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Discussion Paper on Revision of the Trust Companies Act and the Loan Companies Act

July 1982

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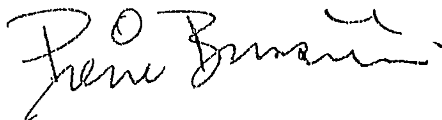
Department of Insurance Canada
Département des assurances Canada

Foreword

This paper, and the proposed Bill to which it refers, set out views developed by officials in the Department of Insurance. They do not represent policy decisions taken by the Government. They are being issued to invite public discussion and comment on some important issues to be considered in a revision of the relevant legislation.

Later this year when the Parliamentary timetable permits, the Government intends to introduce a bill to implement a revision of the acts here discussed. Responses to the matters discussed in this paper and comments on the Department's draft legislation will assist the Government in deciding on final proposals to Parliament.

Any comments or suggestions should be addressed to the
Superintendent of Insurance
Department of Insurance
140 O'Connor Street
Ottawa K1A 0H2



Minister of State (Finance)

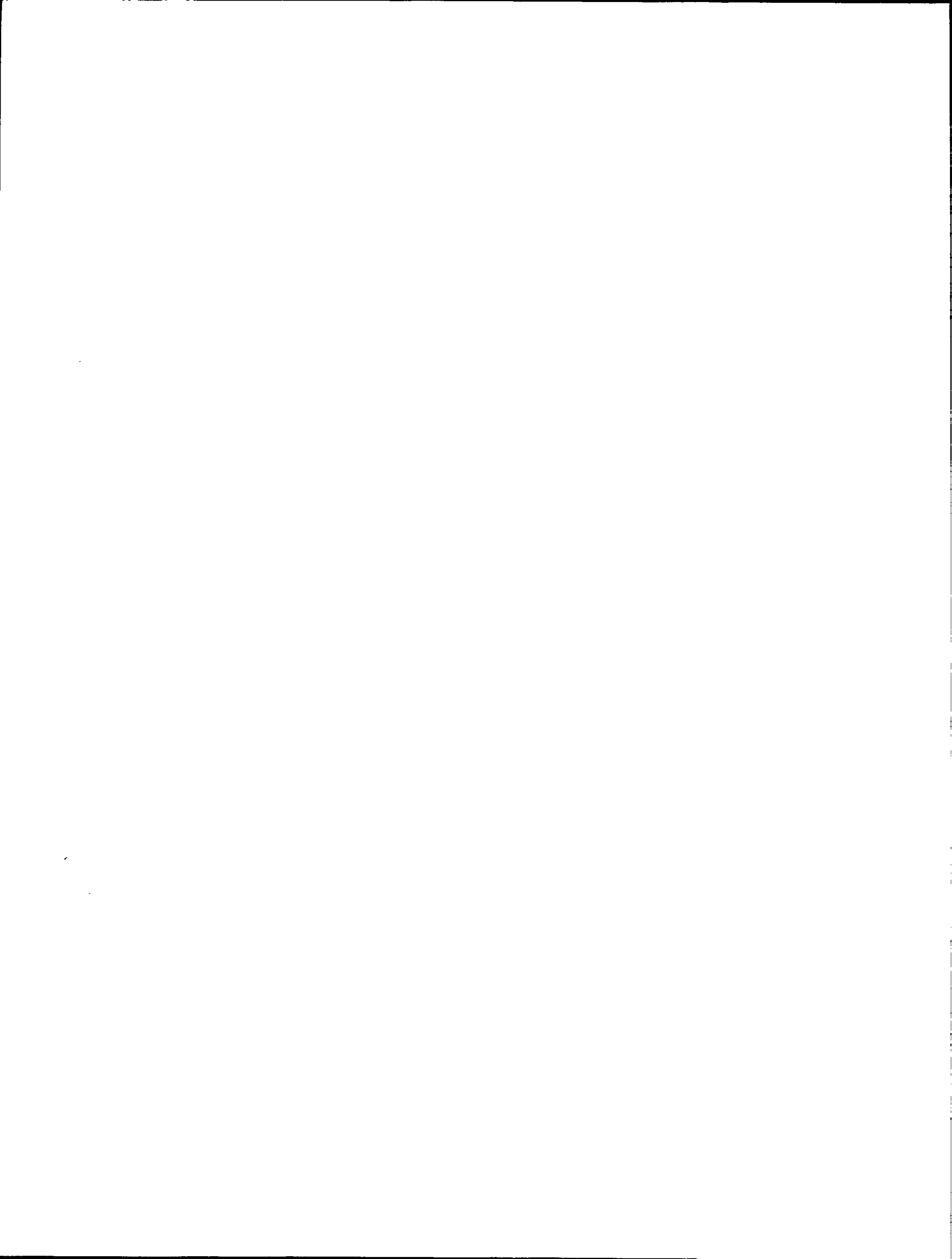
Discussion Paper

During the extensive discussion leading up to the revision of the Bank Act in 1980, it was recognized that the trust companies and loan companies in Canada act as financial intermediaries in receiving deposits and savings from the public and investing or lending the funds so received and that these activities are in many respects identical with certain activities carried on by banks. It was therefore also considered necessary to review in a thorough manner the governing legislation applicable to trust companies and loan companies as soon as reasonably possible following the revision of the banking legislation. Such a review, leading to appropriate revision in the legislation, was indicated for the following reasons:

1. to establish reasonable consistency in the governing legislation applicable to different types of financial institutions, particularly where they engage in similar activities, as a basis for fair and equitable competition;
2. to review and modify corporate powers and general regulatory requirements for financial institutions to enable them to respond to changing needs and desires of the public while still retaining adequate standards of financial strength;
3. to review the provisions relating to financial standards in order to maintain an appropriate degree of protection for the public;
4. to review the provisions that deal with internal corporate governance to recognize modern approaches to corporate law.

In line with these objections, this discussions paper examines the important issues relative to a revision of legislation governing trust companies and loan companies and describes changes that seem appropriate for consideration. It is being released for public discussion. Comments received will be taken into account in determining the final form of legislation proposals.

The main issues are discussed here in general terms. To put them in more precise terms, two further documents have been prepared by the Department of Insurance. One is in the form of a discussion draft bill; the other is a Summary and Guide to the discussion draft. The discussion draft reflects a number of changes from existing requirement in addition to those discussed here. They are mentioned in the Summary and Guide. For the most part they follow changes already made in general corporate law or in the Bank Act or are administrative provisions rather than important matters of principle.



Part I—Background and General Discussion

The trust companies and loan companies resemble the banks and the one savings bank that now exists in that they are engaged to a major extent in savings deposit activity. As used herein, "savings deposit activity" includes the receipt of deposits from the public, redeemable on demand or on short notice, with or without chequing facilities; the receipt of funds from the issue of debt instruments such as debentures, term deposit receipts and savings certificates; and the receipt of money through the issuance of guaranteed trust certificates or guaranteed investment certificates by trust companies.

The banks, because of their size and the spread of their branch network, dominate the savings deposit business. Any change in the regulatory legislation applicable to banks and any resulting new policies adopted by the banks are of the greatest importance to all the other institutions active in the field.

The savings deposit activity of the banks is combined with their main activity, namely, a broad range of commercial banking in both national and international fields.

The loan companies raise funds mostly by the sale of debentures but in an increasing degree through savings deposits by their customers. Traditionally, their investments have been for the most part (80% or more) in the form of mortgage loans on residential property, although in recent years there has been a strong tendency to reduce the emphasis on residential mortgages and increase other types of investments and loans.

Loan companies may be formed under either federal or provincial legislation. At the end of 1981, there were 33 federally incorporated companies and 16 provincial companies. The federal companies had total assets of $20 billion at that date and the provincial companies had assets of $5 billion.

Federal loan companies are governed by the Loan Companies Act. The discussion in this paper relates only to federal companies.

The trust companies are active in the savings deposit field, both through the receipt of deposits from their customers and through the issuance of guaranteed trust certificates, often referred to as guaranteed investment certificates. Technically, these funds are received by trust companies as funds in trust for investment, subject to a guarantee of repayment by the company. However, from the

point of view of the customer there seems to be little or no difference between this activity and the deposit-taking activity based on a debtor-creditor relationship as is the case with banks and the loan companies.

The trust companies combine this savings deposit activity with trustee service to the public, e.g., administration of estates and investment funds, and other agency activities in connection with the custody or management of property.

Traditionally, funds raised through the savings deposit activity of trust companies have been invested in the form of mortgage loans on residential properties, as in the case of loan companies. Like the loan companies, the trust companies have tended in recent years to expand their investment and lending into other fields.

Trust companies may be formed federally or provincially. At the end of 1981, there were 32 federal trust companies and 67 provincial companies. The total deposit funds for federal companies were $22 billion and for provincial companies, $16 billion.

The Federal trust companies are governed by the Trust Companies Act. This paper refers only to Federal companies.

The savings deposit activity of the loan companies and trust companies is very similar. It is principally in the field of what might be called "retail" banking and tends to be concentrated in areas of personal financial security. Their traditional investment activity has been principally in residential mortgage loans. Commercial lending and commercial deposits have been rare.

Although there has been a strong and growing trend in recent years towards similarity of these activities and those of the banks, there are still significant differences in their operations as compared with the banks and it still appears appropriate to consider regulatory legislation designed for the present state of these institutions rather than to think in terms of one statute as, for example, a Bank Act that covers the activities of the whole range of deposit-taking institutions.

The Trust Companies Act and the Loan Companies Act had their origin in 1913. Although they have been amended many times since, there has been no general revision of the legislation since that time. The two statutes are similar and indeed identical as respects corporate governance. Financial standards have been kept fairly similar, as have the investment powers, taking into account the technical difference between the guaranteed trust aspect of the trust company deposit business and the debtor-creditor aspect of the deposit business carried on by the loan companies.

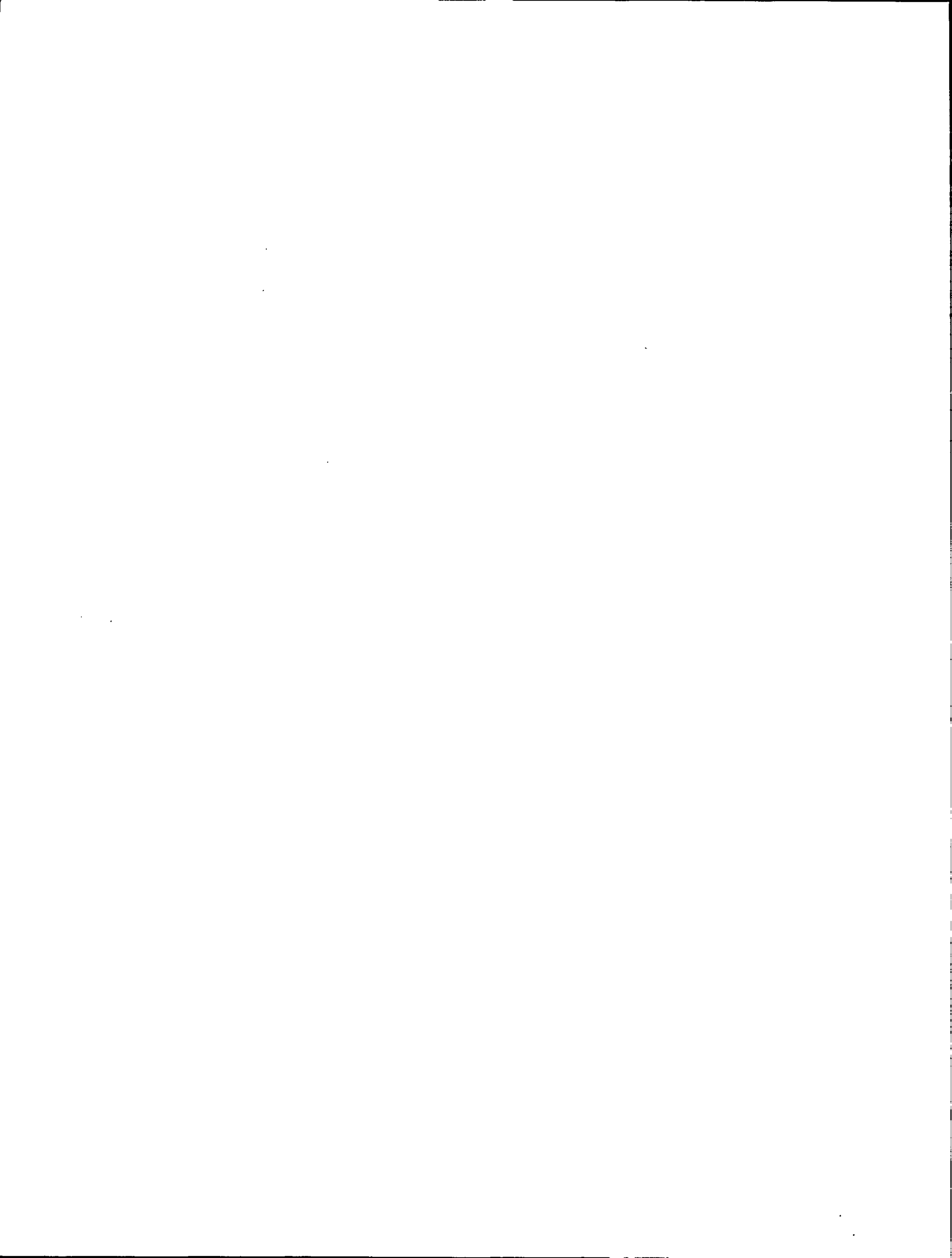
A general revision of both Acts is indicated because both are very old and are in need of extensive modernization to update the corporate clauses, quite apart from consideration of financial solvency and corporate powers appropriate to the current environment.

Since trust and loan companies are now very much alike in their savings deposit activity, there does not seem to be any need or justification for two separate statutes dealing with such matters as the formation of companies, corporate governance, acceptance of deposits, investing and lending, financial standards and supervision. Special attention, within one general statute, would be needed for companies that are active in the fiduciary field because of the special characteristics of trust business.

One statute governing these two types of institutions would be simpler from a legislative point of view and also in terms of supervision and regulation. It would represent a step forward in the rationalization of federal legislation applicable to financial institutions and would open the way to clearer consideration of changes as events develop in the future.

It appears, therefore, that all the considerations point to the desirability of consolidating these two statutes into one, which would deal with the savings deposit activity as the principal focus of attention but also would empower certain companies to carry on fiduciary activities and provide for any necessary regulation or controls in that field.

This discussion paper will consider relevant items in a revised statute on the assumption that the two acts will be consolidated into one act that might be called "The Canada Savings Banks and Trust Companies Act".



Part II—Discussion of Specific Proposals

A. Formation of New Companies

The present Trust Companies Act and Loan Companies Act provide for the formation of new companies by the issuance of letters patent by the Minister of Consumer and Corporate Affairs but with the prior approval of the Minister of Finance. Incorporation is thus not a right but is subject to ministerial discretion.

The letters patent system has worked well since it was adopted in 1970. However, by reason of revisions in the Canada Business Corporations Act, the Department of Consumer and Corporate Affairs is no longer using the letters patent technique to incorporate new companies generally. The system applying to trust and loan companies could be simplified to direct issue of letters patent by the Minister of Finance through the Department of Insurance rather than involving two departments.

Discussions during the revision of the banking legislation led to a decision to provide for a public hearing on an application to form a new bank, should the Inspector General of Banks consider that to be appropriate. By analogy, a similar procedure could be provided for in the legislation under discussion.

At the present time, no machinery exists for the transfer of companies that are subject to loan or trust legislation to the Canada Business Corporations Act or vice versa. From time to time, there have been inquiries about the possibility of changing an existing company that had been incorporated under the CBCA to the status of a trust company or a loan company subject to the relevant legislation. Also, the question has arisen occasionally about the possibility of a trust company or loan company that has no deposit liabilities, transferring out of that category and continuing its corporate structure under the general corporate law. It would appear reasonable to make provision for transfers of this type in either direction, subject to the approval of the Minister of Finance. Transfers-out would be permitted only if there were no liabilities to the public. Transfers-in would be permitted only on the basis of adequate financing, the establishment of operating plans, management expertise, and other matters similar to requirements for the incorporation of a new company.

With respect to capital structure generally, it would appear that the current environment indicates the need for a far larger initial capital than has been traditional in the past. Until recent years, it has been thought sufficient to ask for a minimum initial capital of $1 million for the formation of a trust company and a

somewhat lesser amount for the formation of a loan company. It would appear, however, that at least $5 million should be required for a company that wants to do a trust business and a savings deposit business. For companies that want to do a savings deposit business only and not a trust business, perhaps something less would be appropriate but not less than $3 million. Ministerial discretion should exist to require a larger initial capital if the operating plans and forecasts suggest that stronger financing would be necessary.

B. Ownership and Transfer of Shares

With respect to such matters as the general procedure for transfer of shares, proxy voting, take-over bids and insider trading, there seems to be no reason to have special provisions applicable to these kinds of companies other than those already applicable to corporations in general, under the CBCA. However, certain matters related to the transfer of shares are of particular concern with this kind of company and they will be discussed in the following paragraphs.

B.1 Limitations on Ownership of Shares by Non-Residents

Present legislation puts a limit on the proportion of shares that may be transferred to or issued to a non-resident. Subject to an exception described below, not more than 10% of the shares can be registered in the name of any one non-resident (together with his associates) and not more than 25% of the shares can be registered in the name of non-residents as a whole.

This limitation, parallel to a similar rule for banks and life insurance companies, has been successful in preventing transfer of control of companies out of Canada. The principle was not brought into question during the Bank Act revision.

As a detail and for clarification, the limitation on foreign ownership, now in terms of registered ownership, might be extended to apply also to beneficial ownership and to each class of shares, considered separately. These changes were made in the Bank Act.

Under the present rules, there may be difficulty in some cases in deciding whether a corporation that is or proposes to become a shareholder is a resident or a non-resident. The present legislation simply states that a corporation is considered to be a non-resident if it is incorporated out of Canada or controlled by non-residents. With no definition of "control" in the legislation, it has been considered necessary to follow the common usage and regard legal control to lie where the majority of voting shares are held. This can give rise to difficulty and perhaps defeat the intent of the legislation in cases where the resident holding is fluctuating at or near 50%, and in cases where effective control lies with non-

residents, even though a majority of shares are held by residents. This could happen where there is one large holding by a non-resident and other holdings are very small.

To remove doubt and uncertainty there should be authority for a ruling on the question. This could take the form of deeming a company to be controlled by non-residents if the Minister is satisfied that effective control lies with one or more non-residents even though a majority of share lies in the hands of residents; the converse might also be authorized, i.e., to deem a company to be effectively controlled by residents even though a majority of the voting shares is held by non-residents.

The exception to the limits on foreign ownership, referred to above, permits a non-resident to seek the formation of and own a Canadian trust company or loan company although a non-resident cannot acquire control of a company that is Canadian controlled. This exception, dating from 1965, is partly in recognition of the fact that trust companies and loan companies can also be incorporated at the provincial level. In 1965, none of the provinces had limitations on foreign ownership of trust companies or loan companies. It was thought that closing the door completely at the federal level would be ineffective if provincial incorporation remained available.

Since 1965 when the limits above were adopted in the federal legislation, a number of provinces have adopted limitations on foreign ownership of trust companies within their jurisdictions. In this circumstance, it would be somewhat awkward to have a foreign-owned company incorporated at the federal level and authorized to be active in a province where that province had a rule against incorporating foreign-owned companies.

An important point in this connection is that a change in the Bank Act allows a Canadian bank to be wholly owned by a foreign bank incorporated in a country that gives reciprocal rights to Canadian banks, and subject to restraints on size and market share of the Canadian bank. Because of the growing similarity of activities between trust and loan companies on the one hand and banks on the other, it would seem that consistency requires a close control on the formation of a trust company or loan company owned by non-residents.

Having in mind all of these circumstances and, in particular, the existing controls on the formation of foreign-owned Canadian banks, it seems unnecessary to leave the way open for the formation of foreign-owned trust companies or loan companies subject only to ministerial discretion. Provision must, of course, be made for the formation of loan companies that are subsidiaries of foreign-owned banks since this possibility is contemplated under the Bank Act. As a transitional provision, it would be reasonable to allow the formation of new trust or loan companies by a non-resident but only if the non-resident is a foreign-owned

Canadian financial institution now active in Canada; provision should also be made to ensure that none of these companies would attempt to enter any province that has a rule against the formation of foreign-owned trust companies, unless the province agrees.

In addition, size limitation should be considered analogous to the limits on foreign bank subsidiaries.

B.2 Limitations on Ownership of Shares by Residents

The Trust Companies Act and the Loan Companies Act do not now contain any limitations on the ownership of shares in such companies by residents. Following are the main issues that arise in considering whether such limitations should apply in future.

(1) Existing Rules for Banks

The Bank Act prevents any person, whether resident or non-resident, from becoming the registered or beneficial owner of more than 10% of any class of shares of a bank. The increasing similarity of savings deposit activities of banks and of trust and loan companies would suggest parallel treatment. A similar 10% limitation applies in the Quebec Savings Bank Act; this was confirmed and strengthened in the course of the revision of the banking legislation in 1980. The one shareholder holding a beneficial interest of more than 10% of the shares of the sole existing savings bank was required to divest to 10% within five years.

(2) Conflict of Interest

Recent takeover bids for major trust and loan companies, and the experience of financial institutions in other countries, have raised the danger of a conflict of interest where close control exists.

The ownership limitation was inserted in the Bank Act to maintain the independence of banks and to remove any concern that a bank's investing and lending activity could give rise to a conflict of interest on the part of a major shareholder. Given the importance of banks in the economy, the limitation serves to reduce the possibility of undue concentration of economic power and helps to ensure a broad availability of banking services to the community. The ownership rules have succeeded in maintaining the independence of Canadian banks without hampering their growth, financial soundness or competitive vigour. During the examination of the last Bank Act revision, there were no representations made to remove this limitation.

Except perhaps for the question of size, it appears that the arguments in favour of a limitation of ownership of banks and savings banks apply with equal force to other companies accepting public funds for investing or lending, with an additional concern in connection with trust companies because of the importance of avoiding a conflict of interests in any action as trustee.

While it is true that there has been no serious abuse of existing ownership positions in trust and loan companies in recent years, it is worth noting that three of the largest companies with more than half of all existing trust business, were until recently all widely held so there was no cause for concern in their cases. However, there is no guarantee against a change of ownership in the absence of statutory limitations, and there have been evidences of conflict of interest problems coincident with a controlling interest, both in Canada and in other countries.

An alternative approach to conflict of interest problems could be by way of a legislative prohibition against such situations. While this would achieve some control, it is a practical impossibility to identify in a statute all of the various situations where a conflict of interest can arise.

(3) Existing Voluntary Limitations

One relevant circumstance is the voluntary limitation on share ownership established by amendment to the instruments of incorporation of a number of companies. In the early 1960's, the Royal Trust Company, a Quebec company, obtained a limitation on voting rights in its charter by special act of the Quebec Legislature. In the late 1960's, the Nova Scotia Savings and Loan Company obtained a similar change in its charter by a special act of Parliament.

In 1970, the Trust Companies Act and the Loan Companies Act were amended to provide for incorporation by letters patent instead of by special act and, in a related change, to permit companies to seek the inclusion of limitations on voting rights and share ownership in their instrument of incorporation. Any such change needs the approval of the Minister of Finance before it can be adopted or removed. Three companies subsequently obtained charter amendments placing limitations on ownership of their shares. These were the Canada Permanent Mortgage Corporation, the Canada Trustco Mortgage Company and the Equitrust Mortgage and Savings Corporation.

The general purpose of this permissive legislation was to allow a company's shareholders to maintain the company's independent character. While the legislation was not specific, the general thought was that if any such charter amendment were adopted, it would not be subsequently removed except in the event of financial difficulty where a takeover by another company was essential.

(4) Effects on Investment and Operations

While it might be argued that limitations on share ownership would discourage investment in trust and loan companies and reduce the vigour of their management, this does not seem to be borne out in actual experience. Royal Trustco, Canada Permanent, both large companies and until recently widely held, have not had difficulty in raising capital and have all shown vigorous competitive management. The same might be said of Canada Trustco which is still widely held. In the case of chartered banks, ownership limitation has not interfered with vigorous management and competition.

However, the point may have some validity for newer and smaller companies which are not in a position to raise capital in the market and may therefore have to rely on a lead shareholder. As well, the organization and management of a new company often relies on the impetus of a single shareholder rather than a group. It may be, therefore, that special considerations should apply to new companies and companies below a certain size. This factor is recognized in the Bank Act which provides a 10-year period during which share ownership may exceed the regular limit.

(5) Shareholders' Powers and Rights

A limit of, say, 10% on ownership by any one person, in any class of shares, would not prevent two or three important shareholders from pooling their forces to express a common viewpoint on an issue. This is a normal and acceptable procedure. It is quite different from one shareholder, or an associated group of important shareholders, having a controlling position.

There could be concern that too strict controls on share ownership could lead to disregard of shareholders' rights by management. However, this situation should not normally arise if any single shareholder could own as much as 10% of the stock. In such a case, the shareholders would not be without a voice relative to management action. Furthermore, the directors of a company that does not have a dominant shareholder could be more independent and exercise a stronger check on management than might be the case where there is a dominant shareholder. The experience of mutual life insurance companies, which have widely diffused voting rights of members, does not suggest abuse of management power.

(6) Existing Large Shareholdings

Within the existing trust and loan industry there is a wide variety of companies, new and old, small and large, and with few exceptions they all have a single dominant shareholder. This fact imposes a serious problem in adopting any ownership limitation. Special consideration would have to be given to existing

ownership positions and some transitional measures would have to be adopted to remove or, at least, minimize interference with existing rights.

(7) Provincial Incorporations

One important concern is that, since companies can be incorporated either federally or provincially, a share-owning limitation in federal law could be avoided through provincial incorporation. This point needs careful consideration. However, if the principle of limitation is sound, it can reasonably be expected that some provinces would follow a federal lead in adopting it. This in fact occurred after limitations on foreign ownership of trust and loan companies took effect in 1965.

B.3 Draft Rules on Share Ownership

These various considerations need to be carefully weighed. It is essential to avoid any misuse of savings funds accepted from the public and to ensure that management decisions on the use of such funds will be made with the best interest of the customers in mind. The choice seems to be between ownership limitations to remove any dominant shareholder interest and an expansion of legislative rules designed to avoid a conflict of interests in lending and investing decisions. The former is a direct and simple approach by removing the main source of a conflict of interests but it requires modification in the case of new companies and small companies and careful attention to existing shareholders. The alternative, broader legislation dealing with conflict of interests, would require elaborate provisions that would raise many day-to-day problems and may require arbitrary decision by supervisors.

To focus discussion of this important issue, the following is an outline of rules that might be adopted under a general programme of ownership limitations to deal with new and small companies and with existing shareholders.

Possible elaboration of existing rules to reduce conflict of interests are described in subdivision C.2 (5).

The general rule would be that no person would be permitted to own, either as registered owner or beneficial owner more than 10% of any class of shares of a trust company or a loan company, subject to a number of exceptions as follows:

(1) Since it is not likely that a new company would be organized, except on the initiative of a single investor or a small group of investors, an exception would be made for new companies. A similar exception applies in the Bank Act.

(2) Small or medium-sized companies will from time to time need additional capital in amounts that would not justify floating an issue in the general

securities market. In such a case, where the capital has to be raised from existing shareholders or by a private placement, it may be that the lead of a major or important shareholder would be essential. Therefore, it is proposed that limitations on share ownership not apply until a company achieves a certain specified size. This minimum size might be deposit liabilities of $1 billion or more. At the present time, there are 10 companies in this category.

(3) The limitations on share ownership would not apply to prevent a company that is subject to this legislation owning, as a subsidiary, another company that is also subject to the legislation. In this context, a parent-subsidiary relationship is not significantly different from the operation of a single company. Two of the 10 companies referred to in (2) are wholly owned subsidiaries of two other companies in the group.

(4) A similar exception would apply with respect to a loan company that is owned by a chartered bank. This would except two more of the 10 companies referred to above.

(5) Where, at the date the limitations are adopted, an existing shareholder is the beneficial or registered owner of more than 10% of the shares of a particular class of shares of a company, the following rules would apply:

  (a) that shareholder would not be permitted to acquire further shares of that class of shares of the company;

  (b) there would be no change in the voting or other rights applicable to that shareholding for a period of five years from the effective date of the legislation;

  (c) at the end of five years from the effective date of the legislation, the maximum voting rights of that shareholder would be 10% of the total votes that could have been cast were there no limitations;

  (d) so long as the votes exercisable by that shareholder exceed the votes that may be exercised by all the other shareholders:

    (i) the company would be prohibited from issuing other than voting shares, and

    (ii) after a period of five years from the effective date of the legislation, the liabilities of the company (deposits and other savings funds accepted) would be limited to the sum of—

      (I) the liabilities existing at the end of that five year period (or twenty times the company's capital and surplus at that time, if larger), and

      (II) twenty times any increase in the company's capital and surplus occurring after the end of that period.

  (e) In the case of a company that, at the date of the legislation, is less than the minimum size mentioned above (liabilities of $1 billion), the limitations would become effective at the end of the

financial year of the company during which it first achieved liabilities in excess of $1 billion. On and after that date, or if later, a date that is five years after the effective date of the legislation, voting rights of each shareholder would be limited to a maximum of 10% of the total votes that might be cast were there no limitations and the conditions described in (d) above would apply except that where the ownership limitations became applicable to a company later than 5 years after the effective date of the legislation, the limit on liabilities would apply from that later time.

An alternative to the proposal outlined in paragraph (5) above would be to "grandfather" all existing holdings and voting rights. The 10% limitation would then apply only to any transfer of shares or acquisition of new shares from the company. This course would be more protective of existing rights but would postpone for a longer period the attainment of independence by existing institutions.

B.4 Transfer of Control

Existing legislation requires prior notice to the supervisory authority of any transfer of a major block of stock of a trust company or a loan company. A major block of stock is defined as being 10% or more, or any smaller amount sufficient to put control in the hands of the transferee.

As discussed earlier, it appears to be desirable that the incorporation of a new company be discretionary with the responsible Minister. It is inconsistent to maintain full discretion in the hands of the Minister for the formation of a new company but to permit control to be transferred later without any approval from the supervisors.

It is relevant to note that under the Bank Act, change of ownership of a foreign bank subsidiary cannot take place except with the Minister's consent. It is also noted that in some foreign jurisdictions, change of control of major financial institutions requires governmental approval.

In recognition of this background, it appears to be appropriate to permit the responsible Minister to block the transfer of a major shareholding if he considers that the transfer would not be in the public interest.

Further, lack of such control would permit by-passing of existing rules on amalgamation. Amalgamation of one company with another now requires, first, the permission of the Minister to enter into discussions and, subsequently, governmental approval of the amalgamation agreement itself.

It would not seem to be desirable to require ministerial approval of every major transfer of shares. Rather, it would seem to be sufficient to give the Minister power to block a transfer should it appear to him to be undesirable in the circumstances.

C. Business and Powers

The business and power of companies subject to this legislation can be considered under four heads. The first has to do with raising money from the public, the second with investing and lending the money so received, the third with fiduciary activities, and the fourth with incidental and miscellaneous powers. Each of these will be considered in turn.

C.1 Raising of Money from the Public

As mentioned earlier, the institutions here being considered—trust companies and loan companies—raise money from the public by accepting deposits or selling savings instruments. Many companies now accept deposits in different categories, including deposit accounts with chequing facilities. Nearly all of the companies issue savings instruments of one kind or another, debentures, savings certificates, guaranteed investment certificates, guaranteed trust certificates and term deposit receipts. It is appropriate therefore to endow all companies that would be subject to this revised legislation with the power to raise money by the acceptance of deposits or the sale of debt instruments. This should clearly include the power to provide chequing facilities for customers. Existing provisions respecting deposits in the Bank Act and the Quebec Savings Bank Act could serve as a model.

Under existing legislation, trust companies accept deposits from the public under the general concept of receiving money in trust for investment, subject to a guarantee by the company to repay the principal on a specific date or on demand, subject to notice, and to pay a specified rate of interest on the funds so received. This "guaranteed trust concept" is of long standing. Its origin is now obscure but probably it stemmed from the concept that trust companies were essentially endowed with powers to act as trustees and any moneys they received from the public had to be considered as trust moneys rather than moneys received under a debtor-creditor relationship.

The deposit-taking activity of trust companies has now reached such a level that it should be considered as a separate activity rather than as an extension of trustee powers. The guaranteed trust concept is now largely a technical matter and is little understood and little appreciated by the customers of these companies. To all intents and purposes, the deposit-taking activity of these companies is operated on the same basis and is accepted by the public on the same basis as the deposit-taking activities of mortgage loan companies, savings banks and the chartered banks.

It was thought at one time that the guaranteed trust concept carried with it some measure of additional security to the depositors since the assets so received have to be segregated from all other assets under the control or within the custody of the trust company; the depositors and holders of guaranteed trust certificates have an exclusive claim against the assets in this "guaranteed trust fund" up to the limit of their guaranteed benefits. In addition, they have a claim against the company's capital and surplus if, for any reason, the assets in the guaranteed trust fund are not sufficient to implement the company's guarantee. However, this additional security may be more apparent than real. Experience in recent years indicates that the guaranteed trust concept is not clearly understood by the public. Confusion and errors exist from time to time in the separation and accounting for assets within the company as between the guaranteed trust fund and the company's own funds; legal complications sometimes ensue. Furthermore, legal problems and problems of jurisdiction arise in attempting to deal with these "trust" funds in the event of mergers, amalgamations or sale of blocks of business.

For these reasons, it seems desirable to terminate the guaranteed trust concept for the deposit-taking activities of trust companies under this legislation, and to empower companies to accept deposits and sell debt instruments on a debtor-creditor basis in the same fashion as mortgage loan companies or savings banks do now.

Improved protection for the depositors can be achieved by giving a priority of claim against all of the assets of the company in favour of the depositors and the holders of debt instruments. This, in fact, is proposed under the Bankruptcy Bill that is now before Parliament.

It would be necessary in any such change to permit companies to run off existing guaranteed trust business but the legislation should provide that future activities in the savings deposit field be on a debtor creditor basis rather than on a guaranteed trust basis.

C.2 Investing and Lending

Under existing legislation, the powers of a company to invest funds or lend funds are set out in the governing legislation in specific terms. Categories of investments and loans that are eligible to be made by such companies within their corporate powers and are acceptable as assets in their financial statements are given in the legislation in positive terms. As well, there are quantitative limitations on the extent to which companies can invest and lend in certain categories of investments as, for example, real estate or common shares.

By contrast, legislation applicable to banks operates rather on the "exception" principle in that banks have general power to invest and lend but are subject to certain restrictions to limit activity in one direction or another.

The question of whether to proceed in the grant of investing and lending powers by way of a "positive" basis or an "exception" basis is an important issue.

Generally speaking, existing legislation applicable to trust companies and loan companies operates on the positive principle but it is now very broad. Investment powers have been expanded from time to time by amendments over many years and, in addition, each company has a general area of free investment up to a maximum of 7% of its assets.

A further relevant consideration is that companies in the savings deposit business need as great a degree of flexibility as is possible in their powers to invest and lend in order that they can match, in an appropriate way, the maturity and interest rates available on their assets with the maturity and interest rates applicable to their liabilities.

Taking all the above into account, it appears that it would be appropriate to deal with the investing and lending powers of this group of companies on an "exception" basis; that is to say, to empower them generally to invest and lend funds received in their deposit-taking activities but subject to a number of restrictions designed to maintain the portfolio at a generally satisfactory level of quality.

The restrictions and limitations that might be considered in such a plan are as follows:

(1) Mortgage Lending

At present, companies are permitted to make mortgage loans up to 75% of the value of the underlying real estate unless the excess is insured or otherwise guaranteed. It is appropriate to maintain this traditional limitation (reflected also in the revised Bank Act and in the legislation applicable to insurance companies). However, by reason of current practice in splitting loans, with part secured by a real estate mortgage and part by other assets, it may be appropriate to permit mortgage loans in excess of 75% of the value of the underlying real estate provided that the excess is insured or guaranteed as at present, or is secured by the pledge of other acceptable assets.

(2) Limitation on Investment in Shares of any other Corporation

Present legislation permits a trust company or loan company to buy up to 30% or the common shares of any other corporation provided the shares are otherwise eligible. This 30% limit is of long standing and was intended to permit investment in shares without getting into a position of control. It seems now that the 30% limit is excessive for this purpose in the light of

the more modern approach to the ownership of other companies that are not subsidiaries. It is thought that a limitation of 10% would be more appropriate than 30%, particularly if companies are empowered to buy common shares without the requirement that such shares meet any particular dividend or earnings test. An exception would be made to permit companies to own certain defined types of subsidiaries that carry on activities that are similar to or ancillary to the activities of a trust company or loan company. Ownership of subsidiaries would, as at present, be subject to specific conditions and limitations.

As a general rule, it does not seem necessary to permit one company to own the shares of another where both would be subject to this legislation and if they are both engaged in trust activities or in the acceptance of deposits that are payable on demand or on short notice. Consistency with the banking legislation prohibiting banks from owning subsidiaries in Canada that are active in the banking business would point to a similar limitation for trust companies and loan companies.

Such a limitation would not necessarily apply to subsidiaries active in other countries nor to the ownership of companies that are incorporated under provincial law. This latter exception would permit a company to own trust companies that are incorporated provincially since there may be significant differences in trust activities from one province to another.

A further exception to the limitation on ownership of shares of any other corporation might cover temporary investments to permit participation in a venture project.

(3) Commercial Lending

While companies should be permitted to engage to some moderate degree in commercial lending in order to provide necessary matching for short-term liabilities, it seems necessary to put a limit on this kind of activity if companies under this new legislation are to be distinguished from banks under the Bank Act. Commercial lending and the receipt of deposits from commercial enterprises are appropriate activities for a bank. But the companies that are under consideration here are more in the savings deposit field than in the commercial banking field. This is particularly important for companies that have an extensive trust business because of the danger of a conflict of interests.

A limit of 15% of the assets of a company would be appropriate as the maximum that might be lent in the form of loans to corporations, other than mortgage loan that fit within the category of mortgage loans mentioned above. Such a limitation should include moneys advanced under financial leasing activity whether directly or through subsidiaries.

(4) General Limitations

It would appear that there should be limitations on the proportion of a company's assets that may be lent to any one borrower and persons associated with him and limitations on the proportion of assets that may be invested in the securities of any one issuer and his associates. Furthermore, there should be some limitation on the extent to which a company could invest its funds in certain specific kinds of assets such as real estate or common shares. It is thought that limitations of this type could be dealt with by regulation since there would have to be a definition of the concept of association between different corporations and the size limits may perhaps be changed from time to time.

The following schedule would seem to be appropriate at present:

- limit on loans to and investment in any one enterprise and associates—25% of capital and surplus
- limit on investment in real property not for company's own use—10% of assets
- limit on investment in common shares—15% of assets.

(5) Conflict of Interests

(a) Loans to Officers and Employees

It would seem appropriate to follow the Bank Act prescriptions with respect to limitations on loans to officers and employees. Under this restriction, loans can be made to officers or employees on the security of their residence and unsecured loans can be made but not in excess of $25,000 or the annual salary of the officer or employee, whichever is greater. The consent of the Board of Directors is needed with respect to any loan in excess of $25,000.

(b) Major Shareholders and Directors

Present legislation prohibits loans to directors of the company or to shareholders who own over 10% of the shares. Furthermore, a company cannot make loans to or invest in any corporation if a major shareholder or an officer or director has a significant interest in that other corporation. A significant interest is defined as 10% of the capital stock. It is considered that these limitations should be retained.

(c) Additional restrictions

In addition to existing limitations in the area of conflict of interests, consideration should be given to significant extension of these limitations, particularly if there is no limitation on share ownership of

the larger companies. Restrictions to be considered in this regard could reasonably be as follows:

(i) a company could be prohibited from buying property from, or selling property to, a major shareholder except after prior notice to the Superintendent, accompanied by whatever evidence the Superintendent requires to demonstrate that the transaction is favourable to the company;

(ii) a company could be restricted in the proportion of its assets that may be advanced by way of a loan on the security of real property purchased from a substantial shareholder or being developed by a substantial shareholder;

(iii) conflict of interest rules could be applied to trust funds as well as to deposit funds;

(iv) the Superintendent of Insurance could be given authority to identify investments in loans where he believes that there is a significant conflict of interests and require such loans to be placed before the Board of Directors for approval and to be publicly reported, and;

(v) a limitation could be placed on the management fees paid by a company to a major shareholder.

The discussion draft bill does not set forth limitations of this type since the need of measures additional to those now in place to control conflict of interests depends to an important extent on whether ownership limitations are adopted or not.

(d) Commercial Lending and Trust Activities

Where a trust company engages in commercial lending, it is proposed that it be prohibited from investing trust funds in or lending trust funds to a corporation if the trust company holds a significant amount of the outstanding debt of that corporation. Such a prohibition would apply only where the trust company had discretion in the investment of the trust funds. Further, a trust company might be prohibited from making commercial loans to a corporation if the shares or securities of the corporation are listed on a securities exchange. Securities so listed are more likely to appear in trust funds than unlisted securities.

C.3 Fiduciary Powers

At present, trust companies combine fiduciary activities with savings deposit activities whereas mortgage loan companies are active in the savings deposit field exclusively.

With a single act proposed to govern the activities of all these institutions, all companies that are subject to the act would be empowered to engage in the savings deposit business. In addition, companies now in the fiduciary business would be empowered to continue that activity but new companies would require special authority in the company's instrument of incorporation. This approach is suggested since the trust business is not a field of activity to be dipped into in a casual way. It requires a specific and long-term commitment, the organization of adequate staff and the development of a broad field of expertise. Some companies that are now designated as trust companies, are in fact engaged principally in a type of savings deposit activity, and have no real need of fiduciary powers. For the future, it would seem appropriate to restrict the granting of fiduciary powers to those companies that seriously intend to engage in this activity in a major way.

Except for legislative provisions having to do with control of conflict of interests, clear identification of trust funds and the operation of pooled trust funds, it does not seem necessary to legislate in any particular detail concerning the conduct of the trust business. This falls mostly under provincial jurisdiction and consequently provincial legislation could be relied upon to establish appropriate rules of conduct.

Pooled trust funds represent a special problem. Such funds are generally based on the principle that the participants bear the full and direct result of the investment gains and losses without any guarantee from the trustee. It is most important that full disclosure of this feature be made and that there be no confusion with moneys placed on deposit under a debtor-creditor relationship. Consequently, it would seem necessary to ensure that no company start any such pooled fund unless the supervising authority first consents and second, that there is compliance with provincial or other rules concerning disclosure and other aspects of the operation of any such fund or funds.

It would be appropriate to permit a trust company to delegate certain of its fiduciary functions to one or more of its officers as a practical operating procedure. This has in fact been done under trust company legislation in some jurisdictions.

C.4 General

Companies subject to this legislation could be endowed with certain general powers that are consistent with the savings deposit activity. These would cover such matters as administering mortgages on behalf of others, providing safety deposit services, issuing annuities certain (to accommodate certain RRSP activities) and other activities of a minor nature.

Generally, companies would be considered to have all the powers of a natural person, thus removing any problem with actions that might otherwise be

deemed to be ultra vires of a company; but control over a company's activities would be asserted through a provision that bars a company from engaging in any trade or business or dealing in goods, wares and merchandise except as provided in the Act. Also, it would be prevented from making any investment or loan except as authorized by the legislation.

D. Financial Standards

It is proposed that the requirements in the recent revision of the Bank Act be adopted for this legislation. Under this requirement, companies could be required to maintain adequate margins of capital and surplus and adequate and appropriate forms of liquidity. They would also be required to conform to ministerial directives in this regard and to any regulations that may be adopted by the Governor-in-Council.

Under existing legislation, minimum capital and surplus margins are defined by means of a maximum limit on the ratio of liabilities to capital and surplus. This ratio is often referred to as a company's "borrowing ratio". Trust companies now start with a borrowing ratio of 12 ½ times capital and surplus and mortgage loan companies with a borrowing ratio of four times. Increases in the borrowing ratio can be made if authorized by by-law of the company and approved by the Minister.

It is suggested that pursuant to regulations all companies under this new act might start with a borrowing ratio of 10 times capital and surplus. Any increases in this borrowing ratio within the first ten years of a company's organization would require specific approval, both by the Board of Directors and by the Minister. After a company is ten years old, increases in the borrowing ratio could be made by company by-law up to 20 times capital and surplus. Any increase above that level would require compliance with financial standards promulgated by the Superintendent of Insurance from time to time and specific approval of the Minister.

This approach would be substantially similar to the control mechanism now employed but would have somewhat greater flexibility in that the financial standards would be promulgated by the Superintendent rather than be adopted by regulation as is now the case and, furthermore, companies that are over 10 years old would have at their own discretion the authority to go up to a borrowing ratio of 20.

As an ultimate control mechanism, the Minister would be empowered to reduce a company's borrowing ratio whether adopted with the prior approval of the Minister or not.

The essential principle here would be that each company would be required to place before the Board of Directors a proposal for the establishment of a borrowing ratio. This would force concentration on the matter by the company and should lead to the determination of appropriate ratios having in mind the particular characteristics of a company's assets and liabilities. Ultimate control would be exercised through the Minister's authority to reduce any borrowing ratio and through the requirement of ministerial approval and compliance with departmental guidelines where the borrowing ratio goes above 20 times.

Existing legislation has specific requirements relative to liquidity. However, these are rigid and do not recognize some appropriate forms of liquidity that presently exist. In addition, existing tests are inadequate in some respects since they focus on the quality of assets in order to determine marketability. However, liquidity problems relate not only to the marketability of assets but also to the effect on a company's surplus of selling assets in an emergency situation. This, in turn, is related to the rules applicable to the valuation of assets for the purpose of financial reporting. As a consequence, it is thought appropriate to deal with this matter by regulation or by ministerial directive rather than attempt to establish rules in the legislation itself.

Because of the importance of rules relating to the valuation of assets in presentation of financial accounts, it is considered that power should exist in the legislation to adopt valuation rules by regulation. This in fact is done under the legislation applicable to insurance companies.

In considering appropriate levels of capital and surplus, an important issue is whether subordinated debt may be accepted as an appropriate margin of safety for depositors. Some jurisdictions do in fact accept subordinated debt as being, in effect, part of the company's equity base since it represents an additional safety margin to those creditors who rank ahead of the holders of subordinated debt and the shareholders. Under the Bank Act, banks are permitted to issue subordinated debentures up to a limit of 50% of their paid capital and surplus. The financial market seems to give this subordinated debt some weight in judging the equity base of a bank. A similar principle is followed in certain other jurisdictions.

It is true that other creditors rank ahead of the holders of subordinated debt in any liquidation and, as a consequence, moneys received in return for the issue of subordinated debt instruments can be considered as part of a company's safety margin. However, caution is required in this respect since subordinated debt is a temporary kind of a safety margin and the moneys must be repaid at the maturity of the debt. Furthermore, debt requires payment of interest, a continued drain on a company in case of financial difficulty. By contrast, for true equity, dividends can be deferred thus permitting more flexibility in restoring or maintaining financial strength. Thus, if any recognition is given to subordinated debt as part of a company's borrowing base, it must be within certain limits and

subject to specific control. To deal with this situation, it is suggested that subordinated debt might be accepted as part of a company's borrowing base as may seem acceptable to the Minister from time to time in relation to any particular company. However, this should not exceed 50% of the company's paid capital and surplus and should not be accepted if the subordinated debt has less than one year to run to maturity. Rules of this type may change from time to time depending upon surrounding considerations and may perhaps be considered as part of the Minister's discretion rather than be written into the legislation.

The matching of assets and liabilities by way of maturity and interest rates is very important to secure stability of a deposit-taking institution. Any lack of appropriate matching represents a hazard to a company's financial stability and should be taken into account in fixing the requirements for capital and surplus. If a company is not matched, it requires a greater margin of capital and surplus to provide safety to its depositors and holders of its debt instruments than would otherwise be the case. It is, however, a difficult and complex matter to set down specific standards for the matching of assets and liabilities. It seems more appropriate to examine this matter in terms of the circumstances of each individual company and to exercise control through modification of the borrowing ratio thus, in effect, establishing additional reserves if a company is not well matched.

E. Financial Disclosure

It seems appropriate in the current context to follow the pattern established by the Canada Business Corporations Act and the Bank Act. These requirements are, in general, similar to those that now exist in the legislation and no special comments seem to be necessary.

A point of interest as respects administration relates to the possibility of providing more flexibility than now exists in the choice of a company's financial year. At the present time, all trust and loan companies are, in effect, required to operate on a financial year that coincides with the calendar year. While this has many conveniences, particularly in publishing company statements in the report of the Superintendent of Insurance, it appears that the balance lies in the direction of permitting greater flexibility to companies to choose their own financial year.

Present remedial powers in the legislation are generally adequate to protect the interests of depositors where financial difficulty is encountered by any institution. The Superintendent of Insurance reports to the Minister where he considers that there are financial problems and the Minister, if he agrees with the view of the Superintendent and after giving the company a chance to be heard, may take one or more of a number of courses of action.

Although these procedures are generally adequate, experience has suggested that in certain cases it may be necessary to proceed with much greater dispatch than is possible if it is necessary to give the company a hearing and to obtain a court order to permit the supervisory authority to take control of a company for its continued operation, as distinct from taking control of its assets. It is noted in this connection that, under the Bank Act, if the Inspector General of Banks reports to the Minister that he believes that a bank will not be able to pay its liabilities as they accrue, the Minister may forthwith appoint a curator who has full authority to operate the affairs of the bank. This permits action to be taken very quickly to preserve the assets and the rights of creditors in the case of financial difficulties. It appears that the present remedial powers under the Trust Companies Act and the Loan Companies Act might be expanded or modified in order to permit the appointment of the equivalent of a curator without any delay where such action appears to be necessary. Existing provisions could be left in place providing for a hearing and court order where the situation is not of extreme urgency.

F. The Use of the Term "Savings Bank"

Under the existing Bank Act, the use of the term "bank" is prohibited either alone or in combination with other words to indicate or describe the business of a corporation in Canada, unless the use of the term is specially authorized by legislation. Companies that are subject to the Quebec Savings Banks Act are authorized to call themselves "savings banks".

In the context of the revised legislation here under consideration, it is clear from previous discussions that the companies concerned are in fact in the savings deposit business and conduct themselves in essentially the same way as a savings bank that is subject to the present savings bank legislation. Accordingly, it appears to be appropriate to authorize all companies that are subject to this new legislation to use the term "savings bank" as part of their name should they so wish and to use this term in describing their business and activity, subject to certain limitations and conditions.

Exceptions that should be made to any such designation and authorization would be companies that are subject to this new legislation and have powers to act as trustees but not to act as financial intermediaries. Furthermore, any company subject to this Act that does not accept deposits from the public that are repayable on demand or after short notice should not be empowered to use the term "savings bank" in its name or in describing its business. In fact, such companies would be better designated as being "loan companies" or "mortgage loan companies" or perhaps "savings and loan companies". Some existing loan companies would fall in this category, particularly the loan company subsidiaries of the chartered banks. It is suggested therefore that all companies that are subject to this new legislation should be designated as being savings banks and authorized to use that term, except as follows:

1. Companies that are authorized to transact fiduciary business only.

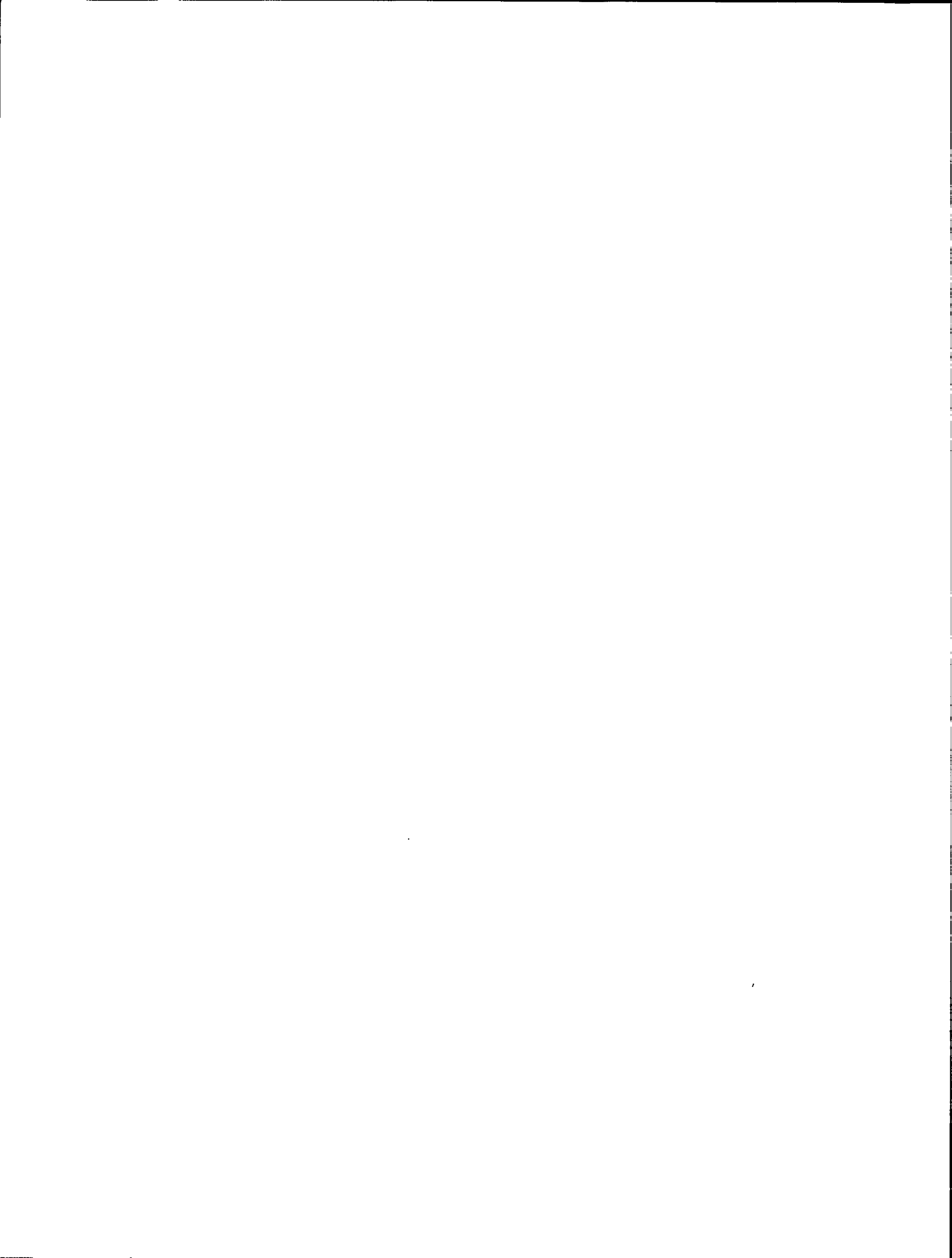
2. Companies that are subsidiaries of chartered banks.
3. Companies that are prohibited by a provision in their instrument of incorporation from accepting deposits repayble on demand or after notice of less than one year.

Where a company that is subject to this legislation has fiduciary powers as well as deposit-taking powers, it should be required to include the word "trust" in its name but should have the option of including the words "savings bank" in its name or not. Some existing trust companies may prefer to continue with their present name rather than add the words "savings bank".

G. Winding up and Liquidation

The existing Trust Companies Act and Loan Companies Act do not contain any provision having to do with the winding up of a company. All such matters are dealt with under the Winding-Up Act. Having in mind that there is a bill now before Parliament to revise the Bankruptcy Act and that that revision will provide for the liquidation of insolvent trust companies and loan companies, the proposed legislation includes procedures for the winding up of solvent institutions should that be necessary. The proposals are modelled on the relevant provisions of the Bank Act and the Canada Business Corporations Act.

The Bankruptcy Bill provides that deposit liabilities rank ahead of all general liabilities in the liquidation of a bank or other deposit-taking institution. It does not seem necessary to deal with this matter in the legislation here under consideration unless it appears likely that the Bankruptcy Bill will encounter long delays.



Part III—Conclusion

The draft bill reflects legislative proposals along the lines of the above discussion with a few exceptions. Among these are limitations on share ownership by residents and extension of provisions designed to avoid a conflict of interests in decisions relative to investing and lending. Final decisions on these matters and the changes reflected in the draft bill will be made following discussion of the proposals with interested parties.

The formation of new companies owned by non-residents is now a matter of ministerial discretion; the imposition of statutory limitations as discussed above will also await further discussion. This applies also to the matter of authority to issue a ruling on the resident status of a Canadian corporation and broaden emergency powers to take control of a company that is in difficulty.