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Canadian Banking

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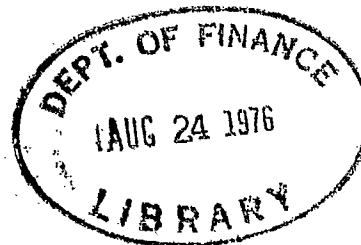
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White Paper on the Revision of Canadian Banking Legislation

Proposals issued on behalf
of the Government of Canada by
The Honourable Donald S. Macdonald
Minister of Finance
August, 1976

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Introduction

The British North America Act gives the federal Parliament exclusive power to regulate banking, currency and payments in Canada. Banks may thus only be incorporated under the exclusive authority of the federal Parliament. The Bank Act confers on the Canadian chartered banks their powers, and subjects them to all the restrictions and obligations contained in it.

The authority of the chartered banks to operate is subject to renewal every ten years. This traditional requirement of the Act provides an opportunity toward the end of each decennial period for a review and revision by Parliament of banking legislation in light of economic and other developments affecting the financial system and the role in it of the chartered banks. This regular and comprehensive review has served well in progressively updating relevant law and has contributed to the fact that Canada has a banking system widely respected for its soundness and effectiveness.

The current decennial period terminates June 30, 1977, and the government will be proposing revised legislation to Parliament.

Prior to the last decennial revision of the Bank Act in 1967, the government established the Royal Commission on Banking and Finance, chaired by the late Honourable Dana H. Porter. The report of this Porter Commission, published in 1964, is the most comprehensive analysis to date of the Canadian financial system, its markets and institutions; its basic findings continue to be relevant.

In the current review the government has undertaken to provide opportunities for the widest possible discussion and presentation of proposals for improving the banking legislation. In September 1974, the Minister of Finance invited all who wished to contribute to formulate their views and submit briefs by the fall of 1975. It was indicated that subsequently there would be a period of time for interested parties to review the government's proposals before legislative action was taken by Parliament. In light of the briefs received and its own studies, the government has formulated its proposals.

This White Paper is being issued at this time to outline those proposals of general interest and to invite consideration and discussion of them prior to the introduction of legislation. So that they can be fully considered by the government, comments and suggestions on the proposals should be submitted to the Minister of Finance as soon as possible. Further, having in mind the need for Parliament to consider the proposed legislation before the expiry of the current legislation, all submissions should be received by October 15, 1976. The government will propose that the legislation be considered by the appropriate committees of the House of Commons and the Senate.

Some Background Considerations

The Role of the Chartered Banks

In granting to the federal government exclusive jurisdiction over currency and coinage, bills of exchange and promissory notes, legal tender, banking and incorporation of banks and savings banks, and the issue of paper money, the Fathers of Confederation established the basis for the development and maintenance of a national financial system. A common currency and means of payment and a standard set of rules and practices permitting the free flow of funds are essential to the economic unity of the nation. An effective national system cannot be restricted by special barriers resulting from differences in rules and regulations or from the uncertainties to which a variety of standards of solvency and supervision give rise.

Put briefly, the economic purpose of the financial system is to contribute to the nation's productivity that arises from specialization and trade by providing the fundamental system for making payments and the basic means whereby savers may accumulate their savings and put them at the disposal of those who require funds to finance consumption, production or capital investments. The chartered bank structure, as it has developed over the years, plays a major and central role in the operations of this financial system on a national basis. By and large, the banks provide the payments mechanism throughout the country and for international exchanges; they perform a major function in the process of intermediation between savers and investors on a national scale and in the provision of financial services on a common standard in all parts of the country; and they are key in the implementation of national policies vital to the monetary and financial health of the system.

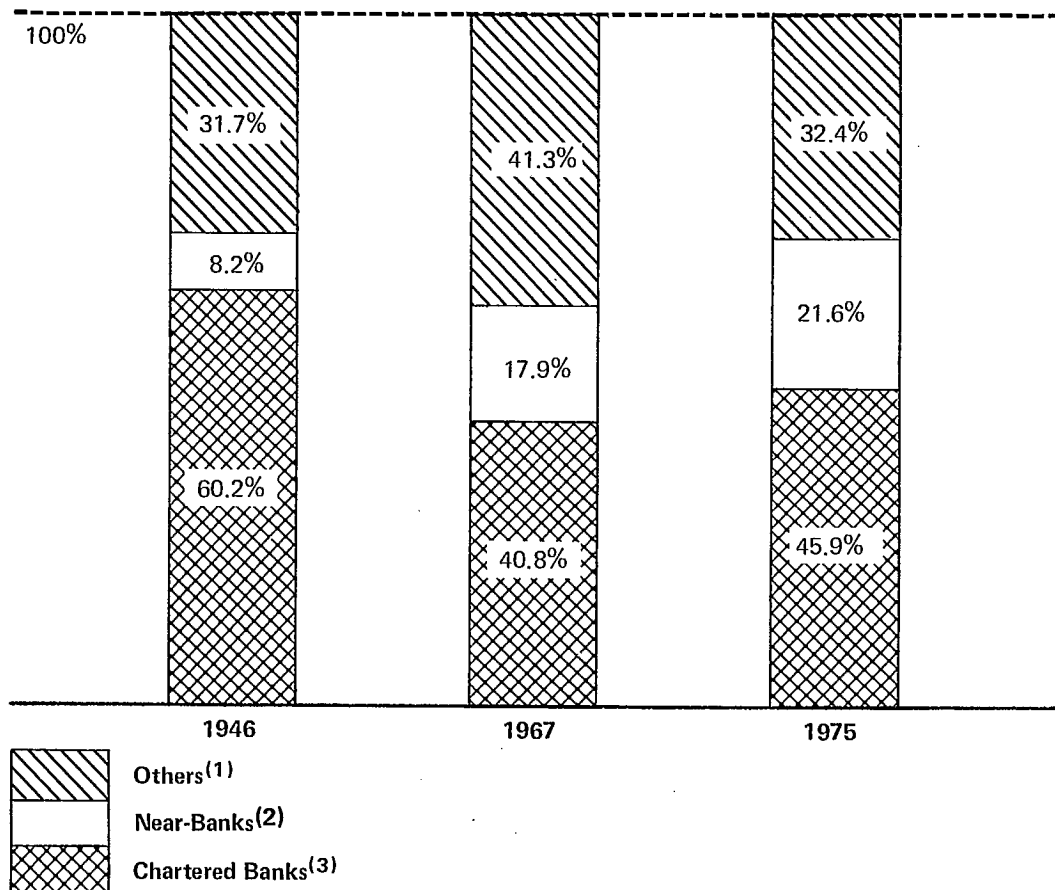
Banks and Near-Banks

While there are sound and compelling reasons for maintaining these fundamental and national roles of the chartered banks, the financial system and its markets are increasingly being broadened and strengthened by other forms of financial institutions. Many of these are more local in the areas and markets in which they operate and more specialized in the services they provide, complementing and competing with the banks. Increasingly, institutions other than banks accept deposits from the public and provide the payment service whereby deposits may be transferred by cheque or similar order. More and more, in the process of financial intermediation, the banks and other institutions are competing in the provision of broader ranges of services both to savers and to borrowers.

A dramatic development in the financial system during the postwar period has been the increase in the relative importance of the near-banks. These are financial institutions which accept deposits from the public, but which are not chartered under the Bank Act, and include principally trust companies, mortgage loan companies, credit unions and caisses populaires. In the 1946 to 1975 period, the near-banks increased their share of Canadian dollar assets of major financial institutions from 8 per cent to 22 per cent and of all deposit-accepting institutions from 12 per cent to 32 per cent.

These increases have been associated with increasing demands for mortgage and consumer financing, reflecting the growing wealth of the personal sector. More recently, the banks and near-banks have benefited from an increase in the importance of financial intermediation, as individuals have chosen to place a higher proportion of their savings with financial institutions rather than directly in the stock or bond markets. The growth of contractual savings institutions, mainly life insurance companies and pension funds, has been slower. Chart I illustrates these postwar changes.

Chart I
The Canadian Financial System
Relative Size of Institutions



(1) Others include life insurance companies, trustee pension funds, sales finance and consumer loan companies and Canadian financial institutions affiliated with foreign banks. Assets of Canadian financial institutions affiliated with foreign banks are only included in 1975. Assets of life insurance companies and trustee pension funds have been estimated for 1975.

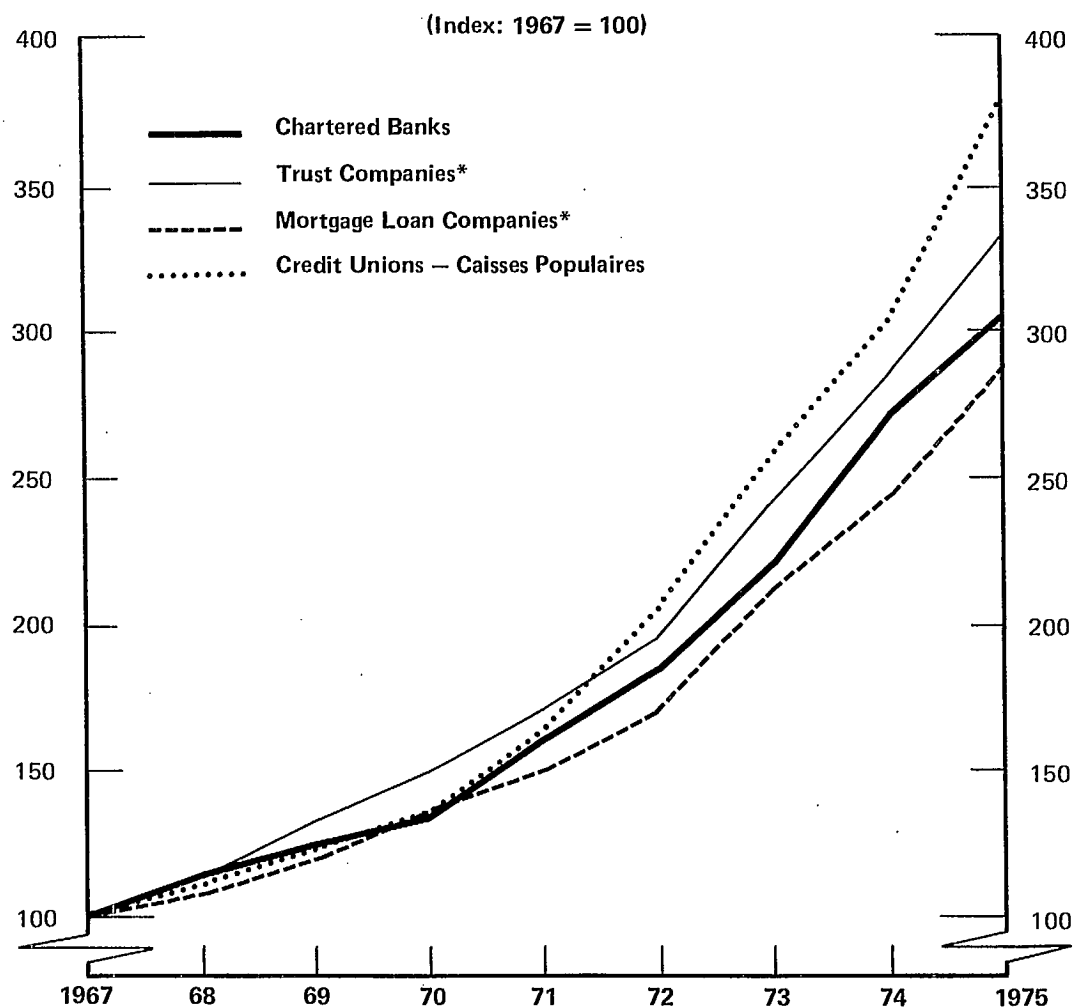
(2) Near-banks include trust and mortgage loan companies, local credit unions — caisses populaires and Quebec savings banks.

(3) Refers to Canadian dollar assets.

Note: Rounding may result in components not adding to 100 per cent.

The removal in 1967 of certain restraints, and particularly the 6 per cent interest rate ceiling on loans of the chartered banks, enabled the banks to expand at a rate more comparable to that of other deposit-accepting institutions. Even through this period, however, as shown in Chart II, the asset growth of trust companies, credit unions and caisses populaires exceeded the chartered banks. Mortgage loan companies grew at a slower pace.

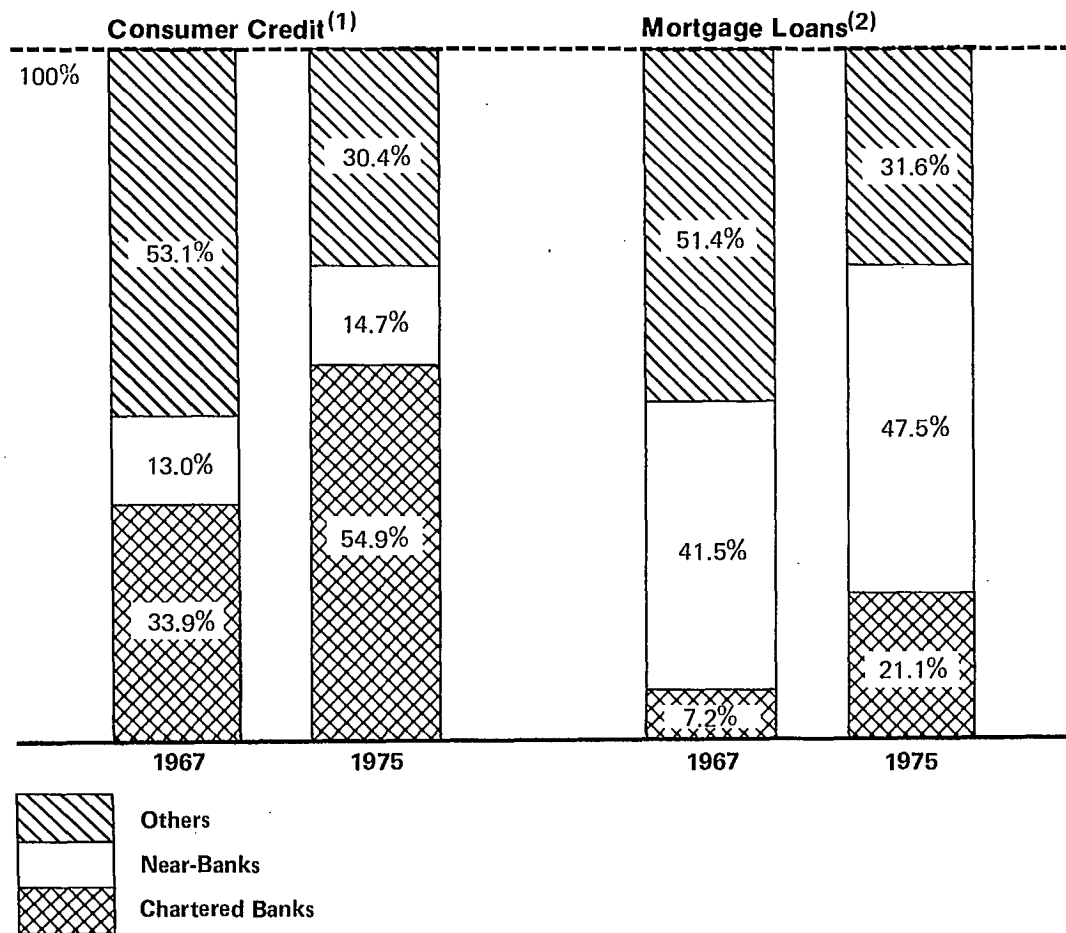
Chart II
Growth of Selected Deposit Taking Institutions
Total Canadian Dollar Assets



*Includes small amounts of foreign assets

The relative improvement since 1967 in the banks' position reflects mainly their activity in the consumer and mortgage credit sectors, as shown in Chart III.

Chart III
Distribution of Selected Assets*
Among Financial Institutions



(1) For consumer credit, others include life insurance companies, sales finance and consumer loan companies and retail dealers. Near-banks are defined in Chart I.

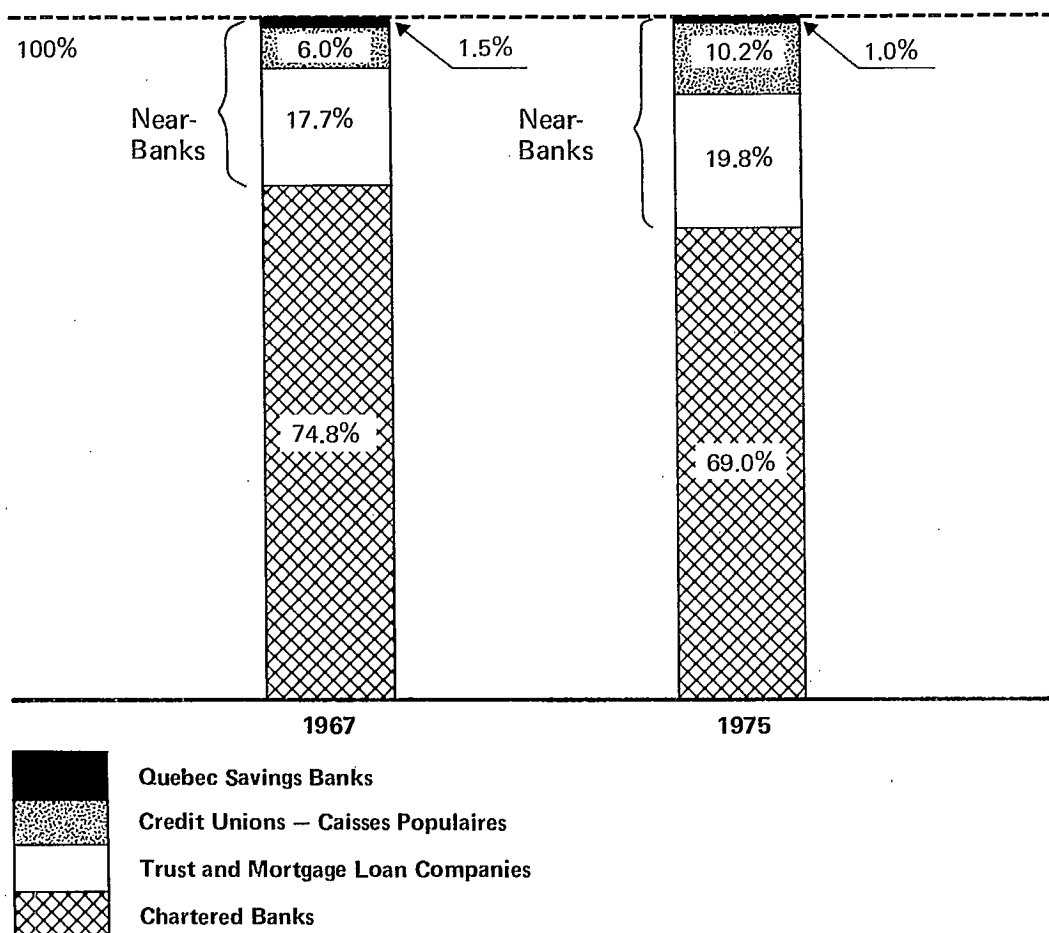
(2) For mortgage loans, which include residential and non-residential lending, others include life insurance companies, trustee pension funds, sales finance and consumer loan companies, real estate investment trusts, mutual funds, fire and casualty insurance companies and investment dealers. The mortgage loan data for 1975 include estimates. The chartered bank figures for mortgage loans include the activities of their mortgage loan company subsidiaries.

* Both assets are calculated on an average of quarters basis

Note: Rounding may result in components not adding to 100 per cent.

At the end of 1975 outstanding consumer credit accounted for about 19 per cent of the banks' major assets compared with 13 per cent at year-end 1967, and their share of such lending by major financial institutions had grown to 55 per cent from 34 per cent. Similarly, at the end of 1975, the banks' mortgage loans, including those held by their mortgage subsidiaries, accounted for 14 per cent of their major assets compared with 4 per cent in 1967; their share of mortgage lending had increased to 21 per cent from 7 per cent. The chartered banks' share of the commercial loan market has remained relatively stable since 1967.

Chart IV
Share of Deposit Market
Among Major Deposit Taking Institutions



The removal in 1967 of the interest ceiling, the authority for the first time to issue subordinated debentures within specified limits, together with the modification of reserve requirements applying to time and demand deposits, enabled the banks to compete more freely for funds with other institutions. As a result, the banks somewhat reduced the rate at which their share of the Canadian deposit market had been declining in the years preceding 1967. The banks' success in competition for large corporate term deposits offset in part a drop of 7 percentage points in their share of the personal savings deposit market between 1967 and 1975. Overall, the banks experienced a loss of 9 percentage points in their share of the Canadian deposit market in the ten years before 1967, and a further decline of 6 percentage points in the years from 1967 to 1975 as shown in Chart IV.

The above comparisons are made on the basis of the banks' Canadian dollar business. There has been a rapid expansion of the foreign currency assets of the banks, which are primarily financed by the deposits of non-residents. From a level of \$6.5 billion or 20 per cent of total assets in 1967, foreign currency assets rose to \$31.2 billion or 29 per cent in 1975. In addition to playing a major part in the Eurocurrency markets, the Canadian banks have increased their activities in a variety of currencies in many countries. Taking this expansion into account, the banks' total assets grew at a compound annual rate of 16.6 per cent from 1967 to 1975, which compares with 16.3 per cent for trust companies, 14.2 per cent for mortgage loan companies and 18.1 per cent for credit unions and caisses populaires.

Along with these varying trends in growth among the financial institutions, there are changing patterns in the services they provide and the degrees of diversification and specialization within and among groups of institutions. This reflects to some extent changes in law, but also the responses of competing institutions to the changing market opportunities as they perceive them. The near-banks, progressively increasing their share of transferable deposits and expanding consumer and mortgage lending, are moving into commercial lending activities. Others, such as the sales finance companies, responding to the competitive moves of the banks into the mortgage and consumer lending markets, have diversified into various forms of corporate lending. As a result of its developing size and depth, the short-term money market, operating through investment dealers, now provides a financing vehicle to corporations in competition with the banks. This market also serves as a supplementary source of funds for the banks and other institutions that gather deposits on a retail basis from the public, such funds being used directly in some cases and for financing their affiliated institutions in other cases. Also it has increasingly facilitated the establishment of financial intermediaries, including banks, which rely on this wholesale source of funding rather than on deposits collected directly from the public. Most notably, this has facilitated the emergence in recent years of financial corporations which are owned by or affiliated with foreign banks.

Finally, a few words should be said about the profitability of the banks and near-banks. The banks' profitability, measured by pre-tax profits per \$100 of assets, rose sharply from 1965 to 1969, and declined almost steadily until 1975 when it rose almost to the 1969 high.

In 1975, the spreads on banks' domestic business were widened, restoring the domestic margin of profit to pre-1974 levels, while the margin of profit on international business appears to have increased dramatically. The combined effect of continuing inflation, real growth and wider profit margins resulted in an increase of 41 per cent in balance of revenue, while assets rose by 18 per cent. About a third of the increase in balance of revenue came from their international operations.

The profit margin per \$100 of assets of the credit unions and caisses populaires was substantially higher than the margin for the banks in 1965 and the years immediately following. However, in the case of the credit unions and caisses populaires, these margins declined steadily over the period 1965-1975 so that by 1975 they were only slightly higher than those of the banks. The same measure of profitability was higher for loan companies than for banks in all but two years of the period. The picture is more mixed for trust companies. In three of the last five years, trust company margins exceeded those of the banks, while in four of the previous five years, bank margins exceeded those of the trust companies.

Looking at the more recent experience, pre-tax earnings per \$100 of assets of Canadian banks, trust and loan companies, credit unions and caisses populaires, all showed exceptionally large reductions in 1974. In the case of the banks and loan companies, margins were restored in 1975 to pre-1974 levels; the trust companies improved their margins but not to 1973 levels and the credit unions and caisses populaires margins continued to decline.

Some may prefer to consider bank profits from a different point of view. In relation to equity, the balance of revenue of banks is greater than that of most other deposit-taking institutions where such a comparison is relevant, a major contributing factor being the high leverage of the banks. However, the extent to which banks have been paying out dividends from balance of revenue has been declining as they have devoted an increasing share to capital accounts. Dividends paid in 1975 amounted to 15.5 per cent of the balance of revenue.

The after-tax rate of return on banks' shareholders equity has not been on average significantly different from that of non-financial corporations over the period from 1963 to 1973, the last year for which reliable statistics are available. There is, however, a marked difference between the pre-1967 period and after. These ratios for the banks were lower than those of other industries before 1967 while, since that date, the banks' ratios exceeded those of other sectors. Since the third quarter 1975 the banks, like other major corporations, have been subject to the profits restraint of the Anti-Inflation Board.

Affiliates of Foreign Banks

The interest of foreign banks in establishing or participating in financial subsidiaries in Canada has accelerated noticeably in the period since the last revision of the Bank Act, particularly in the last four years. At least 60 foreign banks, including some of the world's largest, now have equity interests in affiliated Canadian financial corporations.

These affiliates draw their funds largely from the issue of short-term obligations in the Canadian money market which are frequently guaranteed by their parent banks. They compete with the Canadian banks and other financial institutions in commercial lending and related activities. They are not subject to the responsibilities and constraints required by Canadian banking legislation. This development gives rise to important questions of equitable competition and control by Canadians over their own banking system.

Competition within the Financial System

Traditionally, Canada has placed reliance upon competition among the banks, among other institutions and between the banks and other institutions, all within a framework of law and subject to the basic control of the central bank over the total means of payment, to ensure that the payments system operates efficiently and equitably. As noted above, the chartered banks play a major and central role in the financial system although their relative position is gradually diminishing and, since the last revision, the profitability of the chartered banks as a group has been relatively strong. An adequate level of competition will help ensure that banking services are provided throughout the nation at the lowest cost to borrowers and the highest return to savers that are consistent with the survival and healthy growth of the country's financial system. Reliance on competition to achieve this objective avoids the use of restrictions which tend to dislocate markets and lead to inefficiency.

The government is, therefore, not proposing restrictions in banking legislation which would directly limit the operations or the size of the chartered banks. One such set of restrictions would impose direct controls on bank lending rates or the differential between borrowing and lending rates. Such controls introduce rigidities into the operations of these institutions, impairing their ability to compete and to respond to changing market forces. This was the experience of Canada before 1967 when a 6 per cent ceiling existed on chartered bank lending rates. It is the experience of other countries whose financial institutions are encumbered by interest rate ceilings.

Another restriction would check the size of the largest banks in the system by limiting the growth of their assets. However, one of the unique and enviable features of Canadian banking is that we have institutions that operate not only in every province but in virtually every hamlet of the country. Thus a common standard of services is brought to all Canadians. Savers can share in the returns on investments made right across the country and borrowers can draw on a national pool of deposit funds. The larger banks can also compete with the largest banks in the world for profitable international business and are in a strong position to support the international trade of our commercial corporations. Arbitrarily to limit the size of the larger banks would not bring greater competition in the provision of banking services to Canadians.

Another approach would restrict the banks as a group in the system by curtailing the range of their allowable activities or the degree to which they may carry on particular activities. Yet, in specific terms, a curb on their commercial lending would impair the heart of the banks' activities in relation to their borrowing customers. To limit their holdings of government bonds — federal, provincial or municipal — is both

undesirable and impractical. To limit their investment in mortgages would close off a large source of mortgage money and a desirable element of competition in that market. A rein on consumer credit would ignore the fact that the banks have brought this service to consumers at rates often considerably lower than alternative sources.

The soundness of the basic approach to the strengthening and development of the financial system through effective and equitable competition was reaffirmed by the Porter Commission, was central to its recommendations, and remains the basic underlying objective of the government in its approach to banking legislation.

The continuous evolution of the financial system, its markets and component institutions over the past decennial period indicates some trends, directions and practices which if continued unrestrained could detract from the constant goal of promoting and maintaining a strong national financial and payments system that is effectively controlled by Canadians and their authorities, and that responds to strong competitive forces which are not hampered or distorted by undue concentration or conflicts of interest. It is incumbent on the government to react to these developments and to make adjustments in the banking legislation which, while avoiding major disturbances in the ongoing operations of the system, will contribute to the strengthening of the financial system. Those areas in which regulatory adjustments are desirable and the legislative action proposed by government are outlined in the following sections of this White Paper.

Proposals

A Canadian Payments System

Background

When paper money was the most important medium of exchange, it was issued by the Government of Canada or by banking institutions chartered by the Parliament of Canada. The evolution of paper money as a national symbol reached its peak with the creation of the central bank in 1935 and the granting to it of the sole right to issue notes. This phase in the evolution of the payments system occurred when deposits, transferable by cheque or other order, were growing in importance as the medium of exchange. For a considerable period, the banks, chartered by the Parliament of Canada, were virtually the only institutions prepared to accept orders for the transfer of deposits. Under federal law they organized inter-bank cheque clearing, the system needed to return cheques tendered for payment at one institution to the institution on which they are drawn and to provide for the quick settlement of the net debit or credit positions arising among institutions as a result of clearings. The present system is run by the Canadian Bankers' Association established under federal law and its by-laws are subject to the approval of the Treasury Board. The system is highly automated, but it is on the verge of becoming outdated for two reasons.

The first reason is that inequities have developed in the system as the near-banks, operating under legislation different from that under which the banks operate, have become important in the business of accepting orders for the transfer of deposits. While the banks have made provision for the clearing of the cheques on these institutions, thereby aiding them to gain their present status in the payment system, the near-banks have no voice in the operation of the clearing system. Neither do they have access to lending facilities of the central bank as do the chartered banks. On the other hand, the near-banks have no obligation to maintain non-earning reserves against their deposit liabilities as do the banks.

The second reason why the present system is becoming outdated is that the making of payments is starting to evolve from a system based almost exclusively on paper transactions toward an electronic system in which paper transactions will have a less prominent role. The Government of Canada has already recognized that the near-banks should be represented in the technical work that must precede the introduction of such a new system and they are represented in the committee now at work designing some of the specifications which will be required. These institutions have asked for and welcomed the opportunity to participate.

In considering the evolving role of the near-banks in our financial system, the government has been conscious of the local and regional origins of these institutions and particularly the credit unions and caisses populaires. Many of them were developed early in this century to serve a local community or the workers of a factory who were not being served, particularly in the provision of credit, by the existing financial institutions. They brought both social and economic benefits to their members.

The proposals below take into account these origins and the fact that many of these institutions, as a consequence of their origins and objectives, are provincially incorporated. These proposals are not intended to intrude upon provincial jurisdiction or the ability of these institutions to respond to the needs of their members. The government plans to discuss these proposals with the provinces and interested institutions in the near future.

In the evolution of the payments system of today into the payments system of tomorrow, the economic interests of Canada will be served best by a national clearing system in which all of the institutions directly involved may participate and share the requisite rights and obligations in an equitable manner. The opportunity is provided by the present review of banking legislation to ensure the orderly development of the payments system towards that goal.

Canadian Payments Association Act

To give effect to this approach, it is proposed that a Canadian Payments Association be established by companion legislation to the Bank Act. All institutions in Canada accepting deposits transferable by order will be required to join the Association. Local credit unions and caisses populaires offering chequing facilities will be required to be members of a central or similar body which will belong to the Association. The Bank of Canada will be a special member of the Association.

All members of the Association will have certain rights and obligations. They will have the right to offer chequing facilities to their customers. They will have the right to have such cheques, and perhaps certain other items, cleared through the national clearing system. They will have the right to be represented in the management of the system. Finally, they will be accorded certain borrowing facilities at the central bank.

Members will be expected to cooperate in the effective running of the system and to share its operating costs. To assure all members that their associates are maintaining a sound financial condition, all members will be required either to belong to the Canada Deposit Insurance Corporation, to be insured by the Quebec Deposit Insurance Board, or in the case of credit union centrals and caisses populaires federations, to be members of the Canadian Co-operative Credit Society. Members will also be required to maintain a minimum reserve against specified liabilities in the form of Bank of Canada notes, in non-interest bearing deposits at the Bank of Canada or, in some cases, with other members of the Association. Finally, members will be obliged to meet other requirements of the Canadian Payments Association Act in areas such as reporting information. Provincially incorporated institutions will in all other respects continue to be controlled by their provincial acts of incorporation and subject to provincial jurisdiction.

In order to give flexibility to the system, and indeed to permit it to function as much like the present system as the members desire, it is proposed to permit any bank or non-bank member of the Association to be either a "clearing member" or a "non-clearing member". A clearing member will keep its reserve account with the

Bank of Canada and participate in the clearings at the regional settlement points. A non-clearing member will elect to clear through a clearing member and may keep its reserve account with that member, in which case, the clearing member will have to match the non-clearing member's reserve account by an equivalent amount in its account at the central bank. It is anticipated that many members of the Association will elect to clear through other members.

The business of the Association will be managed by a Board of Directors chaired by an officer of the Bank of Canada, and made up of other directors representing groups of members. The Directors will propose the by-laws of the Association, which will be subject to approval of the Governor in Council. Expenses of the Association will be met by levies on the members fixed from time to time in the by-laws. The operation of the clearing system will be subject to the supervision of the Inspector General of Banks. Members will be expected to furnish relevant information to the Inspector General in respect of their payments activities, and the Inspector General will advise the Minister of Finance. Although government will have a supervisory role through its power to approve by-laws, through the Inspector General of Banks and through the chairman, the detailed work of running the system and planning its evolution will be the responsibility of the members of the Association.

It can be anticipated that the electronic payments system will gradually evolve alongside existing payments methods towards greater use of a card by all individuals, corporations and other entities wishing to make payments. This "payment card" will resemble the bank credit card we know today. Presumably, the credit card and the payment card will meet certain established standards to enable them to be used in the same point-of-sale computer terminals. Beyond this, there need be little relationship between the existing credit cards and the emerging payment card. Indeed when the electronic payments system is operational, it will be immaterial to the merchant, or other party receiving payment, whether a payment or credit card is tendered. The use of credit will be a matter solely between the payer and his banking institution.

The existing credit card system is not being ignored. The government's policy statement, "Towards an Electronic Payments System", said:

The relationship of various deposit-taking institutions to generalized credit card systems is a problem of financial markets structure and competition policy which relates to legal and contractual relationships rather than computer/communications and will therefore be further investigated in that context by the Department of Finance, with the assistance of the Bank of Canada and the Department of Consumer and Corporate Affairs.

A committee for this purpose has been established and it will work closely with the legal and consumer affairs committee and the standards committee which are already at work.

Reserve Requirements

It is proposed to require minimum reserves in the form of Bank of Canada notes and deposits against all demand deposits, all time deposits with an original term to maturity of one year or less, and all time deposits having an original term to maturity in excess of one year that are in practice encashable on demand. Reserves will be required against foreign currency deposits used to finance domestic transactions, as well as against Canadian dollar deposits. The requirements will be met by all members of the payments association.

The banks are not now required to keep cash reserves against foreign currency deposits; they keep reserves against all Canadian dollar deposit liabilities, a substantial amount of which are encashable on demand. The near-banks do not now engage to any considerable extent in the foreign-currency deposit business. The vast bulk of their deposits are notice deposits. Most of their term deposits have an original term to maturity in excess of one year and are not encashable on demand.

It is proposed that the reserve requirement on Canadian dollar notice deposits, and term deposits with an original term to maturity of one year or less, or longer if encashable, be 2 per cent on the first \$500 million of the institution's liabilities in this category and 4 per cent on the remainder. Nearly all the existing banks and a few of the larger trust and loan companies will be required to maintain a reserve at the higher rate against a portion of their notice deposits. Most trust and mortgage loan companies, local credit unions and caisses populaires through their centrals, and small banks will attract only the 2 per cent reserve requirement.

It is further proposed that the reserve requirement on Canadian dollar demand deposits, which applies primarily to banks, be 12 per cent of the liability as at present. Reserve requirements with respect to foreign currency deposits used domestically will be at the 4 per cent rate. The legislation will state specific reserve requirements but it will also authorize the Governor in Council, on the recommendation of the Minister of Finance, to change the requirement on particular classes of deposits within specified limits. This provision will give some flexibility to deal with the uncertainties of a new situation and a rapidly evolving payments system.

The requirement of cash reserves in the form of Bank of Canada notes and deposits is desirable for a number of reasons. Because the reserve requirement needs to be achieved only on average over a period of time, the reserve balance can be used to help meet a deficit on any particular day in the cheque clearing system. A clearing balance is essential to the operation of the system and the near-banks currently hold such balances with the chartered banks. The reserve requirement provides some assurance to participants in the clearing system that cheques which they have cleared, and which are drawn on other member institutions, will be paid. It bears equitably on all institutions competing with one another for deposits. Finally, it provides a framework that will ensure for the future that the central bank will continue to have effective control over monetary conditions in Canada, even should substantial shifts in the relative importance of deposit-accepting institutions occur.

The secondary reserve requirement provided for in the existing legislation will continue to apply to banks chartered under the Bank Act but it will not be applied to near-bank members of the payments association which are subject to different requirements of incorporation than banks.

Entry into Banking

Background

Canada has over the years moved from a system with a large number of locally based banks to a widely branched system with relatively few banks. A century ago there were as many as 51 banks operating in Canada. Between 1820 and 1970, some 45 banks failed or were wound up and another 41 merged with other banks; the last bank failure occurred in 1923.

This undoubtedly reflects the relatively greater financial stability of institutions which are able through their branches to operate in various economic areas and to carry widely diversified assets. The result has been, however, that 90 per cent of the total assets of the existing chartered banks is held by the five largest banks, a fact that gives rise to some concern about the size and the concentration of power in a few institutions. However, as already noted, one of the unique and enviable features of the Canadian banking system is that it includes institutions which operate across the country bringing a common standard of service to all Canadians. The larger banks support the international business of our commercial corporations and, in competing with the largest banks of the world for profitable international business, are an important exporting service industry.

In relation to its economic size, Canada has about as many large banks as other industrialized countries, but fewer small banks. Trust companies, loan companies, credit unions and caisses populaires compete increasingly in retail banking activities in Canada; other financial institutions, including foreign bank affiliates, compete in wholesale banking. These developments and the relatively higher growth rates of smaller banks, have reduced gradually the proportion of total banking business in the broader sense which is done by the larger Canadian banks. The five largest banks held 61 per cent of total Canadian dollar deposits of all Canadian deposit-accepting institutions in 1975 compared with 69 per cent in 1967 and 75 per cent in 1960.

Reasonable freedom for new firms to enter an industry helps to assure a healthy level of competition within that industry. The recent acceleration in the establishment of new banks is important and welcome. But in view of the relatively high concentration of total banking business among the larger banks, entry and growth of new banks should be encouraged and facilitated as far as possible. The following proposals are designed both to ease deterrents where they may exist and to facilitate by further measures the establishment of new Canadian domestic banks. Proposals in respect of foreign-owned banks are set out in the subsequent section.

Proposals

(a) Banks will be enabled to be incorporated by letters patent as an alternative to the present requirement of incorporation by special Act of Parliament.

Banks are the only remaining financial institutions which can only be incorporated by special act. Amendments in 1970 to acts governing federal insurance, trust and mortgage loan companies authorized incorporation by letters patent. The uncertainties of the parliamentary timetable and additional expenses involved may constitute some deterrent to the incorporation of new banks. The Bank Act sets out in some detail the framework within which chartered banks operate, and as already noted, Parliament reviews the law on a periodic basis every ten years. A newly incorporated bank, before it can commence the business of banking, is subject to approval by Governor in Council, and the detailed operations of a bank, once it commences business, are subject to surveillance and other requirements of the Bank Act. With these safeguards, and in the light of the increasing pressures on a crowded parliamentary timetable, it is recommended that, as an alternative to incorporation by special act, the act of incorporation and subsequent changes in bank charters be permitted by letters patent or supplementary letters patent. Whenever such letters patent are issued, the charters of the banks concerned, like those chartered by special act, will be subject to termination if not renewed by legislation at the time of the decennial revision. Letters patent will be issued by Governor in Council on the recommendation of the Minister of Finance.

(b) Canadian institutions with financial experience and expertise will be permitted to establish a new bank with a controlling interest for a period of years. Accordingly, subject to the provisions concerning associated shareholders, Canadian-owned financial institutions, other than trust companies and others which accept deposits from the public, will be authorized to own and vote up to 25 per cent of the voting shares of a new chartered bank, and higher percentages as may be approved by Governor in Council, for a period of ten years, after which the normal 10 per cent limitation on shareholdings will be applied.

Trust companies and other financial institutions which accept deposits from the public are excluded from this proposal because of the basic policy that deposit-accepting institutions should compete at arm's length and to avoid the combination of trust business and commercial lending activities.

The present Act permits a Canadian resident to own and vote in excess of 10 per cent of the voting shares of a new bank, subject to terms and conditions approved by Governor in Council. This provision will be continued, but will be subject to the ten-year limitation.

(c) The provisions of the present Act which preclude the ownership of bank shares by governments will be altered to authorize one or more provincial governments to hold and vote up to 25 per cent of the shares of a new bank, but this percentage will have to be reduced to 10 per cent within ten years. It was established at the 1973 Western Economic Opportunities Conference that

provincial governments might wish to assist through equity participation in facilitating the establishment of new banks. This proposal provides that opportunity.

(d) Sufficient authority and flexibility in the conditions of bank incorporation will be provided to facilitate the conversion of an existing financial institution to a chartered bank. As banks and near-banks broaden the range of their activities, the degree of specialization diminishes and basic differences tend to disappear. Some financial institutions whose functions include activities of a banking nature may wish to become banks. Where such institutions can make an effective contribution to a competitive banking system, their incorporation as banks should be facilitated. To do so it will be necessary to provide for special incorporation procedures and other provisions to enable an institution to adjust to the requirements of the Bank Act over a reasonable period.

(e) The financial commitments which may be assumed by a bank in connection with its organization will be broadened. Such expenditures as the cost of underwriting of the initial share capital issue, and reasonable costs of obtaining a nucleus of management and headquarters accommodation, will be recognized as organizational expenses in the establishment of a new bank.

(f) Finally, a proposal set out earlier in this White Paper provides for a minimal reserve of 2 per cent for the first \$500 million of notice deposits. This bears particularly lightly on new banks and other small deposit-accepting institutions, giving them some advantage until their reservable liabilities exceed \$500 million.

Foreign Banks

Background

Banks throughout the world, particularly the larger banks incorporated in the more industrialized countries, play an active part in the financing of international trade in goods and services and in the international capital markets. Apart from providing banking services in their home jurisdiction, banks generally seek to provide services abroad to non-residents in competition with the domestic banks in the country concerned and with other foreign banks. These operations take several forms. Banks may solicit deposits and lending business from non-residents, booking such business in their own home banks, an activity which involves visiting, soliciting and advertising abroad but no formal establishment of the bank in the other countries.

Many banks, including Canadian banks, engage generally in these activities with non-residents. On the other hand, a bank wishing to compete more directly and to book business in a foreign jurisdiction will establish branches, agencies or banking subsidiaries in conformity with the relevant laws and regulations of that jurisdiction. In some foreign jurisdictions, banks establish branches or banking subsidiaries which compete with the domestic banks of the country concerned in the taking of deposits from the public and the provision of general retail banking services. Others engage, through branches, agencies or bank subsidiaries, particularly in wholesale banking activities, raising funds in the local and international capital markets to provide loans and similar facilities to business.

The form of a bank's operations abroad reflects its own business interests, as well as the laws and restrictions applicable to foreign banks in the jurisdiction concerned, including the extent to which that jurisdiction requires reciprocal treatment of its banks in the home country of that bank. In their operations abroad Canadian banks have established 258 branches, 11 agencies and 48 controlled subsidiaries in about 60 foreign countries. To help establish business contacts and to keep informed on economic and financial developments, banks frequently have offices abroad which perform only a representative function and do not carry on any business in the foreign jurisdiction. Canadian banks have over 50 such representative offices in other countries.

Prior to the last decennial revision there was no legislative limitation on foreign bank ownership in Canada, although then, as now, incorporation of a bank was possible only by a special Act of Parliament. Foreign bank activities had, however, been confined mainly to the booking abroad of some business with Canadians and the establishment in Canada of a few representative offices. In the wake of the purchase of an existing bank in 1963 by a major foreign bank, several provisions were included in the 1967 Bank Act bearing on the foreign ownership of banks. First, with the exception of the above pre-existing situation, no resident or non-resident, together with associated shareholders, may own more than 10 per cent of the voting shares of a bank; a resident may own more than 10 per cent of a new bank, but only temporarily. Second, non-resident shareholdings in total may not exceed 25 per cent. Third, the growth of any bank is restricted if a single shareholder or group of associated shareholders owns more than 25 per cent of the shares of that bank. Furthermore, the Bank Act has prevented and continues to prevent the use of the words "bank", "banker" or "banking" to indicate or describe any business in Canada except in reference to institutions chartered under the Bank Act, or by other special act.

As a result of these several measures, foreign banks may not establish in Canada branches, agencies, or bank subsidiaries. They have not, however, been precluded from incorporating subsidiaries under provincial or federal law provided they do not describe them as banks or their business as banking.

Some limitations on foreign ownership in certain other financial institutions such as loan and trust companies, investment companies and finance companies have also been incorporated in the relevant federal laws and in those of some provinces. More recently, the foreign ownership of Canadian enterprises, including financial institutions, has been subject to screening under the federal Foreign Investment Review Act.

The interests and activities of foreign banks in Canada have intensified since the last revision of the Bank Act, taking the form primarily of financial affiliates incorporated under provincial company laws. Such companies are not normally subject to regulatory legislation and complete data concerning them is not available. However, about 120 Canadian corporations, in which foreign banks have an equity interest and which appear to be engaged in financial activities, have been identified. About 60 foreign banks have an equity interest in these corporations. Approximately half are United States banks and the remainder, except for seven, are from countries which are members of the European Economic Community.

In mid-1974, the Bank of Canada began a survey of those larger foreign bank affiliates in Canada which are in the business of commercial lending and which raise their funds in the Canadian money market. This survey, data on which are published regularly in the Bank of Canada Review, covers 48 corporations affiliated with one or more of 25 foreign banks, many of which are among the largest in the world. Total assets of these reported affiliates have reached approximately \$2 billion. Foreign bank representative offices in Canada now exceed 40, of which over half represent banks which do not appear to have any investments in Canadian financial corporations.

Assessment

This rapid development of foreign bank interests in Canada raises important questions of regulation, fair and equitable competition, and Canadian control over banking.

Some of the financial subsidiaries of foreign banks are operating in lines of activity in which there is provision for supervision under federal or provincial law, such as trust companies, loan companies, insurance companies and investment companies. In other areas, however, they are in general not regulated or constrained by Canadian law. They may engage without restriction in providing various financial services, some of which, such as financial leasing and factoring, may not be provided directly by Canadian banks. They are not subject to reserve requirements or the constraints of federal regulation, including those designed to ensure the soundness of the financial system. Some have a special advantage deriving from their link with their parent banks in establishing relationships with the Canadian affiliates of their parents' customers. Many have some advantage in the Canadian money market, particularly over the smaller Canadian banks and other Canadian borrowers in that market, through use of the guarantee of their obligations by the parent bank. Although they compete with the Canadian banks, they are outside the scope of such forms of central bank influence as moral suasion or other techniques aimed at influencing or controlling the banking system.

The competition with Canadian institutions, particularly in the provision of commercial loans and other financial services to medium-sized businesses, which is provided by these affiliates of foreign banks, is useful. But, because they are precluded from operating in Canada as banks, they are unable to provide to Canadian customers a broad range of domestic and international banking services in competition with Canadian banks.

The conclusion that there should be a legislative basis for regulating the operation of foreign banks in Canada rests upon a number of considerations. Foreign banks are to be encouraged because of the additional competitive and innovative forces that they can bring to bear in the relatively highly concentrated Canadian banking system. They are to be encouraged too because of the additional financial support which they, with their world-wide connections, can bring to the development of our resources, industries and trade. There is also the further consideration that if we

provide a basis in law for the operation of foreign banks in Canada, we can expect our own banks to obtain the reciprocal recognition in other countries which is necessary if they are to extend their participation in international markets as we would like.

Objectives

In considering a legislative framework for foreign banks in Canada a basic conflict arises between the objectives of maximizing competition and ensuring that the control of our financial system remains predominantly in Canadian hands. The proposals related to foreign banks are designed to achieve a balance of these two fundamental goals.

In summary, they seek to provide for more equitable and effective competition between Canadian and foreign-owned institutions, to provide opportunity for Canadian affiliates of foreign banks to operate under Canadian banking legislation, to provide economic and financial surveillance by Canadian authorities, and to provide a basis for reciprocal treatment for Canadian financial institutions abroad, while ensuring that Canada's banking system remains predominantly in Canadian hands.

Proposals

The proposed federal framework is based on the powers granted the federal authorities in respect of banks and banking as well as such other federal powers as those which pertain to international trade and commerce, to aliens and to the census and statistics. Three possibilities for the existing or future interests in Canada of foreign banks are proposed.

First, the Bank Act will make provision for the incorporation of a subsidiary of a foreign bank as a bank under the Act, subject to certain conditions. The Minister will encourage and expect foreign banks who have or intend to establish in Canada banking operations on any significant scale to apply for a charter under the Act. Any foreign bank affiliate engaging in both the making of loans and the accepting of deposits transferable by order will be required to incorporate as a bank under the Bank Act or to cease engaging in this combination of activities.

Second, foreign banks seeking limited operations in Canada will be able to make equity investments in non-bank affiliates or to continue existing ownership of equity shares in non-bank affiliates, whether federally or provincially incorporated. The Bank Act will require such an affiliate to file reports on its activities. Exemptions from this requirement may be granted, for example: to affiliates in which the foreign bank holds only a small interest, say less than 10 per cent of the voting stock; or to affiliates that are subject to regulation under some other act of the federal Parliament or of a provincial legislature. In addition, unless specifically authorized, affiliates of foreign banks will be denied the possibility of borrowing in the Canadian market with the guarantee of its foreign parent or another company associated with the parent.

Finally, foreign banks having or establishing representative offices in Canada will be required to register these offices with the Inspector General of Banks in accordance with terms and conditions established by Governor in Council.

The Act will preclude the establishment in Canada of branches or agencies of foreign banks. Thus those foreign banks wishing to operate in Canada will be able to do so only through bank subsidiaries or non-bank affiliates which are Canadian persons subject only to Canadian laws. This will provide in respect of foreign bank subsidiaries a clear identification of capital, assets and profits to facilitate the establishment and enforcement of regulatory controls. In short, the proposal will lend itself most easily to the application of Canadian banking law. Foreign bank subsidiaries incorporated under the Bank Act will be required to have a Board of Directors of whom a minimum of one-half are Canadian citizens. They will be permitted the use of the parent's name to make clear to the public with whom it is dealing.

These subsidiaries incorporated under the Bank Act will be given the same general powers as those accorded by the Act to Canadian chartered banks. This will provide the maximum benefit for Canadians in terms of increased competition and potential for innovation in the financial market. It will lend itself most readily to a parallel legislative structure for domestic and foreign banks and consequently to direct influence by the federal monetary and economic authorities. It would be expected that Canadian banks would be given comparable banking opportunities in the home jurisdiction of those foreign bank subsidiaries established in Canada.

A basic rule for Canadian banks denies any shareholder or associated shareholders a controlling interest in a bank. This rule ensures that a chartered bank does not become captive to a person or associated persons who have business interests other than banking, thus avoiding a potential for significant conflicts of interest and possible risks to the bank's depositors. The proposal to permit the incorporation of a bank, in circumstances where the bank will be controlled, and in most cases, wholly owned, by a foreign bank does not create the possibility of conflicts of interest between banking and non-banking interests. To avoid indirect conflicts, the parent bank of a foreign bank subsidiary will not be able to establish or retain any other affiliates in Canada, other than those permitted to the bank subsidiary itself as a bank under the Bank Act.

Present legislation places no limit on the growth of a widely-held bank. However, if one shareholder or group of associated shareholders, whether resident or non-resident, holds more than 25 per cent of the voting stock, the bank's total liabilities are restricted to 20 times its authorized capital. Increases in authorized capital are subject to the approval of Governor in Council. This establishes the principle that all major Canadian banks shall be widely held. In proposing that affiliates of foreign banks be permitted to incorporate as banks, it is recognized that a number of the largest foreign banks in the world will qualify. To ensure that the banking system will continue to be predominantly Canadian and to comply with this principle, it may be necessary to limit the growth and size of banks while they are foreign-controlled. It is accordingly proposed that foreign banks' subsidiaries be subject to such limitations on growth and size in relation to the authorized capital of the bank

as may be approved by Governor in Council. The limitation on growth and size will be removed if the bank takes the option to Canadianize by selling its shareholdings in excess of 10 per cent to Canadians. Proposals for applying such limitations and other conditions for incorporation are outlined in the following section.

Conditions of Incorporation

The conditions for incorporating a foreign bank's subsidiary will generally be those applied to domestic banks with the following exceptions and conditions.

The minimum authorized capital will be \$5 million of which \$2.5 million will be required to be fully paid.

The size of a foreign bank's subsidiary will be limited to 20 times its authorized capital. On the basis of approved increases in authorized capital to a maximum of \$25 million, a bank subsidiary could grow to about \$500 million of assets. Increases in authorized capital will be subject to approval by Governor in Council, taking into account the overall growth of foreign banking business in Canada and the performance of the bank subsidiary, including its contribution to competitive banking in Canada. The policy, subject to review, will be to limit total operations of foreign banks to 15 per cent of total commercial lending in Canada. However, as already noted, a foreign bank subsidiary at its growth ceiling will be able to Canadianize under an approved program for the reduction of foreign ownership to 25 per cent in total and 10 per cent for any one owner or group of associated owners and thus remove any constraint on its growth.

Although the Bank Act will establish the above ceiling on the authorized capital of a foreign bank subsidiary, some power to increase this limit by regulation will be accorded to the Governor in Council to permit adjustments in light of experience in the achievement of the goals outlined above.

The foreign bank affiliate will be limited to one place of business but, subject to the approval by the Minister of Finance as to the number and location of branches, could be permitted to open branches to a maximum of five.

The authorities, in recommending the incorporation of a foreign bank subsidiary, will wish to be satisfied that the parent bank is of good reputation and that the subsidiary would have the potential of making a contribution to competitive banking in Canada.

A foreign bank, incorporating a subsidiary under the Bank Act, will not be permitted to establish or to continue to have in Canada any affiliate other than those permitted to the subsidiary itself as a bank under the Act. Provision will be made for a conversion period to allow existing foreign affiliates in Canada to meet this and other requirements associated with their incorporation.

The subsidiary will be required to maintain assets in Canada at least equal to Canadian liabilities and to maintain all records in Canada.

A foreign bank subsidiary will normally be incorporated under the Bank Act only in circumstances where treatment as favourable for Canadian banks in the jurisdiction of the parent bank exists or is arranged.

Finally, because of the unique importance of the banking system to the economy and to economic and monetary management, the regulation and control of foreign bank entry into the Canadian banking system will be guided by the relevant provisions of the Bank Act, notwithstanding the Foreign Investment Review Act.

Bank Business Powers and Regulations

Background

In this as in previous revisions of banking legislation, the basic objective of changes affecting the powers of banks is to improve the competitiveness and effectiveness of the financial system. It is also desirable to delineate more clearly the role and powers of the banks. Proposals to these ends reflect the following three important principles.

Conflict of Interest: In the general trend away from institutional specialization and toward the provision of a broader range of services by most financial institutions, near-banks have tended to move into activities traditionally performed by banks, and the banks have tended to move into activities which have been traditionally carried on by some of the specialized institutions. In many instances this has been a healthy development, resulting in keener competition among the institutions and less cost to the public for better services. There are, however, certain specialized services, offered primarily by Canadian institutions capable of meeting Canadian requirements in a competitive manner which, if offered in conjunction with bank services, raise potential conflict of interest problems which overshadow the benefits of added competition. An example is the combination of trustee services and commercial lending. Where this consideration is relevant in the areas of underwriting corporate securities, trust and quasi-trust activities, data processing, and the corporate affiliates of banks, constraints on bank powers are proposed.

Extension of Specialized Financing Services: A number of specialized services are now being provided by non-bank financial institutions, including some services which are closely related to, or are competitive alternatives to, bank services such as commercial lending activities. Where these services are not susceptible to conflicts of interest, and are not being provided broadly by Canadian institutions, the competitive environment for such services should be broadened by including them in the range of services banks may provide. This consideration is relevant to the discussion below of factoring and leasing.

Use of Affiliates: Within the limitations established at the time of the last decennial revision, the banks have established a variety of corporate affiliates in the process of broadening the range of services offered in financial markets. The proposals below apply the principle, with exceptions in special circumstances, that basically the

banks should provide their financial services in Canada within the corporate structure of the bank and not through corporate affiliates. This ensures that the basic activities of the banks are subject to the provisions of the Bank Act and avoids conflicts of interest. Furthermore, except in special circumstances, banks should not engage in non-financial activities directly or through corporate affiliates. Such activities change the nature of risks in banking operations and raise the possibility of undue concentration of power as well as problems of conflict of interest.

The specific proposals in respect of bank business powers and regulations are:

Financial Leasing of Equipment

The financial lease is an alternative to debt for a firm having to finance capital assets. It is usually a medium to long-term arrangement under which the lessee assumes the cost of holding and using the asset.

There are some direct advantages in financial leasing compared to other means of financing. Small businesses, which frequently are short of capital, have found the device particularly useful. Equipment leasing in Canada, the United States and the United Kingdom is a relatively fast-growing activity.

In Canada, subsidiaries of foreign banks as well as other Canadian corporations have been active in this field. United States national banks are permitted to provide financial leasing services. The Canadian banks have not, however, participated in the financial leasing of equipment other than, in recent years, through partially owned affiliated companies.

The power of banks to engage in financial leasing is not specifically provided in the present Bank Act. The question of banks participating directly in this business was considered during the current decennial period. The government felt, however, that an additional power of this importance should be specifically authorized by legislation. Associated with this position was concern about the implications of enabling the application of capital cost allowance against bank income, particularly in connection with the financing of high cost equipment such as aircraft for companies, including crown corporations, with little or no taxable income. The budget of May 25, 1976, has removed the cause for this concern. In the words of the budget speech, "taxpayers will not be allowed to claim capital cost allowance on leased equipment in excess of their net rental income from that type of property."

Without the possibility of tax sheltering of non-leasing income, leasing will become a closer substitute for term lending and borrowing in the capital market. It becomes, therefore, a natural activity for banks as they can contribute to the development of this form of lending for the benefit of industry as a whole and in particular for small and medium-sized businesses.

It is now proposed to allow the banks to engage in financial leasing of equipment subject to regulations prescribed by the Governor in Council. The regulations will ensure that the leases are the functional equivalent of credit by requiring that the

lease must be tied to specific equipment; it must be on a non-operating basis, that is, the bank would have no responsibility for the operation, maintenance or repair of the equipment; and the lease must be on a full payout basis, that is, the bank will obtain its full compensation from the rental revenues and will not be dependent on a residual value of the equipment for its profit, except to an amount not exceeding 20 per cent of the acquisition cost of the property to the lessor.

Factoring

Factoring is a practice whereby a seller of goods or services contracts with another party, the factor, to finance, to assume the credit risk of, and to collect his accounts receivable. The factor has the right to do a credit screening in respect of the customer of a merchant whose accounts receivable he is factoring.

Factoring tends to be particularly appropriate in certain secondary industries and small transportation companies. It is used increasingly in the export business. Its orientation is towards small business, and particularly firms which are young and/or fast-growing and short of working capital. Such firms often have many accounts which place small orders resulting in high costs in credit-checking and record-keeping.

In the United States, national banks have been permitted to do factoring since 1963. The banks have brought familiarity, marketing ability, and the personnel and computing resources to expand factoring into new markets. Some U.S. banks are now extending their factoring operation into Canada.

In Canada, factoring is under-developed and the leadership of the banks could provide an important stimulus. Bank entry into the business would increase the competition and the Canadian presence.

An expanded factoring industry would provide benefits to the economy in general. The collecting of accounts receivable is, for some smaller businesses, a difficult and expensive operation and they would welcome the opportunity to sell their accounts receivable to bankers whom they know and with whom they have established relationships. Some smaller concerns, recognizing these advantages, have urged the government to allow the banks to offer factoring directly.

It is proposed that banks be specifically authorized to engage in factoring.

Residential Mortgages

The Bank Act revision of 1954 enabled chartered banks to lend against mortgages insured under the National Housing Act and as a result they entered the mortgage market for the first time. By the end of 1955, NHA mortgages already amounted to 2.7 per cent of total major assets, and this proportion approximately trebled in the next four years to 8 per cent by the end of 1959.

By 1960, however, the banks found themselves once again outside the mortgage market, because of a stipulation prohibiting them from setting any loan rate in excess of 6 per cent. Apart from a limited amount of mortgage loan approvals in 1964 and 1965 the banks were absent from the primary mortgage market until the next Bank Act revision in 1967, and their mortgage holdings declined as they were amortized.

In the 1967 revision, the 6 per cent ceiling on loan rates was removed and the banks were also permitted to make conventional as well as NHA mortgage loans. In order to phase in and limit the impact of this new competition with trust and mortgage loan companies, the new legislation limited the total principle amount outstanding of conventional residential mortgages held by a bank to 10 per cent of its Canadian deposit liabilities and debentures. It required that this be phased in on the basis of 2 per cent plus 1 per cent for each year of operation of the bank after October 31, 1965. This regulated growth continues to apply to new banks.

Since 1967 the chartered banks have more than made up for the ground they lost in the mortgage market after 1960. By the end of 1975, the banks and their mortgage loan subsidiaries were responsible for 21 per cent of all institutionally supplied mortgages, a share approaching three times that of 1967 and in excess of the 17.6 per cent they accounted for in 1960. At the end of 1975, mortgages accounted for about 14 per cent of banks' major assets, compared with 4.4 per cent in 1967.

The relative increase in the size of banks' holdings of residential mortgages has been limited primarily by considerations such as management judgments on asset mix and not by the current arbitrary limits in the Act. Only new banks have been constrained by the application of these limits. While some of the larger banks are approaching the 10 per cent ceiling, the conventional residential mortgages held by the banks as a group at the end of 1975 amounted to only 5.8 per cent of total Canadian dollar deposit liabilities and debentures.

As there continues to be a growing need for residential mortgage funds, particularly for small and medium-priced homes, it is desirable that banks not be constrained by arbitrary limits. It is accordingly proposed that the existing limits on holdings of conventional residential mortgages be removed.

Data Processing

The chartered banks have made extensive use of computers and electronic data processing over recent years. Today a major portion of their systems are automated and they make use of sophisticated communication equipment to handle their data transmission needs. As a result, the provision of many of the traditional banking services is now facilitated by computerized data processing.

The introduction of the computer facility, however, has also enabled the banks to provide clients with additional services in respect of accounts payable and receivable, and small business accounting.

At approximately the same time as the banks were developing their computer systems, independent computer service firms were commencing to provide service to the public, thus bringing the two groups into direct competition.

While there may be economic efficiency, public convenience and industrial policy arguments for an extension of bank powers to offer a wide range of computer services, there are also concerns about the possibility of unfair competition, concentration of economic power and conflict of interest if banks were to operate both as commercial lenders and as sellers of computer services. Consequently, in January, 1975, the Minister of Finance issued guidelines for bank-provided data processing services outlining areas of permissible activities, pending a full review of the Bank Act. Basically, these guidelines limited banks to offering automated payments services, that is, data processing services related to the making of payments; and wholesale banking services, that is, the provision to other financial institutions of computer services integral to banking operations. All other services were prohibited except that the banks could continue to serve existing clients.

Since that time, the government has received briefs from interested parties and has studied the computer services industry in Canada. This industry is mainly Canadian-owned; most companies are small, operating on a local or regional scale, although a few large companies with annual sales in the \$20-30 million range are emerging; competition is keen and profit margins are low. The industry is now competing successfully with foreign-owned companies and continued Canadian control appears probable.

It is expected that the Canadian independent data processors will be able to service the public and to meet the growing demands for data processing as a specialized service, provided they are not subject to undue competition from banking institutions in areas not closely related to banking. Accordingly, it is proposed that the power of banks to engage, directly or indirectly, in data processing be limited to offering directly to the public certain "banking-related" data processing services where the data processing is done by the bank, subject to regulations approved by the Governor in Council on the recommendation of the Minister of Finance. The regulations will restrict the banks to services directly related to the making of payments, such as the classification of deposits and payments, cheque reconciliation, pre-authorized debits and credits, payroll preparation plans and data processing in connection with a factoring service. The provision to other financial institutions of computer services that are an integral part of banking operations will also be permitted. The banks will be required to provide any customer, at his request, with any machine-readable data regarding his business which may have been acquired in providing a service.

Under a proposal outlined later in this paper, banks will be required to reduce their ownership in any data-processing firm to a maximum of 10 per cent.

Securities

In the early post-Confederation period, banks were the only significant financial institutions engaged in the securities business. The authority for banks to "deal in" securities, without any definitional limitation, has been included in the Bank Act since 1876. Provincial legislation in developing regulation of the securities industry in the province concerned has recognized this authority by generally exempting banks. The Bank Act, while conveying this general power to banks, has not undertaken to regulate in any way the activities of banks in this important and developing market function, nor has any other federal legislation. Section 157(2) of the Act, which is directly relevant, reflects some past uneasiness concerning possible conflicts of interest, and constrains the use of the name of the bank in promoting the sale of securities, a prohibition that now applies only to corporate securities.

Over the years, as the capital market and the supporting securities industry and stock exchanges developed, the provincial governments have expanded and strengthened the regulation of the securities market. The question of whether and to what extent there should be federal regulation of this national market has been under study for some time.

While investment dealers and brokers are clearly the most prominent bodies involved in underwriting, distributing and trading in securities, the banks have traditionally participated in the distribution of securities of the federal government, and in the underwriting and distribution of securities of provinces and municipalities. With a few exceptions, the banks have not been part of the underwriting groups for corporate issues and have distributed such securities only passively, acting as agent and taking orders.

Their role as underwriter and distributor of securities of Canadian governments and their agencies has been recognized as entirely appropriate and the Bank Act permits the use of the name of a bank in advertisements of securities issued by these governments. Because of the possibility of a conflict of interest between the role of a bank as a lender to a corporation and its role as a promoter of the sale of that corporation's securities, the use of the name of the bank in connection with underwritings and distributions of corporate securities is denied under present legislation.

The securities industry, by underwriting new issues and by maintaining secondary markets and consequently liquidity for outstanding securities, plays a significant role in our capital markets. It is important that it should continue to be a strong segment of these markets and that the corporate sector should continue to have a choice of sources for funds, that is, the banking sector or the public through the underwriting facilities of an independent dealer. To help ensure this choice, and taking into account conflict of interest concerns and possible undue concentration of power, it is proposed to define more precisely the role of banks in the sale of corporate securities.

Canadians will be required to find large amounts of capital to finance industrial growth and major resource-oriented projects. To ensure that the broadest possible Canadian market for securities can be tapped, it will be useful to have available the potential distributing power of the chartered banks through their comprehensive branch systems. While for reasons expressed above, it would not be appropriate for banks to promote the sale of corporate securities, it should be possible to make these securities available through a bank or banks and so inform the public. It would also seem desirable in the interest of full, true and plain disclosure that where a bank has a role, its name should appear in a prospectus or advertisement of a security being offered to the public. It is, therefore, proposed that the Bank Act be changed from providing a general power to deal in securities to specifying areas where the banks will be permitted and excluded.

For example, in the underwriting field the banks will continue to be able to distribute federal securities, and underwrite and distribute securities of federal government agencies, securities of provincial and municipal governments and their agencies, as well as securities of international agencies of which Canada is a member. The power of banks to underwrite corporate securities or to act as agent in the private placement of corporate securities will be withdrawn. A bank will be authorized as at present to underwrite and make private placements in respect of its own securities and those of authorized financial affiliates of the bank.

Banks will, however, be permitted to distribute corporate securities as members of a selling group. If banks were not permitted a role in the distribution of new issues of securities as members of the selling group, Canadians purchasing such securities through banks would always have to pay a commission in addition to the issue price. This additional cost would fall particularly on securities purchasers outside the major urban centres who may not have ready access to investment dealers and brokers.

The name of a bank will be allowed to appear in a prospectus or advertisement listing the selling group of a corporate security. Banks will also be permitted to advertise that they deal in securities but not to advertise or otherwise solicit the sale of any particular corporate security except as described above.

As a result of these proposals, investment dealers as underwriters will receive protection from bank competition in their most important underwriting field — that of corporate securities. At the same time they, the corporate issuers and the purchasers of securities across Canada, will have somewhat expanded access to the banks as distributors of corporate securities.

Trust and Quasi-Trust Activities

The management of other persons' assets placed "in trust" is the principal responsibility of trust companies in Canada. This power has never been given to the banks. The performance of the trustee function, while at the same time serving as a major business lender, raises potential conflicts of interest. The banks have recognized the undesirability of such conflicts, as have the trust companies. In their briefs, both groups have recommended against giving the banks trustee powers.

While the granting of trust powers is neither proposed here, nor sought by the banks, since 1967 the banks have become involved in activities which are to some degree related to trustee business. It is desirable to clarify the powers of the banks in these "quasi-trust" areas.

Mutual Funds

For the same reasons that it is desirable for the banks to continue to distribute securities, it is also desirable for them to distribute the shares of mutual funds. It is therefore proposed that the banks be permitted to act as selling agents for mutual funds provided that the moneys are put in the hands of the fund for management.

Because of the potential conflicts between the bank as commercial lender and fund manager, it is recommended that the banks be prohibited from the management of mutual funds. The management of existing mutual funds will have to be transferred or the funds liquidated over time. This proposal avoids the risk of such conflicts as the trading in and voting of securities of a business client to the detriment of the fund shareholders, the access by fund management to inside information of business clients and the selection of brokerage firms on the basis of their commercial banking relationships.

Registered Retirement Savings Plans and Registered Home Ownership Savings Plans

These are tax-deferral or incentive arrangements designed to promote saving for retirement and home ownership. Income tax legislation requires the funds to be placed in a "trust". These programs have been made readily available to as many individuals as possible by virtue of the participation of various institutions including the chartered banks and the near-banks.

Two problems arise from the legislation. First, the requirement that the funds be placed in trust necessitates the involvement of a trust company. As a result, a situation has developed in which banks carry out the selling and administration, but a trust company receives the actual application and delegates most of its functions to the bank concerned. Second, the legislation permits the funds to be invested in bonds, equities and mutual funds and the banks have set up mutual funds for this purpose. There are possibilities of conflict of interest in any mutual fund and, in the case of banks which are engaged in business lending, the risks are particularly great.

To resolve these problems without preventing the banks from making available to their clients the same opportunities to participate in those programs as are offered by other deposit-accepting institutions, it is proposed that the banks be restricted to offering registered retirement savings plans (RRSPs) and registered home ownership savings plans (RHOSPs) in the form of deposit plans only and that they be prohibited from accepting new clients under their existing equity and bond plans; and that the Income Tax Act be amended to recognize such deposit plans in the bank so as to eliminate the trust requirement.

Banks will not be prevented from offering for sale bond and equity RRSPs and RHOSPs where the proceeds are handed over for management to a fund operating at arm's length.

Real Estate Investment Trusts and Mortgage Investment Companies

Real estate investment trusts (REITs) and mortgage investment companies (MICs) are like mortgage-based mutual funds. In both cases income is not taxed in the hands of the REIT or MIC if it is passed through to the shareholder. It is, of course, subject to tax in the shareholder's hands. Three banks have established REITs. Organizationally, participation in a REIT involves the bank through individual bank officers acting as trustees and the bank acting as fund adviser. In this latter capacity the bank not only recommends investment decisions relating to the fund's management but is placed in a conflict situation as the bank is simultaneously making similar investments for its own account. This kind of conflict occurs for trust companies as well.

Because of the importance of the flow of funds into residential mortgages and the role of the banks in this process, and because the conflicts here are not of the same nature and concern as those involving corporate securities, it is proposed that the banks be permitted to continue to act as advisers for REITs and MICs on the condition that the REITs and MICs have a board of trustees or directors, the majority of whom are independent of the bank.

Portfolio Management, Investment Counselling and Securities Advising

For reasons discussed above, there would appear to be little benefit in permitting the banks to engage in portfolio management and investment counselling except in the case of REITs and MICs. Once again, conflicts arise for the banks. The market would seem to be adequately served by trust companies, investment dealers and independent investment counsellors.

However, in the course of their normal banking activities, banks are often called upon to give advice on particular securities, usually by small clients or infrequent investors who have no other contacts in the financial community. A prohibition against this form of securities advising would be undesirable and is not proposed.

In the same way, the banks have been providing certain administrative services for clients' portfolios such as custody, collection of interest and dividends, and preparation of periodic reports on the portfolio. These services do not raise conflict questions and will not be prohibited.

Bank Investments in Canadian Corporations

The traditional approach to the development of banking in Canada has been that the business of a bank should be provided directly through its branch network. The only wholly-owned domestic subsidiaries permitted have been bank service corporations designed as vehicles to carry bank premises. To avoid concentration of power and to prevent the banks from engaging indirectly in trade or business, the Bank Act revision in 1967 placed limitations for the first time on the power of the banks to hold voting shares of other Canadian corporations. The Act prohibits a bank from holding more than 10 per cent of the voting shares of a corporation except where the bank's investment is \$5 million or less. In the latter case, the bank can hold up to 50 per cent of the voting shares.

The banks now have invested about \$120 million in over 50 corporations under the 50 per cent provision. Business lending, leasing and mortgage corporations account for 16 of these companies and three-quarters of the capital invested.

The 50 per cent voting limitation has not prevented a bank from dominating or effectively controlling a corporation. Domination may occur, for example, when the bank holds 50 per cent of voting shares with a minimum dollar investment and puts up the bulk of the capital in preferred shares; when the bank holds 50 per cent of the shares while an affiliate of the bank owns all or a part of the remaining shares; or when the development of business for the corporation is dependent upon promotion by bank branches.

In order to clarify and regulate the nature and extent of banks' interests in Canadian corporations, it is proposed to apply the following principles, with the exceptions indicated, in respect of banking operations, that is, those activities in which the banks are specifically authorized to engage, in respect of other financial activities, and in respect of non-financial business.

Banking Operations

Banks' operations should be confined within their own corporate structure and subject to all aspects of banking legislation and regulation. Accordingly, banks should not, except as authorized by the Bank Act, carry on activities in Canada or provide services to the public in Canada through wholly-owned subsidiaries or through partially-owned affiliates.

Proposed Exceptions:

Mortgage Loan Corporations: Banks will be entitled to sole ownership of corporations engaged primarily in the business of residential mortgage lending, subject to regulations established by Governor in Council. The liabilities of such corporations will be consolidated with the liabilities of the bank for cash reserve purposes.

Banks which own in excess of 10 per cent of the voting stock of a mortgage loan corporation may acquire sole ownership of the corporation, subject to the above conditions. Alternatively, they may continue to own the same proportion of the voting shares of such a corporation provided that the cost of the shares is \$5 million or less.

REIT Service Corporations: A separate corporation to serve as a borrowing vehicle and fund adviser is necessary for the operation of REITs and has been found useful for MICs. Banks will be entitled to sole ownership of REIT and MIC service corporations or to invest in such corporations in partnership with other financial institutions including one other chartered bank, subject to regulations established by Governor in Council.

The regulations will provide for a board of trustees which will manage the REIT and will place limits on interlocking directorships between the board of trustees and the REIT service corporation or bank.

The proposals with respect to mortgage loan corporations, and REIT and MIC service corporations are in line with the government's general objective of maximizing the availability of funds for housing financing.

Bank Service Corporations: Banks will be authorized to have sole ownership of service corporations, in respect of realty for use of the bank as now provided and of corporations which provide services only to the bank which are incidental or ancillary to the business of the bank. Provision will also be made for corporations owned by a group of banks to provide special export financing facilities and other specialized services such as credit card facilities.

Other Financial Activities

Except as authorized by the Bank Act, banks will not be permitted to acquire more than 10 per cent of the voting shares of Canadian corporations engaged primarily in financial activities.

However, in order to provide for innovations and for joint ventures, banks will be permitted to exceed temporarily the 10 per cent limit in new investments in corporations for which there are no specific exceptions. The excess must be disposed of within two years from the date the limit is exceeded, subject to further extension with the approval of the Minister.

Proposed Exceptions:

Where a bank owns more than 10 per cent of the voting stock of a Canadian financial corporation, it may, subject to terms and conditions approved by Governor in Council, continue to own the same proportion of the voting stock of the corporation provided the cost of its shares is \$5 million or less. Terms and conditions will be designed to prevent a bank from dominating the corporation.

Banks will be authorized to own corporations engaged in venture capital investments, subject to regulations established by Governor in Council. The regulations will define venture capital investments, limit the extent of investments by a bank in venture capital corporations, and provide for the disposal of mature investments by such venture capital corporations.

Non-financial Business

Banks will not acquire more than 10 per cent of the voting shares of any non-financial Canadian corporation, except as authorized by the Bank Act.

To provide for temporary joint venture investments, banks will be permitted to exceed the 10 per cent limit to a maximum of 50 per cent, provided the excess over 10 per cent is disposed of within two years from the date the limit is exceeded, subject to further extension with the approval of the Minister.

Where a bank owns more than 10 per cent of the voting stock of a Canadian non-financial corporation, it may, subject to terms and conditions approved by the Minister, continue to hold those shares provided the excess is disposed of within two years from that date, subject to further extension with the approval of the Minister.

Extension of Credit Against Security

Several enabling sections of the Bank Act grant the banks powers to lend against and realize on security similar to those exercised by other institutional lenders. Also, in order to assure a source of financing for small primary production and processing industries, certain sections, notably Section 88, include special lending and security provisions and establish the facility for registration of the security. This form of inventory financing is designed to assist agriculture, industry and commerce in producing and manufacturing the various products of the country. The present special provisions in the Bank Act will be retained and modified as necessary to meet developing or changing needs.

Proposed changes in these provisions include facilities for owners of mineral reserves to give security and to borrow, similar to those currently available to owners of hydrocarbon reserves; facilities for farmers to give security and borrow on feed (in addition to current facilities relating to borrowing against security in livestock); facilities for farmers to borrow for the purpose of overhaul of agricultural equipment (in addition to current provisions whereby farmers may borrow for the purpose of repair of agricultural equipment); an increase in the present \$7,500 priority of claims of growers of perishable products and producers of dairy products in the event of the bankruptcy of a debtor who has provided Section 88 security.

Non-banking Activities of Special Social or Economic Benefit

The banks are frequently requested by governmental authorities and by charitable and other organizations to provide services in the interest of special social or economic objectives. Other financial institutions are relatively free to react to such requests. Legally, the banks may carry on activities related to the business of banking but must be authorized under the Bank Act to engage in other activities. Requests to the banks to provide distribution services have included the sale of tickets, including lottery tickets, in connection with special celebrations of municipal, provincial or national interest; the distribution of tickets or other forms of services for charitable or social organizations; and, on a permanent basis, the sale of government lottery tickets and urban transit tickets.

The branch system of the chartered banks provides an attractive distribution outlet for such services. If the banks were to meet all requests, the service standards of branches in respect of banking customers could be adversely affected. On the other hand, the distribution by banks of some of these services can make a useful contribution. It is proposed to authorize banks to participate in the following activities:

- the sale of tickets (including lottery tickets) in connection with special, temporary and infrequent, non-commercial celebrations or projects of local, municipal, provincial or national interest, as a public service;

- the sale of urban transit tickets; and

the sale of lottery tickets which are sponsored by federal, provincial or municipal governments.

Bank Corporate Powers and Regulations

Background

The body of federal law which directs and regulates the affairs of most corporations has recently undergone significant revisions and this activity is continuing. There has already been enacted, or exposed for public review and comment, revised and improved legislation dealing with corporations, competition and bankruptcy. Further legislation in the field of competition is imminent and a bill concerning borrowers, lenders and depositors is to be introduced.

Because of the special regulated status of the chartered banks, they have in the past generally been exempt from the provisions of corporate legislation. The provisions of the Bank Act and the close supervision to which the banks are subject have served as a successful alternative to the application of general legislation to this group of financial institutions.

However, in light of these new and comprehensive federal laws, it is desirable to ensure that banking legislation is consistent with them, either by having such legislation apply generally to banking corporations or by revisions in the Bank Act to apply to banks all the features of such general acts that are appropriate to banking institutions. Proposals to this end are summarized below.

Canada Business Corporations Act

The recently enacted Canada Business Corporations Act does not apply to federally regulated financial institutions. In some respects, such as those dealing with incorporation, capacity and powers, financial disclosure, financing of the enterprise, and limitations on share ownership, the provisions of the Bank Act must be more comprehensive and restrictive than the Canada Business Corporations Act. In other areas, where special aspects are not involved, the provisions of the Bank Act should, where appropriate, be consistent with the principles and provisions of the Canada Business Corporations Act. This will include sections dealing with the duties, powers, responsibilities and liabilities of directors, and precautions against "insider trading". Other more specialized areas will be revised along the lines outlined below.

Methods of Financing

There has been little change over the years in the forms in which banks are enabled to raise capital. Only one class of stock, with a par value, and with pre-emptive rights to existing shareholders following the original distribution, is permitted. Holders of these shares must be given pre-emptive rights to subscribe for any additional share offering. Authority to issue subordinated debentures, payable in Canadian dollars and limited to 50 per cent of paid-up capital stock and Rest Account, was introduced at the last decennial revision. The limitation to these two methods is restrictive compared to most other financial institutions and corporations under the

Canada Business Corporations Act. It will be necessary for the banks to keep the growth of their capital base more in line with the growth of their assets and liabilities. While it can be expected that a high proportion of bank profits will continue to be retained in the form of reserves, there may be a growing need to tap the capital markets. In order to facilitate this, additional flexibility in form and methods of raising capital is desirable.

Additional flexibility will be provided in the following ways:

The authorization of no-par value shares, a requirement for corporations under the Canada Business Corporations Act, will provide established banks with some flexibility by eliminating the present constraint on the sub-division of shares. Par value stock will continue to be a requirement for a new bank for a minimum of five years or until retained earnings and appropriated reserves have reached 25 per cent of total capital and contributed surplus.

The present requirement that bank capital stock, following the original distribution, must be issued with pre-emptive rights to existing shareholders has meant that banks, unlike other industries, may not issue convertible securities or offer stock options for other specific purposes. It is accordingly proposed to authorize the issue of bank shares without the application of pre-emptive rights in connection with the conversion of convertible securities and to permit stock dividends. In the interests of encouraging the establishment of new banks, authority will also be provided to permit, within defined limits, the issue of stocks under stock option plans to bank promoters and bank staff in respect of new banks. While retaining the general provision for pre-emptive rights, shareholders will be empowered to enact by-laws to waive such rights, leaving a bank free to issue stock with or without them. The terms and conditions of private placements will be subject to the approval of the Inspector General of Banks.

The banks will be authorized to issue convertible debentures denominated in Canadian dollars and non-convertible debentures denominated in foreign currencies, subject to the present limitations on the issue of debentures. Conversion rights to acquire voting shares will be subject in all circumstances to the normal limitations on shareholdings in a bank.

The banks will be authorized to issue preferred shares which could include a conversion provision. Where preferred shares are issued on a redeemable basis, the exercise of the redemption feature by the bank will be subject to the approval of the Inspector General of Banks.

A matter related to the forms of capital is the nature and extent of disclosure of information to the public at the time of the distribution of an issue. The Canada Business Corporations Act requires only that federal authorities be provided with a copy of any prospectus or similar form of offering circular distributed by the corporation. It is proposed to require banks to make public disclosure in respect of new issues of equity or debt securities in accordance with regulations issued under the Bank Act.

Financial Disclosures

Two types of disclosure should be distinguished. One is disclosure concerning the financial position of the banks for the information of the shareholders, depositors, financial analysts and the public generally. The other is information required by regulatory authorities to monitor the operations of the bank, to implement regulations, to publish regularly information in respect of the banking industry, and to meet other information requirements of Statistics Canada. The objectives of the latter category can be met under the present legislative provisions, which provide for modifications and additions to information and reporting as may be required.

The present provisions concerning the financial position of the banks will, however, be strengthened and updated in order to assure proper disclosure of significant changes in the structures and activities of the banks, of changes in accounting practices and to reflect changes in other legislation dealing with financial disclosure.

To ensure a high degree of standardization and comparability of information reported by the banks, the basic report formats will continue to be incorporated in the Act. The basic annual and quarterly financial statements of each bank will be required to be published as well as distributed to shareholders. Additional statements or modifications will be made on the initiative of or with the approval of the Minister of Finance. The form, content and presentation of the statements will be updated and expanded to reflect and disclose significant changes in the structure or financial position of that bank.

In conformity with general accounting and disclosure principles, bank statements will be in consolidated form to reflect any activities carried on through controlled corporations, with the statements of each such subsidiary to be available to the public. The "equity method of accounting" will be applied to the banks' investments in affiliates where the bank holds 20 per cent or more of the voting stock or has effective control of the affiliate. Banks will also be required to provide financial statements with general explanatory footnotes disclosing the accounting principles applied by the bank in any special circumstances, in accordance with regulations prescribed by the Minister of Finance.

Loans to Directors

The present legislation requires that loans, exceeding an amount related to a bank's paid-up capital, to a bank director or to a firm of which a bank director or the bank general manager is a member or shareholder, must be approved by two-thirds of the Board of Directors. This will be modified to apply to loans to a bank director, and to firms of which a director or any officer of the bank is a member or director. A principle of the Canada Business Corporations Act will be applied to the effect that such loans shall not be more favourable to the borrower than to comparable borrowers of similar creditworthiness in the normal course of business. It will also be stipulated that loans shall not be made to directors during the first two financial years of a bank.

Appointment of Bank Auditors

In the regulatory approach to Canadian banks, a significant degree of responsibility and reliance is placed on the external auditors of the banks. The Bank Act has required that individuals be appointed as auditors, a departure from the more common practice of appointing firms. This has given rise to some difficulties where the individual auditors have been unavailable when required on short notice in connection with bank business. It is proposed to meet this problem, while retaining the special attention to the bank audit by individual auditors, by permitting banks the option of appointing either individuals or firms, but requiring in the case of the appointment of firms that the bank designate the individual partner it wishes to direct the audit work.

Limitations on Holdings of Bank Shares

The basic principle that banks should not be subject to control by any person or associated group through holdings of voting shares of the bank was incorporated in the Bank Act at the last decennial revision. Several developments make it desirable to clarify the application of these provisions.

In applying the present legislation on shareholdings in banks, the association of corporations is measured on the basis of corporate shares, an approach which does not apply to the association of co-operative forms of financial institutions. A special rule will apply to the latter group in light of the principle that banks should not be controlled by associated interests and in particular that financial institutions, especially those engaged in the taking of deposits from the public, should compete at arm's length. For the purposes of the 10 per cent limit, centrals, federations, or regional unions will be deemed to be associated with their member credit unions or caisses populaires and their combined holdings of shares in any bank will be limited to no more than 25 per cent. The extent of interlocking directors between these institutions, their affiliates and banks will also be limited.

Under the present Act trustee funds are treated as independent, unassociated shareholders whether or not they are independently managed or controlled. This unqualified treatment of trustee funds fails to apply the normal controls on shareholdings in banks, particularly in respect of government trustee pension plans where the trustee of the plan is frequently an employee or agent of the government, and in circumstances where trustee pension funds are significant investors in the shares of a bank. To strengthen and clarify the control on shareholdings in banks it is proposed to amend the sections dealing with the association of shareholders to establish the relationship between governments, government agents and pension funds for government employees in a manner which will adhere to the basic principle.

To preclude abuse of the provision that a bank shall not deal in its own shares or those of other banks, the Bank Act prohibits a bank from making contributions to a pension fund if the fund invests in shares of any bank. This broad

restriction is considered to be an unnecessarily severe constraint on the investment portfolio of bank pension funds. These funds are subject to the provisions of the Pension Benefits Standards Act and to the normal limitations in the Bank Act on ownership of bank shares. It is proposed that the prohibition continue to apply to shares of the bank itself, that it be made applicable to shares of any corporate affiliates of the bank, but that a bank's pension fund will be permitted to invest in the shares of other banks on a non-voting basis.

Adequacy of Capital and Liquidity

The present Bank Act does not regulate the levels of capital or liquid assets to be maintained by the chartered banks.

Developments over the years have enabled financial institutions generally to move to relatively lower levels of both capital and liquidity, a reflection of increasing access to and reliance on money markets both domestic and international, and of more flexible financial instruments, institutional structures and management techniques. Banks in industrialized countries in general have increased their leverage. Banks in Canada have increased their leverage to what is for them an historically high level, somewhat higher than the rising level of leverage in other financial institutions. The desirability of these trends continuing is being questioned in light of banking developments throughout the world. The relative responsibilities of the institutions, the market and regulatory authorities are being reviewed in many countries.

The assessment of capital or liquidity adequacy is, however, a complex procedure which, due to the differing nature of the banks' business and varying intangible and judgmental factors, cannot be adequately made by the application of formulae which could be conveniently legislated. It is accordingly proposed that the Bank Act stipulate that a bank shall maintain adequate capital and liquidity and that the Minister of Finance may make regulations on these matters. This will provide for the development of guidelines and, if necessary, the issue of specific directives to individual banks.

Borrowers and Depositors Protection

The Department of Consumer and Corporate Affairs, in consultation with others, is developing legislation in respect of the protection of borrowers and depositors which will apply to all lending institutions, including the banks. All aspects of protection for borrowers and depositors which are applicable to banks will be incorporated in that legislation and its regulations. The present relevant provisions of the Bank Act will be superseded by this new and broader legislation.

Combines Investigation Act

Except for mergers and agreements, all provisions of the Combines Investigation Act apply to banks. Banks, for example, are subject to that Act with respect to tied selling, misleading advertising, and price maintenance.

With certain specific exceptions, the Bank Act, as recently amended in connection with the revision of the Combines Investigation Act, applies the principles of that Act and prohibits agreements on the rate of interest on deposits and loans, on charges for services, on the amount or kind of loans or services, and on the person or class of person to whom a loan or service would or would not be provided.

On mergers, the Bank Act presently permits the sale of the assets of one bank to another or the amalgamation of two or more banks, subject to the approval of the Governor in Council. To the extent that provisions in respect of agreements and mergers are included in the Bank Act, their administration is the responsibility of the Minister of Finance. In view of the comprehensive revisions of competition legislation and in order to concentrate in a single organization, insofar as possible, responsibility for the administration and enforcement of combines legislation, it is proposed that these areas also be made applicable to banks under the Combines Investigation Act.

In this transfer, the responsibility of the Minister of Finance will be retained in two important respects. First, the Minister of Finance will continue to have authority to approve agreements among banks that are desirable for reasons of monetary or financial policy. Second, it will be a requirement that the Minister of Finance be consulted in respect of all mergers between banks and that he have the power to authorize such mergers which, in his view, are in the interests of the stability of the financial system.

Summary

The proposals in this White Paper are based on the assumption that Canadians want a banking and financial system which is national in scope, controlled by Canadians and as competitive as possible.

One main group of proposals is designed to ensure that the national payments system in Canada will evolve in a manner that is fair to all participating institutions, that will respond to technological change, and that will give Canadians a highly efficient service. To this end, it is proposed that the federal law recognize the fact that the so-called near-banks are now intermediaries in the making of payments in Canada and that the near-banks be embraced within the national payments system with rights and obligations as participants in that system equivalent to those of the chartered banks.

A second group of proposals is directed to the conditions of entry of new or existing Canadian-owned institutions to the banking system. The objective of these proposals is to increase the number of competitors in the banking system.

A third group of proposals responds in part to the same objective. These proposals concern the role of subsidiaries of foreign banks in the Canadian banking system. They provide for recognition of these institutions in federal law and accord them a role in the system as important competitors while at the same time ensuring that the Canadian banking system remains predominantly Canadian-owned and managed.

A fourth group of proposals is specifically focused on other aspects of the objective of promoting competition in financial markets. Some of the proposals in this group deal with the business powers of banks. In some instances they extend the powers of banks. Banks are permitted, for example, to engage in financial leasing of equipment and factoring. In other instances, essentially to avoid conflict of interest situations, they constrain the banks' powers. This is the case in such areas as the underwriting of corporate securities, ownership of financial and other corporate affiliates, and data processing. Other proposals in this fourth group deal with the corporate powers of the banks. They are designed to improve statement of those powers in the present Act and to ensure that the principles and provisions of other federal legislation which regulate the affairs of corporations will apply as appropriate to banks, either directly or through comparable provisions in the Bank Act. The other federal legislation involved is the Canada Business Corporations Act, the Combines Investigation Act and the prospective legislation in respect of the protection of borrowers and depositors. This emphasis on competition in banking seeks to ensure that Canadian consumers and business will enjoy financial services as lenders or borrowers at prices as favourable as they can be, consistent with the interests of each and the financial health and stability of the institutions involved and the economy at large.

The government is confident that the evolutionary approach proposed in this paper will permit the Canadian banking system to continue as a basically Canadian system and to assume a more national character. The government believes the approach will strengthen the forces needed to ensure that Canadians are served by an efficient and innovative banking system.

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