Executive Summary

New Directions for the Financial Sector

Canada

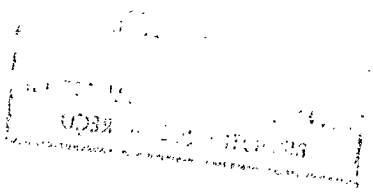
Executive Summary
New Directions for the Financial Sector

Canada

December 18, 1986

The Honourable Thomas Hockin
Minister of State for Finance

Table of Contents



Introduction

Canadian financial institutions are in a period of rapid change. Communications technology has created 24-hour global markets and has dramatically increased the importance of international capital flows in financing and saving decisions. Traditional institutional roles are being reshaped by a variety of new developments. These market trends are challenging existing financial institutions legislation designed for an earlier and less dynamic era.

Global market forces have caused financial regulatory reform to become a prominent issue in many industrialized countries, including Canada.

In November 1984, the government announced its intention to work with the provinces, the public and the financial community to reform federal financial laws in a way that seized opportunities for economic renewal. In April 1985, the Honourable Barbara McDougall, Minister of State (Finance), released a discussion paper, *The Regulation of Canadian Financial Institutions: Proposals for Discussion* (the "Green Paper"), to encourage public debate and focus attention on some possible policy responses. This document was soon followed by a technical supplement and the *Final Report of the Working Committee on the Canada Deposit Insurance Corporation (CDIC).*

These papers sparked a vigorous and searching debate. Major contributions were made by the House of Commons Standing Committee on Finance and Economic Affairs, the Senate Standing Committee on Banking, Trade and Commerce, the Ontario Task Force on Financial Institutions and the Economic Council of Canada.

As this debate unfolded, a number of domestic and international events focused public attention on financial regulation. These included:

- rapid and significant changes in the structure of foreign financial markets;
- the failure of the Canadian Commercial and Northland banks in mid-1985, which led to the appointment of the Commission of Enquiry chaired by Mr. Justice Willard Z. Estey and a review of the operations of the Office of the Inspector General of Banks by the firm of Coopers & Lybrand;
- the acquisition of Canada's largest trust company by a commercially based conglomerate, which led to certain undertakings from the non-financial parent;
- proposals to liberalize entry into provincially regulated securities markets; and

- the commencement of discussions on trade in financial services in multilateral and bilateral forums.

In light of these events, it is important to remove uncertainty about federal policies that is preventing the financial community from planning its future effectively and in ways that will benefit Canadian savers and investors. This paper summarizes the policies that will be tabled as legislation in the current session of Parliament that will provide the broad framework within which the government will exercise its authorities with respect to federally regulated financial institutions.

Principles and Directions

The government is committed to maintaining a sound financial system that provides Canadians with innovative and competitive services, that broadens the range of choice for Canadian savers and investors, and that fosters safe and well supervised financial institutions that can compete effectively around the world.

To achieve this important and desirable result, the government is proposing a reform agenda based on four elements:

- the integration of the financial services industry through the common ownership of institutions and extension of powers;
- a pragmatic ownership policy which checks the growth of commercial-financial links in the economy while maintaining balanced competition within the financial services sector;
- a stronger framework for prudential regulation; and
- a modern and effective supervisory system.

Powers of Financial Institutions

A basic thrust of federal reform proposals will be to remove unnecessary regulatory barriers and allow common ownership of firms from the traditional "four pillars" (banks, trust and loan companies, insurance companies and securities dealers), while retaining separate institutions for supervisory purposes. Financial institutions will have the option of achieving such linkages through affiliates or direct subsidiaries. Networking of financial services will be allowed, except for the retailing of insurance.

In-house powers will also be increased. Trust, loan and insurance companies will be granted full consumer lending powers and – provided they have a minimum of $25 million in capital and supervisory approval – full commercial lending powers.

All federally regulated institutions will be permitted to offer investment advice and portfolio management services, and banks and insurance companies will be granted ancillary fiduciary powers.

Acquisition of financial service companies will require the approval of the Minister of Finance. To protect against concentration, large financial institutions will generally not be allowed to acquire other large institutions. An exception to this general policy will be made for the securities industry.

Ownership Policy for Financial Institutions

Current Canadian law requires all large domestic banks to be widely held, and closely held domestic banks to attain widely held status within 10 years. Non-bank financial institutions, on the other hand, do not have similar ownership rules and many of these institutions have significant commercial links. This variety of ownership forms is not unique to Canada.

In recent years, Canadians have witnessed the development of significant corporate conglomerates that include major financial institutions. This has generated some controversy. Concerns have been expressed about concentration of economic power and the increased potential for self-dealing and conflicts of interest. However, there is also clear recognition that entrepreneurial owners have provided dynamic leadership and financial strength which has enhanced competition in domestic financial markets.

To lessen potential problems from growing commercial-financial links, while promoting competition in the financial services sector, the government will implement the following ownership regime.

Banks

Smaller banks will be permitted to be owned by domestic investors on a closely held basis, as long as these investors have no significant commercial interests. They will be allowed to remain closely held until they attain a capital base of $750 million – a base that will support about $15 billion in assets.

Banks exceeding the capital threshold of $750 million will become subject to the following rules:

- Shareholders with less than 10 per cent of shares in any class, or any series of any class, will be permitted to acquire additional shares of that class or series to a ceiling of 10 per cent.

- Shareholders with more than 10 per cent of such shares will not be permitted to acquire additional shares in the same class or series.

- Within five years of reaching the capital threshold of $750 million, at least 35 per cent of voting shares must be publicly traded and widely held. The

penalty for non-compliance will be a constraint on the bank's ability to grow.

These measures will ensure that major existing banks will remain widely held, while any new banks that achieve substantial size will move toward wide ownership as new equity is issued.

Trust, Loan and Insurance Companies

Effective December 18, 1986:

- Approval for the incorporation of new trust, loan and insurance companies will be restricted to applicants with no significant commercial interests.

- Commercial interests will not be permitted to acquire or increase significant ownership positions in non-bank institutions with capital in excess of $50 million.

- Such larger non-bank institutions with commercial links will be required to have at least 35 per cent of their voting shares publicly traded and widely held by December 31, 1991, or within five years of reaching the $50 million capital threshold.

- Commercial interests will not necessarily be precluded from acquiring or increasing significant positions in existing trust, loan and insurance companies having less than $50 million in capital.

- Trust, loan and insurance companies with no commercial links and with capital in excess of $750 million will also be required to have at least 35 per cent of their voting shares publicly traded and widely held by December 31, 1991 or within five years of reaching the $750 million capital threshold. Once this threshold is exceeded, no shareholder will be able to acquire an ownership position in the institution in excess of 10 per cent and significant shareholders will not be permitted to increase their ownership positions.

These policies will foster the development of wider ownership of large financial institutions in the future while recognizing the existing position of current investors. By causing current laws protecting minority shareholders to come into play, they will also ensure market disclosure, public scrutiny and the presence of strong outside directors.

This ownership policy recognizes that the existence of some dynamic, closely held non-bank financial institutions has provided significant and beneficial competition in Canadian financial markets. It recognizes that while ownership policy alone cannot guarantee the elimination of self-dealing, it has an important role to play in supporting an effective system of self-governance. To reinforce this role, the government will rely on the following mechanisms:

- limits on future commercial-financial links,
- a sufficiently broad minority shareholding to ensure market disclosure and public scrutiny, and
- cumulative voting rules for the election of directors.

A Framework for Prudential Regulation

Financial institutions are in a special position of trust in maintaining the financial well-being of millions of Canadians, and the confidence of the public in their stability and integrity is essential to their ability to fulfill that role. An effective system of prudential regulation is a key element in maintaining that confidence. Prudential regulation protects depositors and policyholders, through rules constraining potentially dangerous transactions or investments, through obligations on directors to ensure proper and prudent institutional behaviour, and through the role of auditors and supervisors.

The overall framework for the regulation of financial institutions will remain broadly intact. It will, however, be brought up to date and powers will be provided to respond to the regulatory concerns raised in the recent past. This regulatory regime will be the primary mechanism to control self-dealing and abuses of conflict of interest.

Strict controls on self-dealing will be introduced. The list of non-arm's-length parties will be expanded and made uniform for all financial institutions. With limited exemptions, asset transactions with such parties will be banned and service transactions will be strictly controlled. Transactions between related financial institutions will be monitored and controlled.

Safeguards against abuses of conflicts of interest will be introduced. Procedures and controls will be implemented to prevent the use of "insider information" in financial transactions. Disclosure rules will also be enhanced.

In accord with the overall approach recommended by Mr. Justice Estey, the government will maintain the basic division of responsibilities for ensuring and monitoring the health of institutions among the supervisory authority, corporate self-governance and the external auditors. A number of proposals will, however, strengthen directors' supervision of their institutions' operations and the role of auditors.

Rules governing the make-up of boards will ensure directors' access to independent, objective views, and independent directors will be given an important role on committees to examine transactions that might involve conflicts.

While major changes are not proposed for the role and standards of auditors, measures will be introduced to strengthen the role of external auditors and

improve information flows and communications among auditors, boards of directors and supervisors.

The existing investment rules for trust, loan and insurance companies will also be replaced with a new regime based on the concept of a "prudent portfolio". To implement this approach, there will be a clearly stated duty on institutions' boards of directors to maintain prudent investment practices by diversifying investment portfolios and by ensuring an appropriate degree of matching of the nature of assets to the nature of liabilities. In addition, institutions will be required to observe prescribed investment limits and restrictions.

Improving the Supervisory System

The federal organizations that have a special interest and role in the supervisory system are:

- the Office of the Inspector General of Banks, which supervises the banks;
- the Department of Insurance, which supervises the federally regulated trust, loan and insurance companies, the financial co-operatives registered under the Cooperative Credit Associations Act, and the companies regulated under the Investment Companies Act;
- the Canada Deposit Insurance Corporation (CDIC), which acts as deposit insurer; and
- the Bank of Canada, which acts as lender of last resort.

The government's proposals respond to the issues raised in recent studies of the supervisory system, while minimizing disruption to Canadian traditions in this area and to the nature of the existing organizations.

Consistent with the integration of the financial services industry, the two federal supervisory agencies will be consolidated into a new body – the Office of the Superintendent of Financial Institutions. The new Office will have full supervisory responsibilities for banks and federal non-bank financial institutions. The Minister of Finance will have overall responsibility for the new Office. The Superintendent will be clearly responsible for the administration of statutes, the execution of supervisory actions and the assessment of solvency. Measures will also be introduced to clarify and strengthen the power of the Superintendent to assume control of financially troubled institutions.

The government recognizes that the ability of the Superintendent to carry out his or her duties requires a full awareness of market trends and developments. The government will therefore act on Mr. Justice Estey's recommendation to establish an advisory committee of technical experts with a broad mandate to assist in the improvement of early warning systems and the development of uniform guidelines for financial accounting.

The CDIC will remain a separate body. This will allow the retention of private sector expertise on the CDIC board of directors and will preserve the CDIC's established relationship with provincial authorities supervising CDIC-insured provincially regulated institutions.

The new policy will extend CDIC discretion regarding the issuance of deposit insurance coverage to federal institutions and clarify its power to initiate a process for termination of coverage. Measures will also be taken to eliminate the existing deficit in a timely way.

To ensure the effectiveness of federal supervisory actions, a committee will be created to ensure full consultation and co-ordination among the Superintendent, the Chairman of CDIC, the Governor of the Bank of Canada and the Deputy Minister of Finance on supervisory issues relating to their respective mandates. This approach will strengthen the supervisor's "will to act" – an important concern raised by Mr. Justice Estey.

Foreign Participation in Canadian Financial Services

The guiding principles for policies with respect to foreign participation in Canada's financial services are:

- to maintain a strong Canadian participation in domestic markets;
- to foster competition that will benefit Canadian consumers through foreign entry; and
- to protect the ability of Canadian financial institutions to be world-class participants, by assuring that non-residents' access to Canadian domestic markets reflects Canadian firms' access to markets abroad.

The government has reviewed existing laws regarding foreign ownership of federally regulated financial institutions and concluded they should not be changed, subject to international negotiations now under way.

Thus, non-resident firms will be able to enter Canada on the same terms as at present and will, as a general rule, enjoy the same extensions of powers as will be provided to domestically owned institutions. Foreign-owned firms wishing to take advantage of this ability to expand into new areas of financial business in Canada generally will be required to do so by creating new firms rather than by acquiring existing ones. This is consistent with the policy that will apply to the major Canadian-owned institutions. It ensures that the foreign-owned firms established in Canada will not be given preferential treatment over Canada's own institutions within Canada's borders.

The federal government believes that, as the domestic securities market is opened to international competition, efforts must be made to assure a strong and viable

Canadian presence in this strategic industry. Schedule B banks and other non-resident-controlled federally regulated institutions will be allowed to acquire 50-per-cent ownership positions in securities dealers only as of June 30, 1987, and 100 per cent positions only as of June 30, 1988. Pending amendment of the Bank Act, Section 193 of the present Act will be administered so as to give effect to this policy.

Conclusion

Over the past 120 years, Canada has been well served by its financial institutions. They have evolved and grown to meet the changing needs of a developing society. Over this same period, financial laws have been amended to reflect the changing realities. Yet, in recent years, the pace of change has increased and public policy and legislation have lagged behind.

Federal financial sector proposals are designed to modernize our financial laws through policies which reflect global market trends towards the integration of financial services. Pragmatic ownership rules have been proposed which check the growth of commercial-financial links in the Canadian economy and ensure greater public scrutiny of closely held financial institutions, while maintaining balanced competition in the domestic market. A framework for prudential regulation will improve directors' supervision of their institutions' operations and enhance the performance of auditors while strictly controlling the practice of self-dealing and safeguarding against potential conflicts of interest.

The supervisory system will be strengthened, taking care to preserve the best of Canada's supervisory traditions. Taken together, these proposals will ensure that Canadians can continue to have confidence in one of the finest financial systems in the world.