first dollar coinsurance as a means of addressing this problem.

11. Moreover, brokered funds are characteristically extremely volatile, and the Wyman Committee cites evidence to the effect that many of the recently-troubled financial institutions relied heavily on brokered funds: *ibid.*, at 31. On the other hand, many schedule B chartered banks and smaller financial institutions, lacking extensive branch networks, are dependent upon such funds.

12. The Committee recommends that CDIC have the power to impose a freeze on brokered deposits, a ceiling as to the percentage of brokered deposits to the total deposit base, or a modest annual growth rate on brokered deposits: *ibid.*, at 32.

4. Uninsured Depositors

The report is critical of the tendency of governments to compensate uninsured depositors, arguing that this causes large depositors to be insufficiently concerned about the solvency of those institutions in which they place their funds. Nevertheless, no measures which would directly address this problem are contained in the report.

5. Risk-Related Premiums

Under the current deposit insurance system, a single insurance premium rate is charged to all member institutions, with no variation based on the degree of risk a particular institution is seen to present to the deposit insurance fund.¹³ Under a risk-related premium structure, insurance premiums would reflect the perceived relative riskiness of different institutions. Higher premiums would affect profitability and presumably act as an incentive to management to alter practices to the extent necessary to qualify for lower premiums. The Wyman Committee acknowledges the theoretical attractiveness of risk-related premiums, but concludes that "... it is not possible at the present time for CDIC to establish a system of risk-related premiums."¹⁴ The reasoning on which this conclusion is based is as follows: first, there is no consensus on how to measure risk objectively; second, it is impossible to forecast risk and measure it before it occurs; third, the imposition of premiums costly enough to produce the incentive to reduce risk-taking may in fact have the result of encouraging excessive risk-taking to cover the higher costs; and fourth, the implementation of a risk-related premium could give rise to the development of an extensive appeal program as member institutions would frequently disagree with their assessments.¹⁵

6. Private Sector Participation in the Provision of Deposit Insurance

A number of observers¹⁶ have suggested that the entry of private insurers to the deposit insurance market should be facilitated. Their argument is that the decisions of private insurers with respect to whether or not they would be prepared to provide coverage, and if so on what terms, would convey concrete market-based judgments to the various actors in the system and thereby affect behaviour in material, and ultimately positive, ways. This topic is discussed only in passing in the Wyman Committee report; the Committee concluded that "the private sector insurance market does not have the capacity to provide any meaningful amount of additional insurance."¹⁷

13. It is argued that this amounts to requiring low-risk institutions to subsidize high-risk institutions through the unrealistically low insurance premiums that the latter pay. See, for instance, Edward Kane, *infra*, note 16 at 1-2.

14. *Supra*, note 7 at 27.

15. The report recommends as a substitute for risk-related premiums the use of penalty premiums to compensate for the added costs of monitoring problem institutions: *ibid.*, at 19 and 27.

16. See for example, G. Benston, "The Regulation of U.S. Banking" and E.J. Kane, "Correcting Incentive Problems in U.S. Deposit Insurance: The Range of Alternative Solutions" (Conference on the Changing Regulatory Environment for Canadian Financial Institutions, Toronto, 18 May, 1985) (Toronto: Insight, 1985); E. Short and G. O'Driscoll, Jr., "Deregulation and Deposit Insurance" (September 1983) *Economic Review* (Federal Reserve Bank of Dallas) 11.

17. *Supra*, note 1 at 28.

7. Capital Requirements

The report maintains that the existence of a strong capital base is both the best insurance against loss to depositors and a significant form of market discipline, creating an incentive on the part of shareholders to closely scrutinize the performance of management. Accordingly, the Committee recommends an increase in initial capital requirements for entrants to the deposit-taking sector; the adoption of uniform standards with respect to the definition of capital and the computation of leverage; and the setting of maximum leverage ratios for individual institutions, based on particularized risk analyses.¹⁸

C. Conclusion

Under the framework envisaged by the Wyman Committee, CDIC would have an expanded monitoring role, appreciable authority over the ongoing operations of deposit-taking institutions and significant new powers both with respect to "insurance" decisions and brokered funds. In systematically rejecting various devices which would have the effect of introducing "discipline" to the system, the Wyman Committee's recommendations would ensure that the participants in it would not have to bear the immediate financial consequences of their actions to any greater degree than is presently the case. Only depositors would feel the direct effects of the recommendations. This is curious in light of the report's expressed point of departure: ". . . the primary object of CDIC should be to insure small unsophisticated depositors against loss and to administer the Deposit Insurance Fund."¹⁹

III. The Senate Committee Report²⁰

The interim report²¹ of the Standing Senate Committee on Banking, Trade and Commerce contains a reasonably thorough discussion of the role of CDIC, and, subject to one noteworthy exception,²² largely rejects the Wyman Committee's vision of a "super-CDIC". By contrast, the Committee's treatment of "market discipline" is extremely abridged, addressing directly only the topic of co-insurance. The issues of multiple accounts and private sector participation in the provision of deposit insurance are not mentioned, and the only reference to risk-related premiums is the observation that ". . . none of the witnesses who appeared before us was willing to argue for risk-related premiums."²³ Similarly, while expressing the view that capital requirements should be "enhanced" and that new reporting requirements should be instituted with respect to brokered deposits, the report provides no specifics with respect to these recommendations.²⁴

18. It is interesting to note that in this context the Committee does seem to have come to the conclusion that it is possible to develop individualized risk profiles: *ibid.*, at 26.

19. *Supra*, note 1 at 14.

20. Canada, Interim Report of the Standing Senate Committee on Banking, Trade and Commerce: Deposit Insurance (Ottawa: Queen's Printer, 11 December 1985) (Chair: L. Murray).

21. The Senate Committee's final report had not been made public at the time of the writing of this article.

22. That exception, to be noted below, is problem institutions, in respect of which the Senate Committee would grant broad powers to CDIC.

23. *Supra*, note 20 at 11.

24. Apparently details will be provided in the Committee's final report.

A. The Role of CDIC

1. Insurance

The committee would grant broader discretion to CDIC both with respect to applications for coverage and with respect to the maintenance of existing coverage, and would authorize CDIC to set standards in these regards. Under the Senate Committee recommendations CDIC would not, however, possess the authority to withdraw coverage from a member institution. Rather, in specific circumstances it would have the capacity to require the responsible minister either to accept its recommendation of withdrawal of coverage or to agree to guarantee any CDIC liabilities with respect to the institution in question arising after a specified date.

2. Regulatory Powers

The Senate Committee report expresses the view that the traditional separation of functions in Canada between the regulator and the insurer should be preserved, and that CDIC should continue to be constituted as a separate institution with the primary responsibility of acting as an insurer. It is for this reason that, in the main, the report rejects the suggestion of the Wyman Committee report in favour of granting broad new powers to CDIC. Nevertheless, for reasons nowhere clearly expressed, the Senate Committee would grant new powers to CDIC to enable it to deal more effectively with "problem institutions".²⁶

B. Market Discipline

1. Co-Insurance

The Senate Committee rejects the Wyman Committee's recommendation of first dollar depositor co-insurance for the following reasons. First, it sees such a system as being inconsistent with the goal of small depositor protection, which it views as the primary rationale for the existence of deposit insurance; second, the committee believed that it is inappropriate to impose a duty of risk assessment on the average depositor; finally, the report states that the introduction of such a system would likely confer an undue advantage on larger institutions, which are generally viewed by consumers as being "failure proof".

Nevertheless, arguing that co-insurance would benefit the system, and citing evidence to the effect that 96 percent of chartered bank deposits are in amounts less than \$20,000,²⁶ the Senate Committee report recommends

25. *Supra*, note 20 at 5. These powers would include: the authority to alter leverage ratios of member institutions; the authority to issue cease and desist orders with respect to selected activities or practices of member institutions; the authority to lend its support to initiatives such as mergers or takeovers; and, the authority to advance liquidity to a member institution on assignment of assets, if such action is deemed consistent with protecting the integrity of the deposit insurance fund.

This recommendation is curious given that it is in precisely these situations that the insurer and the regulator may have differing interests.

26. The figures with respect to the distribution of bank deposit accounts by account balance may be found in the Canadian Bankers' Association brief "Comments on the Final Report of the Working Committee on the Canada Deposit Insurance Corporation" (September, 1985) Brief of The Canadian Bankers Association. [unpublished] Appendix 2.

the eventual introduction of a system of co-insurance which would affect deposits beyond the \$25,000 threshold.²⁷ Under this proposal, deposits in amounts between \$25,000 and \$75,000 would be insured up to 80 percent, with no coverage for amounts in excess of \$75,000.

2. Segregated Pools

The Senate Committee report is alone among the reports reviewed in endorsing the funding proposal of the Canadian Bankers' Association calling for the creation of "segregated pools," one each for chartered banks, trust companies and credit unions. While premium rates would be identical across the pools, rebates would be possible on a "pool-specific" basis, and losses arising from the failure of an institution would be funded out of the contributions of other member institutions in its pool. It is argued that the institution of such a system would produce incentives in the direction of industry self-regulation. In the words of the Senate Committee report: "... it will be in the interest of all trust companies that their primary regulators are doing an effective job because the failure of a trust company anywhere will saddle them with surcharges to cover the resulting CDIC liability."²⁸

C. Conclusion

As noted above, the Senate Committee's discussion of the relevant issues is incomplete. Moreover, one can legitimately question the perspective which informs the report's discussion of the role of CDIC, namely that the separateness of the insurance and regulatory functions must be maintained. Indeed, the report is internally inconsistent in this respect, advocating that new powers—parallel to those of the primary regulator—be granted to CDIC to deal with problem institutions. On the other hand, the Senate Committee report does largely reject the duplicative approach to regulation endorsed by the Wyman Committee and its discussion of the questions surrounding co-insurance is useful.

IV. The Dupré Committee Report²⁹

The discussion of market discipline in the Report of the Ontario Task Force on Financial Institutions (the "Dupré Committee") is the soundest of any of those reviewed in this paper. Although decidedly incomplete,³⁰ the report addresses squarely the issues surrounding co-insurance, brokered deposits and uninsured depositors, and is alone in dealing with "deposit equivalents" and Registered Retirement Savings Plan funds on deposit. On the other hand, although one can discern the general approach of the committee to the question of the appropriate role for CDIC in the regulatory system, its views on the specific issues in this regard are not clearly set forth.

27. *Supra*, note 20 at 14. The report observes that "... the current financial environment is not conducive to the immediate introduction of coinsurance..." and recommends that the current system of full insurance coverage up to \$60,000 remain in place "... until a redesigned CDIC has been in place and operating for at least one full year."

28. *Supra*, note 20 at 28.

29. Ontario, *Report of the Ontario Task Force on Financial Institutions* (Toronto: Queen's Printer, December 1985) (Chair: J. Stephan Dupré).

30. The report does not, for instance, address either risk-related premiums or the possibility of private sector participation in the provision of deposit insurance.

A. The Role of CDIC

The Dupré Committee's expressed point of departure with respect to the role of CDIC is that financial sector regulation should be non-duplicative and that CDIC should be confined to the role of insurer. Unlike the case with the Senate Committee's report, however, there is no inconsistency in the Dupré report between its point of departure and its concrete recommendations: no significant new powers would be granted by the Committee to CDIC.

1. Insurance

Unfortunately, the Dupré report does not deal at all with the implications of the proposition that CDIC should be confined to the role of insurer. It does not address the questions whether CDIC should have the right in individual cases to vary the terms of the insurance contract or to decline to maintain coverage upon a change in control of a deposit-taking institution. Nor does the report discuss the extent to which CDIC should have discretion to decline to grant or renew coverage. Insofar as the withdrawal of coverage is concerned, the committee notes in a passing reference that CDIC should always have "the power to withdraw deposit insurance to ensure that its concerns are heard by the regulator."³¹

2. Regulatory Powers

As noted above, and with the exception of its recommendations on the topic of deposit brokering, the Dupré Committee does not favour the granting of new powers to CDIC, noting only that a reconstituted CDIC board of directors "... could play a vital role in pooling the information, experience and perspectives of the key constituencies involved in promoting the solvency of deposit-taking institutions, ..." ³² and advocating a "... federal-provincial agreement which would delineate the respective roles of federal regulators, provincial regulators and CDIC." ³³

B. Market Discipline

The Dupré Committee report subscribes to the view that "market discipline" must be introduced to the deposit insurance system in order to control excessive risk-taking by deposit-taking institutions. Unlike the case with the Wyman Committee report, however, its adherence to this principle is reflected in its recommendations.

1. Co-Insurance

The Dupré Committee rejects the Wyman Committee's call for first-dollar depositor co-insurance, arguing that "it is unrealistic to expect small, probably unsophisticated, depositors to incur the relatively high information costs involved in assessing the risk posed by various deposit-taking institutions."³⁴ It proposes instead a system of depositor co-insurance which would

31. *Supra*, note 29 at 55.

32. *Ibid.*

33. *Ibid.*

34. *Ibid.*, at 49.

affect deposits in excess of \$20,000.³⁵ Recognizing the special character of Registered Retirement Savings Plan funds which are invested in insured deposits, the report recommends that such deposits continue to be insured up to \$60,000.

2. Brokered Deposits

The Dupré Committee's recommendations on the topic of deposit brokering are the most novel, and if implemented would likely be the most useful of any of those reviewed. Deposit-taking institutions would be required to report to the deposit insurer the identity of brokers with whom they deal, the methods and rates on the basis of which brokers are remunerated by them, and the percentage of deposits originating from deposit brokers. In addition, the Committee recommends the creation of a system of mandatory registration for deposit brokers under which registration would be conditional upon disclosure of the following information by the broker to its clients: whether a commission is being paid to the broker by the institution and, if so, both the amount of that commission and the commission rates paid by other institutions, and, the extent to which deposit insurance is available in respect of the deposit in question.

3. Uninsured Depositors

The committee is critical of the tendency of governments to reimburse uninsured depositors, arguing that this practice encourages depositor indifference to depositary solvency and is thus itself a source of instability in the system. Nevertheless, the only concrete measures it proposes in this connection are with respect to publicly-financed "institutional" depositors such as municipalities, school boards, hospitals and universities. Noting that many such entities had funds on deposit with the recently-troubled institutions and that their predicament "... added significantly to the pressures that led governments to override deposit insurance limits, ..." ³⁶ the report recommends requiring all institutions or agencies whose revenues include grants or tax-deductible donations to adopt and regularly review investment policies requiring diversification of all assets, including deposits and other short-term instruments.

4. Deposit Equivalents

The Dupré report points to the emergence in recent years of relationships which are identical in many respects to those which exist between depositors and deposit-taking institutions, but which are nevertheless not covered by CDIC insurance. Examples include credit balances with securities firms which earn daily interest rates and incorporate chequing privileges, and short-term annuities not contingent upon the life of the annuitant and having a term of only a few days, offered by a number of life insurance companies. The Committee urges that attention be given to the development of a policy regarding the appropriate protection to be afforded to such deposit equivalents.

35. *Ibid.*, at 45-50. Under this proposal, deposits under \$20,000 would be fully insured by CDIC, deposits from \$20,000 to \$60,000 would be insured to 75 percent and deposits from \$60,000 to \$80,000 would be insured to 50 percent. Deposits in excess of \$80,000 would not be insured.

36. *Supra.*, note 29 at 51.

5. Capital Requirements

The Committee calls for more onerous capital requirements to be imposed on new entrants to the financial services sector³⁷ and recommends as well that regulators devote greater attention to reviewing and assessing the soundness of the business plans of such prospective entrants.

C. Conclusion

It is unfortunate that the Dupré report does not address the issue of market discipline more fully. Its treatment of the topics of co-insurance, brokered deposits, uninsured depositors and deposit equivalents suggest that a thorough discussion by it of all the relevant questions in this area would have contributed considerably to the current debate.

V. The House Committee Report³⁸

The most striking feature of the Report of the House of Commons Standing Committee on Finance, Trade and Economic Affairs is the degree to which its premises and recommendations differ from those of the other studies reviewed. On the one hand, the Committee's view that one entity should act both as regulator and as insurer made it unnecessary for it to deal with the issue of the appropriate role for CDIC.³⁹ On the other hand, its confidence that "... risk control can be effectively exercised through the use of more stringent prudential standards. . ." ⁴⁰ led it to reject those measures which would serve to introduce to the system elements of market discipline as a mechanism for controlling risk.

Notwithstanding its recommendation that the insurance and regulatory functions should be exercised by one body, it might have been thought that the House Committee report would address those questions which would have to be confronted by the consolidated agency in carrying out its insurance mandate: in what circumstances can coverage not be granted or, once granted, be terminated; would there be individual insurance contracts, as such, and if so, to what extent could there be variation amongst them; and, would a change in ownership of a deposit-taking institution have any effect on its coverage? None of these issues was addressed. The Committee's only pertinent observation in this regard is that the new agency would have the authority to establish conditions for membership in the "consumer protection plans" it administers.⁴¹ By contrast, the report does discuss a number of the topics falling under the general heading of "market discipline". This discussion will be summarized below.

37. *Ibid.*, at 81. In this connection the report endorses the provisions of the Ontario Draft Loan and Trust Corporations Act requiring minimum capitalization for new loan and trust corporations of five million dollars and ten million dollars respectively.

38. Canada, Report of the Standing Committee on Finance, Trade and Economic Affairs: Canadian Financial Institutions (Ottawa: Queen's Printer, November 1985) (Chair: D. Blenkarn).

39. *Ibid.*, at 12. The House Committee favours the creation of a National Financial Administration Agency to act as the insurer and regulator of all federally incorporated financial institutions.

40. *Ibid.*, at 72.

41. *Ibid.*, at 17 and 72-73. It appears that these conditions would include compliance with minimum capitalization and maximum leverage rules.

A. Market Discipline

1. Co-Insurance

The House Committee report rejects both the strict form of first dollar co-insurance advocated by the Wyman Committee and the modified forms endorsed by the Senate and Dupré Studies.⁴² Its reasons for rejecting the former are by now familiar: such a system is inconsistent with the goal of protecting small depositors, is unlikely to result in increased pressure being brought to bear on financial institution management and will likely cause depositors, mistaking size for security, to withdraw their funds from smaller institutions. Its reason for rejecting a modified form of co-insurance is that “. . . to lower full coverage from the present level . . . would be destabilizing.”⁴³

2. Brokered Deposits

The House Committee acknowledges the impact of brokered funds upon the stability of the system but argues that deposit brokering is essential to the viability of smaller, regionally-based institutions. Accordingly, the report rejects the proposal that deposit brokers be subject to a registration requirement and advocates instead the development of “appropriate procedures” to monitor brokered deposits.

3. Uninsured Depositors

Although the House Committee is critical of the tendency of governments to reimburse uninsured depositors, its report is sensitive both to the intense pressures to which governments are subject in such circumstances and to the predicament of uninsured depositors. The report points out that many of these depositors are dependent upon deposit accounts to meet ongoing payroll and operating expenses. As a means of easing the plight of such depositors and thereby reducing the pressure on governments, the report advocates the creation of an “uninsured depositor cash advance program” under which depositors would receive, prior to the completion of the liquidation process, an amount based on the anticipated value of their claims. They would, however, remain exposed to losses based on actual amounts realized in liquidation.

4. Capital Requirements

The House Committee recommends an increase in capital requirements for all financial institutions,⁴⁴ and a reduction in permissible leverage ratios for the deposit-taking sector.

42. In fact the House Committee recommends that all deposits, irrespective of their terms to maturity, be eligible for insurance coverage up to \$60,000. Currently there is a five year maturity limitation.

43. *Supra*, note 38 at 72.

44. *Ibid.*, at 158 and 183. Trust, loan and property and casualty insurance companies would be subject to an initial capitalization requirement of five million dollars; for life insurance companies the requirement would be six million dollars.

B. Conclusion

Implementation of the House Committee recommendations would produce a significant degree of re-regulation and no change in the underlying economic incentives of the various actors. If one is of the view that the current travails of the deposit insurance system stem largely from the character of those incentives, then one is unlikely to conclude that adoption of the House report's proposals would represent a useful response to the current problems.

VI. Towards Reform of the Deposit Insurance System

A. Introduction

The proposals advanced below are based on the premise that the problems of the deposit insurance system are primarily a result of the degree to which the various participants are insulated from the risks ordinarily attendant upon private economic activity. Depositors, for example, need not concern themselves with the solvency of the institutions with which they deal, for in the event of failure, full compensation will be forthcoming. Indeed, the "rational" depositor is in effect encouraged to make determinations based exclusively on relative interest rates. The managers of financial institutions recognize that while the benefits of a strategy of excessive risk-taking will accrue principally to shareholders, the costs—should the strategy prove unsuccessful—will be borne disproportionately by the deposit insurer.⁴⁵ High leverage ratios⁴⁶ and the existence of a premium structure wholly unrelated to risk constitute further inducements to the adoption of such a strategy. Finally, the statutory framework under which it operates effectively precludes the deposit insurer from conveying to the participants in the system its judgments as to the relative riskiness of financial institutions. In its current configuration the deposit insurance system permits actors to profit fully when their behaviour proves successful and encourages them to shift onto others the consequences of unsuccessful strategies. A well-conceived plan of reform must redress this imbalance.

B. Co-Insurance⁴⁷

Proponents of co-insurance assume that depositors faced with the prospect of financial loss in the event of an institution's insolvency will have an increased incentive to assess the relative solvency of deposit-taking institutions in deciding where to place their funds. This heightened scrutiny, it

45. See P.M. Horvitz, "The Case Against Risk Related Deposit Insurance Premiums" 2 Housing Finance Review 253: "Deposit insurance actually provides an incentive for increased risk taking: owners keep all the returns that may be associated with increased risk; if the risk turns out badly and the institution fails, costs are largely borne by the insurance agency." See also E.J. Kane, *supra* note 16: "The problem is that incentives exist for managers to bet their firm on the future course of interest rates and on the prosperity of specific projects and geographic areas. Some of those bets must lose. . . ."

46. The Dupré Committee report explicitly acknowledges the incentives created by high leverage ratios. *Supra*, note 29 at 30: "The ability to operate with such extensive leverage creates a great temptation to engage in excessive risk taking. If, by taking high risks, a financial institution earns extraordinary returns, the shareholders will reap extraordinary profits. However, if these extraordinary risks result in extraordinary losses, the potential losses of deposit holders will vastly exceed the losses of the shareholders."

47. "Co-insurance" is a device for dealing with the dilemma of insurance known as "moral hazard"; that is, the tendency of insurance to itself generate behaviour likely to result in claims being made on the insurer. For a brief but illuminating discussion of moral hazard see K.J. Arrow, *Essays in the Theory of Risk-Bearing* (Chicago: Markham Publishing Co., 1971) at 220-222. For a discussion of moral hazard in the context of deposit insurance see J.F. Sinkey, Jr., "Risk Regulation in the Banking Industry" (Proceedings from a Conference on Bank Structure and Competition, Chicago, 1984) (Chicago: Federal Reserve Bank of Chicago, 1984) at 432; E. Short, *supra*, note 16.

is thought, will influence institutions in the direction of less risky economic activities.

The argument against co-insurance is three-fold. It is argued, firstly, that the average depositor, being leery of the complexity and potential delay associated with the making of a claim from the deposit insurance fund, is already attracted to the institution he or she perceives to be the most stable. Secondly, some observers⁴⁸ question the assumption of depositor perspicacity which underlies the proposal and argue that to the extent large numbers of depositors make the "wrong" decision about a particular deposit-taking institution's solvency, the putative benefits of the co-insurance scheme will not have been obtained. Finally, it is said that the introduction of co-insurance will disadvantage small, well-run institutions, given the tendency of depositors to equate size with stability.

The co-insurance schemes outlined in the first section of this paper are of two types: one would affect the first dollar on deposit and the other would operate at some point beyond the \$20,000 level. It does not seem either appropriate or realistic to expect small depositors to obtain and evaluate the information necessary to the making of sound determinations with respect to relative solvency. Accordingly, the introduction of first dollar co-insurance would be ill-advised. On the other hand, it appears likely that some utility would be derived from subjecting the small proportion of depositors with funds in excess of \$20,000 to a meaningful degree of risk, and therefore it would be advisable to institute a co-insurance feature at this level.

C. The Limits to Coverage⁴⁹

The issue of the appropriate limits to publicly-provided deposit insurance coverage raises the question of the purposes served by the current system of deposit insurance. Given the fact that the great majority of deposit accounts are in amounts less than \$20,000,⁵⁰ the statutory \$60,000 limit extends far beyond the level necessary to protect the average depositor. To the extent that the system is being utilized to insure "investment" accounts,⁵¹ it can legitimately be argued that the current limit distorts the original objective of deposit insurance and burdens the system unduly.⁵² The logical response, and the one advocated by many observers, is to reduce the limit to a level in the range of \$20,000 to \$30,000.

48. See for example Sinkey, *Ibid.*, who discusses the credit unions and savings and loans associations with uninsured funds at the failed Penn Square Bank. See also T. Mayer, "Should Large Banks be Allowed to Fail" (1975) 10 J. Financ. Quant. Anal. 603 and W. E. Gibson, "Deposit Insurance in the United States: Evaluation and Reform (1972) 7 J. Financ. Quant. Anal. 1575. Mayer points out that it would be interesting to know to what extent deposits in excess of the statutory limits are placed with failing institutions at a time when "sophisticated" depositors ought presumably to know of the difficulties these institutions are encountering.

49. Upon its creation in 1967 the deposit insurance plan provided for a maximum amount of \$20,000 of coverage per insured account. Although there were suggestions prior to 1983 that this figure be increased, the main impetus for the change to \$60,000 which occurred in that year was the "Greymac Affair".

50. This assumes that the Canadian Bankers' Association data referred to above can be reliably extrapolated across the deposit-taking sector.

51. See R. Humphrys, "Insolvencies of Financial Institutions and Problems of Deposit Insurance" (Conference on the Changing Regulatory Environment for Canadian Financial Institutions, Toronto, 18 May, 1985) (Toronto: Insight, 1985) at 49: "The figure of \$60,000 goes well beyond the limit of a normal savings account balance and is clearly insuring investment instruments."

52. See G. Benston, *supra*, note 16 who argues that the increase in FDIC coverage from \$40,000 to \$100,000 per account has contributed significantly to current problems in the United States. The same argument is made by Kane, *supra*, note 16.

Many accounts with balances in excess of \$20,000, however, contain Registered Retirement Savings Plan funds; others are not investment vehicles at all but are rather accounts maintained by employers in order to meet ongoing payroll and operating expenses. While RRSP funds could quite easily be excepted from a reduced limits scheme, considerable administrative complexity would be associated with the creation of an exception for the latter category of accounts.

Reducing the statutory limits to coverage would achieve greater consistency between the original purposes and actual operation of the deposit insurance system, and would bring significant discipline to bear upon some large depositors. Such a measure would also impose hardship upon those persons who are dependent upon the categories of accounts referred to above. As the concrete benefits to be gained from altering the statutory limits can likely be obtained by introducing a material degree of co-insurance to the system, co-insurance is preferable.

D. A Private Market for Deposit Insurance Coverage

One of the potential side effects of scaling back the statutory limits to coverage or introducing co-insurance beyond the \$20,000 level is the emergence of private insurers able and willing to enter the deposit insurance market. Faced with significantly increased numbers of depositors with funds at risk, some institutions may find it a competitive necessity to satisfy depositors as to the security of their funds. Arrangements between such institutions and private insurance carriers may develop as a result.

Such arrangements would bring market discipline to bear on affected institutions in an extremely direct way, for the willingness of a private insurer to provide coverage and the terms on which it is prepared to do so will be based on its assessment of the institution's performance and overall stability.⁵³ Deposit-taking institutions would have to satisfy market-based threshold judgments in order simply to obtain insurance coverage; the prospect of fuller coverage and lower premiums would impel them to improve their economic performance. We would begin to see market-based risk-related premiums.

It is, of course, not at all certain that a private market for deposit insurance coverage would emerge in the wake of reduced statutory limits or the institution of co-insurance.⁵⁴ Some observers have suggested that private insurers will be extremely wary of entering the market in light of the outside risk of systemic collapse,⁵⁵ and, as we have seen, the Wyman Committee believed that private carriers do not in any event have the capac-

53. As Kane, *supra*, note 16 at 20 puts it: "Private players have an economic incentive to provide a product at a price which will make it in the client's own best interest to keep its risk exposure within prudent bounds."

54. As J. Pesando points out in "Government Response to the Regulatory Challenge: The Interim Report of the Ontario Task Force and the Federal Green Paper" (Conference on the Changing Regulatory Environment for Canadian Financial Institutions, Toronto, 18 May, 1985) (Toronto: Insight, 1985) it would be instructive to know to what extent private arrangements for deposit insurance existed in Canada prior to the introduction of the statutory scheme in 1967.

55. See for instance Pesando, *ibid.*, and K.E. Scott and T. Mayer, "Risk and Regulation in Banking: Some Proposals for Federal Deposit Insurance Reform", (1970-1971) 23 *Stanford Law Review* 857.

ity to assume a meaningful proportion of the risk.⁵⁶ Still others point to the rather unusual character of the risk to be underwritten.⁵⁷

Nevertheless, evidence from the United States⁵⁸ suggests that the evolution of a private market for deposit insurance coverage is not beyond the realm of possibility. Initiatives such as co-insurance and reduced statutory limits have merit, not only on their own terms, but also because they would promote the emergence of a private market in Canada.

E. Uninsured Depositors

All of the studies reviewed in the first section of this paper lament the tendency of governments to compensate uninsured depositors; each calls for an end to the practice. In general terms, the argument is that compensating uninsured depositors has the effect of further reducing the incentives of depositors to prudently place their funds, thus obviating the need for financial institutions to "persuade" prospective large depositors as to their stability. This analysis is, on the whole, convincing and the issue is indeed an important one, for if in the final analysis all uninsured depositors receive compensation, then debates about co-insurance and limits to coverage are largely hollow.⁵⁹ The question is less whether governments should be resisting the temptation to compensate uninsured depositors than it is how best to ensure that governments are able to do so.

Concrete proposals for addressing this problem are scarce. The Dupré Committee would impose a duty of prudent investment on all publicly-financed entities; while this may well be desirable, it would not in any way deter a publicly-financed entity with a claim against a failed institution from pressing the government for full compensation. Moreover, it would not affect non-publicly-financed uninsured depositors. The House Committee would introduce an uninsured depositor cash advance program; while this recommendation likewise has merit, it is difficult to credit the assumption that the prospect of a speedy pay-out will cause uninsured depositors to pursue claims for full compensation less assiduously.

Uninsured depositors invariably win their case for compensation for two reasons: first, there are no incentives on such depositors not to seek compensation, for they incur no long-term costs from receiving it; second, governments incur no political costs in acceding to these pressures, as there

56. *Supra*, note 1 at 28.

57. In fact this does not seem an overwhelming problem. As Short and O'Driscoll *supra*, note 16, point out at 21: "The complexity of risks covered in a standard personal liability policy at least equals, if it does not exceed, the complexity of risks covered by deposit insurance." They note as well that private investors in developing countries routinely obtain insurance against insurrection, expropriation and currency inconvertibility.

58. Benston, *supra*, note 16, reports that there are five States in which banks obtain deposit insurance from private carriers. And in a recent book, *The Gathering Crisis in Federal Deposit Insurance* (Cambridge, Mass.: The MIT Press, 1985), E. Kane has written (at 160) that "In fact private insurance companies have begun to nibble eagerly around the edges of the deposit insurance market. So far they have focused principally on offering supplementary guarantees for individual account holders that, beginning where federal guarantees stop, greatly extend the size of the balance covered. Such insurance is particularly attractive to non-depository institutions such as brokerage firms and insurance companies seeking to market newfangled substitutes for ordinary deposits." See also T. S. Campbell and D. Glenn, "Deposit Insurance in a Deregulated Environment" (1984) 39 *Journal of Finance*.

59. As Kane, *supra*, note 16, puts it: "As long as large deposit institutions and their creditors may count on drawing federal subsidies to extract themselves from what would otherwise be do-or-die situations, the potentially salutary effects of market discipline have little opportunity to make themselves felt."

has not tended to be organized or widespread opposition to such measures. The solution to this problem lies in making the decision to compensate uninsured depositors costly both for the decision-maker and the recipient. This implies imposing economic costs on uninsured depositors who obtain relief and political costs on governments which grant it. The following proposals are designed to impose such costs:

1. Amend the Canada Deposit Insurance Corporation Act to provide that compensation for uninsured depositors may not be financed either through the deposit insurance fund or through surcharges on member institutions. This will mean that compensation for uninsured depositors will have to come from general government revenues. To the extent that the payment of compensation to uninsured depositors represents taxpayer-financed welfare for the "rich and powerful," the political potential of the issue is unlikely to remain untapped for long.
2. As an adjunct to the above, and in order to make the political attractiveness of the issue almost irresistible, require public disclosure of the aggregate amount of uninsured depositor compensation in the wake of an institution's failure, as well as the names of all persons and entities receiving compensation. Taxpayers have a right to know how much such compensation is costing them and who is benefitting from it.
3. If the person or entity receiving uninsured depositor compensation is also a recipient of public funds, five to ten percent of the amount which it has received as compensation should be deducted from the amount to which it would otherwise have been entitled in its next fiscal year. This will create an incentive on the part of publicly-financed bodies more carefully to manage and diversify their portfolios.

F. Risk-Related Premiums

The premium structure of a private insurer ordinarily reflects past claims experience and the insurer's assessment of the degree and character of risk being assumed. This assessment is communicated to the insured in the form of the price of insurance coverage. The prospect of higher premiums confronts those whose behaviour produces a changed perception on the part of the insurer as to the nature of the risk being underwritten. The insurer's premium structure thus reflects its judgments about the insured's conduct and generates incentives in the direction of risk control by insured parties.

No such incentives to curb risk-taking are generated by the premium structure of the deposit insurance plan, under which all deposit-taking institutions pay premiums at the same rate.⁶⁰ Indeed, since aggressive risk-taking by an insured institution has no effect on the price it pays for insurance, and given the incentive to risk-taking inherent in high leverage ratios,

60. That rate is currently 1/10 of 1% of insured deposits. 61. Even Horvitz, *supra*, note 45, a leading opponent of the possible introduction of risk-related premiums in the United States, acknowledges that they are ideal in theory. His argument is that it is impossible to design an actuarially sound system, and that an imperfect system could result in a greater distortion of the allocation of resources than the present system. For a response to Horvitz's article, see P. T. Peterson, "The Case Against Risk-Related Deposit Insurance Premiums — A Contrary View" 2 *Housing Finance Review* 265.

the system in fact encourages member institutions to adopt high-risk strategies. By contrast, under a scheme of "risk-related" or "variable rate" premiums, the relative riskiness of deposit-taking institutions would be reflected in the price paid for deposit insurance coverage.

The Wyman Committee report is the only one of the studies reviewed to have addressed the merits of risk-related premiums. Although acknowledging the theoretical appeal of such a scheme,⁶¹ the committee concluded that it could not be incorporated into the deposit insurance system. As we have seen,⁶² it gave four reasons: first, there is no consensus on how to measure risk objectively; second, it is impossible to forecast risk and measure it before it occurs; third, the imposition of premiums costly enough to produce the incentive to reduce risk-taking may in fact have the perverse result of encouraging excessive risk-taking to cover the higher costs; and fourth, the implementation of risk-related premiums could give rise to the development of an extensive appeal program as member institutions would frequently disagree with their assessments.

Although the first two of these propositions may well be valid, the task of devising a variable rate structure would not require that risk be "measured" or "forecasted". That is, there would not be a necessity to reach conclusions as to the objective probability of an institution failing or the likely gravity of such an event should it occur. Rather, it would be necessary to rate deposit-taking institutions on the basis of a number of criteria and to rank them according to whether they are "most" or "least" likely to generate the making of claims from the deposit insurance fund.⁶³ Indeed, elsewhere in its report the Wyman Committee speaks approvingly of a rating system which could easily form the basis for such a ranking:⁶⁴ the Federal Deposit Insurance Corporation's "CAMEL" system, which rates institutions according to their capital, assets, management, earnings and liquidity. Insofar as the last of the reasons given by the Wyman Committee is concerned, extensive appeals will result only if they are not statutorily precluded. Moreover, absent bias or clear evidence of abuse of discretion, ordinary rules of administrative law would militate against successful appeals of premium rate determinations.

The only persuasive reason advanced by the Wyman Committee report for rejecting risk-related premiums is that it will prove extremely difficult to set premiums at a level which is sufficiently high to moderate behaviour but not so high as to induce further risk-taking. Although one can to some extent rely upon the system of primary regulation to identify instances of reckless risk-taking, recent experience teaches that inevitably some of such conduct will evade detection. One approach capable of resolving this practical difficulty is that of the FDIC in the United States,⁶⁵ which favours

62. *Supra*, note 1 at 8.

63. An analogy may be drawn to the task performed by bond rating services, which do not forecast the likelihood of default by debtors, but rather make judgments about their relative stability. Indeed, those ratings which currently exist in respect of deposit-taking institutions could serve as a useful starting point in the development of variable rate premiums.

64. *Supra*, note 1 at 19.

65. See "Deposit Insurance in a Changing Environment" *A Report to Congress on Federal Deposit Insurance prepared by the Federal Deposit Insurance Corporation, Federal Home Loan Bank Board, and National Credit Union Administration Board* (Washington, D.C.: U.S. Government Printing Office, June, 1983).

the adoption of a variable rate system containing relatively few categories of risk.⁶⁶ Under this system it would not be necessary to translate composite rankings into precisely calibrated premiums.⁶⁷ Rather, ranked institutions would be grouped according to whether they presented a normal, high or very high degree of risk to the deposit insurance fund.⁶⁸ There would only be as many different premium rates as there are groups.

In sum, it seems clear that deposit-taking institutions can be compared on the basis of objective criteria,⁶⁹ and that there could be produced a reasonably reliable ranking of institutions from the most to the least stable. Of course, there will be guesses and judgment calls involved in arriving at such a ranking, but these guesses and judgment calls will be better informed by far than the virtually identical ones made daily by the financial markets. The real difficulty lies in translating the ranking scheme into variable insurance premiums which produce the desired incentive. Adoption of the FDIC proposal would represent a useful first step. For the first time there would be an explicit relationship between the risk presented by an institution to the insurance fund and the price paid by that institution for insurance coverage.

G. Segregated Pools

The segregated pools proposal advanced by the Canadian Bankers' Association,⁷⁰ and endorsed in the Senate Committee report, calls for grouping member institutions along industry lines and providing for industry-specific rebates to absorb the costs of the failure of an industry member. Premiums would be uniform both across and within industry pools. It is argued that such a system would produce incentives in the direction of self-regulation, as all members of an industry would have an economic interest in ensuring that each of them conducts its affairs prudently.

This proposal is not as attractive as the FDIC scheme, as it does not allow for the possibility of variable premiums or rebates within industry groups. Moreover, even under the current structure of the deposit insurance system it has likely been apparent to all of the participants that they would ultimately bear at least some of the costs associated with failures; yet trends towards meaningful self-regulation have not been pronounced.

Nevertheless, if instituted the scheme likely would overcome some of the existing jurisdictional and institutional obstacles to increased self-regulation.⁷¹ More importantly, it would compel industry groups as a whole to internalize the costs associated with the excessive risk-taking of an industry member, and as such would serve to introduce an added dimension of discipline to the system.

66. For an earlier argument in favour of such a system, see R. E. Barnett, P.M. Horvitz and S.C. Silverberg, "Deposit Insurance: The Present System and Some Alternatives" (1977) 94 *Banking Law Journal* 304.

67. The system would be implemented through the rebate program, with rebates varying according to the risk class of the deposit institution.

68. Approximately 80% of deposit-taking institutions would fall within the "normal" category. See Sinkey, *supra*, note 47.

69. These criteria could include capital adequacy, liquidity, leverage ratios, proportion of non-performing loans to total assets, asset diversification and maturity mismatch.

70. For a clear explanation of the proposal, see "Comments on the Final Report" *supra*, note 26 at 20.

71. For an argument in favour of increased self-regulation, see W. Moull, E. Waitzer and J. Ziegel, "Constitutional Aspects and Federal Provincial Relations" (Conference on the Changing Regulatory Environment for Canadian Financial Institutions, Toronto, 18 May 1985) (Toronto: Insight, 1985) at 80-82.

H. Multiple Coverage

One of the deficiencies of the existing deposit insurance system is the degree to which the nominal limits to statutory coverage can be multiplied by the simple expedient of maintaining separate accounts either in the same⁷² or in different institutions. One means of addressing this problem is to impose a maximum on the amount which may be claimed by a depositor from the deposit insurance fund.⁷³

As we have seen,⁷⁴ the Wyman Committee rejected such a proposal on the grounds of administrative complexity, but in reality the administrative apparatus required to record all claims satisfied by the deposit insurance fund would not have to be elaborate. A more troublesome problem which could emerge is the development of devices designed to disguise the beneficial claims to deposit funds. Also complex would be the task of apportioning the claims of a depositor with funds in two failed institutions where the aggregate amount of funds on deposit exceeds the depositor's allowable maximum. Similarly difficult apportionment problems would arise if the limitation were applied more narrowly, that is, on the amount which could be claimed by a depositor in respect of a single failed institution. In the final analysis, it may be that the most serious aspects of the multiple coverage problem can be addressed by imposing controls on deposit brokering, a practice premised on actively manipulating the nominal limits to coverage. In this regard the recommendations contained in the Dupré Committee report merit serious consideration.

VII. Conclusion

The precise regulatory arrangements under which the deposit insurer functions are far less important to the health of the deposit insurance system than the nature of the economic incentives to which the various actors are subject. Those who would adjust the regulatory arrangements without significantly restructuring the underlying incentives fail to appreciate the sources of the predicament in which the system now finds itself. The measures canvassed in the second portion of this paper would alter the character of these underlying incentives by ensuring that the participants in the system could no longer shift the adverse financial consequences of their activities onto others.

72. *Supra*, note 8, the opportunities to multiply coverage are more limited in the case of a depositor dealing with a single institution.

73. Humphrys, *supra*, note 51, has made such a suggestion.

74. *Ibid.*, at 6.

