New Directions for the Financial Sector

Canada

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The Honourable Thomas Hockin
Minister of State for Finance

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Preface

In the 1984 document, *A New Direction for Canada: An Agenda for Economic Renewal*, the federal government announced its intention to work with the provinces, the public and the financial community to develop legislation that would effectively respond to the rapid changes taking place in the financial system. Six months later, the government released a discussion paper, *The Regulation of Canadian Financial Institutions: Proposals for Discussions.* The purpose of this "Green Paper" was to encourage public debate and to help focus attention on possible policy responses to the challenges of change. As was stated in the preface to the Green Paper, "While the road to reform will be a difficult one, there is ... no turning back.... Changes will be required to modernize the regulatory system whatever course of action is finally decided upon".

In the ensuing months, market trends and events at home and abroad have reinforced the imperative of financial sector reform. Numerous studies have been undertaken to examine all aspects of the industry, and the issue has been the subject of intense debate. Parliament has played an important role in this debate, through reports issued by standing committees of the House of Commons and Senate.

The policies set out in this document, which will be reflected in legislation to be tabled in the current session of Parliament, bring to fruition this process of financial sector reform. This statement of federal policy will remove the uncertainty that currently constrains financial market participants from planning and acting with confidence. The full details of these proposals will take final shape in the course of drafting the legislation, in consultation with the financial services industry.

This document also provides the broad policy framework within which the government will exercise the specific powers regarding the transfer of institutional ownership proposed in two bills currently before Parliament. As well, it describes the main elements of the regulatory framework to be brought forward. The legislation to implement the proposals for the supervisory structure will be tabled early in 1987 with the legislation implementing the balance of the proposals to follow later in the year.

The task of developing a modern financial sector framework is challenging. The policy issues are complex. The proposals described herein constitute a coherent and pragmatic set of principles and actions which balance competing interests responsibly, and which will help us achieve the objectives set out in 1985 – the creation of a financial system of stability and integrity where sound, world-class institutions compete to provide individuals and firms with innovative, convenient services and broad access to credit.

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Introduction

In November 1984, in the document *A New Direction for Canada: An Agenda for Economic Renewal*, the federal government identified the financial sector as one of the key contributors to renewal of Canada's economy. The government announced its intention to explore, in consultation with consumers, business and the provinces, the question of how traditional thinking about financial institutions and their regulation should be altered to help improve the economy. The document posed a question being addressed in some other major financial centres throughout the world: how far should financial regulation move from the historical approach, which emphasized specialization in services, to permit financial institutions to offer a broader range of services to the public? To what extent, in other words, should separation be maintained between the traditional "four pillars" – banks, trust and loan companies, life insurance companies and investment dealers?

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 on the broad issues affecting the users of financial services and the financial community alike. The paper provided a number of specific proposals to focus attention on policy responses. This document was followed by a technical supplement, published in June 1985. The *Final Report of the Working Committee on the Canada Deposit Insurance Corporation (CDIC)* (the "Wyman Report"), which considered ways of improving Canada's system of deposit insurance, was also made public in June 1985.

These papers sparked a vigorous and searching debate. The financial industry associations, individual institutions, business people involved in the financial sector, the financial press, and Canadians from many walks of life contributed to the discussion through submissions, briefs, articles and letters. Major contributions to this debate were made by the House of Commons Standing Committee on Finance and Economic Affairs in its report, *Canadian Financial Institutions* (November 1985), and the Senate Standing Committee on Banking, Trade and Commerce in its two reports, *Deposit Insurance* (December 1985) and *Towards a More Competitive Financial Environment* (May 1986). Both committees provided comprehensive commentary on the Green Paper and Wyman Report proposals and introduced a number of new proposals for consideration. More recently, the Economic Council of Canada provided a comprehensive review of the issues in its consensus statement on the regulation of financial institutions, *Competition and Solvency: A Framework for Financial Regulation* (November 1986). The issues were also examined from a provincial perspective by the Ontario

Task Force on Financial Institutions, chaired by J. Stefan Dupré, in its *Final Report* (December 1985).

As the debate unfolded, additional events served to focus public attention on financial sector regulation. The failure of the Canadian Commercial and Northland banks in mid-1985 put in sharp focus the issues of solvency, deposit insurance, and banking regulation and supervision in general. These failures led to the appointment of the Commission of Enquiry chaired by Mr. Justice Willard Z. Estey, whose report was released in October 1986. The failures also motivated a review of the supervisory methods of the Office of the Inspector General of Banks. The firm of Coopers & Lybrand was retained to conduct this review and its report was made public in August 1986.

In March 1986, the acquisition of Canada's largest trust company by a commercially based conglomerate heightened public concerns about links between financial and non-financial institutions and the related issues of concentration of ownership, self-dealing, reduction of competition and conflicts of interest. The federal government sought, and received, undertakings from the non-financial parent pending the implementation of a new framework for the regulation of the financial sector and the ownership of financial institutions. These undertakings were tabled in Parliament in April 1986. The acquisition also motivated the House Finance Committee to issue a supplementary report in June 1986 with further proposals to deal with financial-commercial links.

The debate on domestic financial sector issues unfolded against the backdrop of rapid and significant changes in the international environment in which Canada's financial institutions operate. These changes are reshaping international financial markets, and governments around the world are adjusting their regulatory frameworks accordingly. As a trading nation that is integrated with the international financial system, Canada must take account of these changes in developing its domestic policy. Moreover, discussions on the liberalization of trade in financial services are being conducted multilaterally under the General Agreement on Tariffs and Trade (GATT) and bilaterally in the negotiations between Canada and the United States.

The financial community has conducted its affairs for some time now with the prospect of regulatory change certain – but the direction and dimensions of that change unclear. The government considers it important to give financial markets and participants a clear indication of federal policy intentions so that they can plan and act with confidence. This policy statement gives that indication. It outlines the policies that will be implemented as legislation in the current session of Parliament. It constitutes the broad policy framework within which the government will exercise specific powers regarding the transfer of ownership of financial institutions as proposed in two bills currently before Parliament – Bill C-8, *An Act to amend the Canadian and British Insurance Companies Act, the Foreign Insurance Companies Act and the Winding-up Act*, and Bill C-9, *An Act to amend the Loan Companies Act, the Trust Companies Act, the Bank Act* *and the Quebec Savings Banks Act*. Both of these bills received first reading on October 6, 1986.

The breadth and complexity of the issues at hand pose a formidable challenge to the formulation of policy. The government, however, has now had the benefit of an intensive and thoughtful discussion. While there is not consensus among Canadians on all issues, the government is confident that the policies it is now proposing reflect a responsible, pragmatic and balanced approach, an approach that will best serve Canadian depositors, policyholders, businesses and other users of financial services and the financial community alike.

I. Principles and Directions

Principles

In the Green Paper, the federal government enunciated nine principles which would form the basis for financial sector policy. These principles are:

(1) to improve consumer protection;

(2) to control self-dealing;

(3) to guard against abuses of conflict of interest;

(4) to promote competition, innovation and efficiency;

(5) to enhance the convenience and options available to customers in the marketplace;

(6) to broaden the sources of credit available to individuals and businesses;

(7) to ensure the soundness of financial institutions and the stability of the financial system;

(8) to promote international competitiveness and domestic economic growth;

(9) to promote the harmonization of federal and provincial regulatory policies.

These principles apply to the various types of regulated financial institutions: banks, trust and loan companies, insurance companies, investment dealers and financial co-operatives.

They have received widespread approval and the government reaffirms its commitment to maintain them as the basis of financial sector policy.

Directions of Change

A General Financial Sector Policy Approach

The major public policy issues addressed in this paper are of broad relevance to all Canadians. Among the main challenges are the following:

- the need to seize the opportunity provided by the internationalization of financial markets to foster world-class Canadian financial institutions;
- the desire to capture the benefits that healthy competition by dynamic financial institutions can offer to Canadians;
- the need to enhance protection against self-dealing and conflicts of interest; and
- the desire to strengthen prudential practices to enhance institutional solvency.

The policies proposed in this paper respond to these challenges by applying like solutions to like problems, while allowing the various types of financial institutions to retain a good deal of their institutional uniqueness.

They build upon the significant base provided by the Green Paper and the commentaries thereon, and on the discussions and consultations that followed publication of the Green Paper.

They provide the framework for an effective, dynamic and sound financial system that will contribute to economic renewal and benefit all Canadians.

Industry Structure and Institutional Powers

The government is proposing that, in principle and subject to the ownership policy described below, there be no restrictions on common ownership of regulated financial institutions. Such institutions will be allowed to hold financial subsidiaries in other pillars (including securities dealers) or to be affiliated with other financial institutions through a holding company structure.

Broader in-house powers will also be granted to financial institutions, including full consumer lending powers and – for non-bank institutions that are above a minimum size and have regulatory approval – full commercial lending powers as well. Additional flexibility will be provided through allowing ancillary fiduciary and some securities-related powers to be exercised directly by all federally regulated financial institutions. As well, a full "networking" capability (that is, the ability to offer customers the products and services of another institution) will be granted to all institutions for the full range of financial services, excepting the retailing of insurance.

This approach recognizes market trends towards greater competition among all types of financial institutions. It removes regulatory restrictions that no longer serve public policy goals and that, in fact, risk denying the full benefits of competition, efficiency and innovation to Canadian users of financial services.

To ensure that these new powers are channelled towards benefiting the economy and enhancing competition, the Minister of Finance will retain the discretionary power to approve mergers or acquisitions. In the exercise of this discretionary power, large financial institutions will not generally be permitted to acquire other large institutions. As a general rule large institutions will be permitted to expand into new areas only by creating new subsidiaries rather than by taking over existing firms. An exception to this will be the securities industry, where large financial institutions will be permitted to acquire ownership positions in existing securities dealers.

The policy recognizes that the financial system worldwide is evolving in a manner that will allow financial institutions in any one of the traditional four pillars to provide, directly or through affiliates or subsidiaries, a full range of financial services. It protects the capacity of Canadian institutions to be effective world-scale participants by bringing financial services in Canada into step with the needs and realities of the market, at home and throughout the world.

As the financial system becomes increasingly integrated, greater care must be taken to ensure the safety of Canadians' savings and the capacity of the financial system to allocate these savings in an unbiased and efficient manner. These concerns are addressed in changes proposed to the system of prudential regulation and supervision and to policies regarding ownership.

Ownership

Ownership issues featured prominently in the policy debate. Financial institutions in Canada, as well as in other major industrial countries, are now characterized by a variety of ownership forms. In Canada, these range from purely financial, widely held institutions to closely held institutions with significant commercial links. The fact that institutions with different forms of ownership – some with and some without commercial links – have encountered financial difficulties has ensured a spirited debate. Various prescriptions for the formulation of a general ownership policy were put forward based on often differing views of the potential for ownership policy, by itself or in conjunction with other measures, to help achieve various public policy goals.

The ownership policy presented below reflects this debate. It responds to the concerns that have been raised about financial-commercial links. But it also recognizes that ownership policy is only one of several ways to address these concerns. It can support – but not replace – rigorous controls on self-dealing and vigilance in the system of corporate governance.

The policy also reflects the reality that some commercial interests now have majority ownership positions in financial institutions and have provided access to capital, innovation and shareholder guidance that have served Canada's financial system well. These linkages were formed in good faith and according to the rules and regulations that applied at the time.

The government's ownership policy also allows explicitly for the benefits that institutions – particularly smaller institutions attempting to establish themselves – can derive from a strong shareholder presence.

Finally, it takes into account the potential benefits to financial institutions, which play an important custodial role, that a significant element of broad public ownership can bring in terms of ensuring market scrutiny of the institution's operations, establishing the basis for effective corporate governance, and ensuring there is public accountability for the institution's use of the public's funds.

In respect of domestic banks, which are now all widely held, the proposals provide scope for smaller banks to be wholly owned by financial interests and grow to a substantial size before coming under the requirement to move towards widely held status. This reflects the view that close ownership, with no commercial links, can provide benefits important to the growth and development of financial institutions with less danger of self-dealing. This policy will support other measures to promote competition in the financial system.

In respect of trust, loan and insurance companies, which at present are not subject to domestic ownership controls, the proposals arrest the industry trend towards more pervasive financial-commercial links. They also allow for the development of significant and broad minority shareholding to provide increased support to the functioning of a more effective system of corporate governance.

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 roles of auditors and supervisors.

The overall framework for prudential regulation of financial institutions will remain broadly intact. It will, however, be brought up to date and measures will be introduced to respond to the regulatory issues raised in the recent past.

In accord with the overall approach recommended by Mr. Justice Estey, the basic division of responsibilities for ensuring and monitoring the health of institutions among the supervisory authority, the directors of the institutions and the external auditors, will remain in place. A number of proposals will, however, seek to strengthen the directors' role in their institution's operations, to enhance the performance of auditors, and to strengthen the supervisory authorities.

The regulatory regimes in respect of non-arm's-length transactions and conflicts of interest will be modified to take into account the wider range of activities which may be carried on by a financial group. The self-dealing controls that are now in the financial institutions' statutes will be extended to cover more comprehensively those in positions of influence or control and will prohibit most loan, investment and asset transactions between such persons and the financial institutions with which they are associated. Transactions that are not prohibited will be controlled and limited.

A more flexible regime will apply to transactions between two affiliated regulated financial institutions. This will facilitate the integration of their activities and the provision of a full range of services to their customers.

Investment rules for the non-bank financial institutions will be modernized in line with the "prudent portfolio" approach, replacing quality tests on individual investments with general quantitative rules on the composition of an institution's portfolio.

The System of Supervision and Deposit Insurance

In line with the evolution of the financial system, the federal supervisory agencies will be consolidated as a new body – the Office of the Superintendent of Financial Institutions – to bring all federally regulated financial institutions under one supervisory authority.

The proposals will also ensure co-ordination among the Office of the Superintendent, the Canada Deposit Insurance Corporation (CDIC) and the Bank of Canada. This will strengthen the effectiveness of the supervisory system by ensuring that the views of those with financial exposure to the failure of institutions are given full weight by those who make supervisory decisions.

In addition, new powers will be provided to permit a timely and cost-effective resolution of cases of troubled financial institutions.

Finally, reforms will clarify and strengthen the role of the Canada Deposit Insurance Corporation and provide authority to levy higher insurance premiums in order to eliminate the CDIC deficit over time.

II. Powers of Financial Institutions

The policy described below requires separate and identifiable institutions for major functions, while permitting common ownership of banks, trust, loan and insurance companies and investment dealers. This will allow financial institutions to market their financial services as a package, while retaining separate institutions for supervisory purposes.

Financial institutions will have the option of organizing themselves under a holding company or of owning other regulated financial institutions as direct subsidiaries. There will also be an increase of in-house powers.

Financial Subsidiaries

Banks and federally regulated trust, loan and insurance companies will, in principle and subject to the proposed new ownership policies, not be restricted as to the proportion of shares they may hold in any type of regulated financial institution that is incorporated in Canada, in a province of Canada or in a foreign jurisdiction. They will be permitted to own securities dealers.

To prevent double-counting of capital, any investment that exceeds 10 per cent of another financial institution's equity will be deducted from the capital stock of the parent in calculating its capital requirements for supervisory purposes. As well, where insurance companies wish to acquire subsidiaries, supervisory procedures will be established to protect the rights of participating policyholders.

Affiliation Through Common Ownership

Regulated financial institutions will be free to form affiliations with other regulated financial institutions under the umbrella of a holding company. This avenue is already open to the trust, loan and stock insurance companies. This will be a new option for banks.

Extension of Direct Powers

Trust, loan and insurance companies will have significantly increased powers to undertake consumer and commercial lending. Additional powers ancillary to institutions' present main activities will also be provided.

Commercial Lending

Trust, loan and insurance companies are now limited in their ability to enter into commercial lending arrangements. They do, however, have broad powers to acquire corporate debt and equity securities which, from a business perspective, can be structured to resemble a commercial loan in every important respect. As well, these companies may engage in commercial lending through their "basket clauses", which permit them to enter, on a limited basis, into otherwise restricted areas of investment.

Broadening the powers for commercial lending can provide important benefits to Canadian business. Large companies have a diversified asset portfolio and experienced credit officers. Consequently, it is proposed to provide unrestricted commercial lending powers to non-bank institutions such as trust, loan and insurance companies that have a minimum of $25 million in capital and have received supervisory approval.

Companies that do not meet these criteria will be restricted to having 5 per cent of their assets in commercial loans or commercial loan equivalents. For purposes of these limits, commercial lending will be defined to include substantially all means of advancing funds, credit, or guarantee of funds to business. Those instruments excluded from this definition include securities issued under prospectus; securities issued in private placements, or commercial paper, with a broad distribution; and corporate mortgage loans undertaken in accordance with existing rules.

The availability of broad commercial lending powers to non-bank institutions increases the importance of addressing the issue of competitive equity, as between bank and non-bank institutions, which arises from requirements on banks to hold non-interest-bearing deposits at the Bank of Canada.

These required deposits, over and above the amount needed for clearing purposes, have no bearing on the solvency of banks. They are used to assist in the implementation of monetary policy, but they have the side effect of imposing unequal costs on institutions competing for the same business. These deposits are no longer essential for the implementation of monetary policy and will be phased out beginning in 1990. This approach will provide an adequate period to allow for transition in the implementation of monetary policy.

Consumer Loans

Currently, trust, loan and insurance companies have only limited capacity to make personal loans. However, consumer loans are interest-bearing assets that are an appropriate match for the interest-bearing liabilities of these companies and pose no particular solvency concerns. In view of these considerations, there will be no portfolio limits on consumer loans for trust, loan and insurance companies.

Investment Advice and Portfolio Management

At present, there are a variety of restrictions in the federal financial institutions' statutes regarding the provision of investment advice, portfolio management services and similar securities-related services. Financial institutions have indicated an interest in providing these services to the public, and their provision would raise no solvency concern.

It is therefore proposed that banks, trust, loan and insurance companies be permitted to provide investment advice and portfolio management services.

In addition to this expansion of direct powers, regulated financial institutions will be allowed, through subsidiaries, to engage in a full range of securities activities.

Ancillary Fiduciary Powers

At present, banks and insurance companies face blanket prohibitions on the exercise of trustee powers, including management and agency powers.

It is proposed to expand the range of eligible fiduciary powers by permitting the direct exercise of trust powers by banks and insurance companies, with these exceptions:

- carrying out trusts conferred by order of a court;
- carrying out *inter vivos* trusts;
- acting as executor or administrator under wills or bequests;
- acting as official guardian or tutor, or as curator of mentally infirm individuals;
- acting as a stock transfer agent.

Banks and other regulated financial institutions will be able to engage in a full range of fiduciary activities through a subsidiary or related company.

Networking

With the exception of the retailing of insurance, full networking powers will be available to all federally regulated financial institutions. This will allow financial institutions to provide a broad range of financial services to consumers.

Non-Resident Participation

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

- to maintain a strong and healthy Canadian participation;
- 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.

These principles have been implemented historically through policies that, broadly speaking, allow non-residents to enter Canada's financial markets on a start-up basis but not through takeovers of existing Canadian-owned firms and, once established, to compete on an equitable basis with Canadian-owned institutions. This approach has worked well. Canada's institutions are well placed to compete in world financial markets.

The government has reviewed existing laws regarding foreign ownership of federally regulated financial institutions and concluded they should not be changed, subject to trade negotiations currently underway.

Thus, non-resident firms will be able to enter Canada on the same terms as at present and will enjoy the same extensions of powers as will be provided to domestically owned institutions. This approach will benefit Canadian consumers of financial services and will maintain fair treatment of foreign-owned firms.

Foreign-owned firms wishing to take advantage of the 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, which are major international participants in their own right, will not be given preferential treatment over Canadian institutions within Canada.

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. For this reason, the federal government will permit domestically owned, federally regulated financial institutions to own securities dealer subsidiaries and will amend relevant federal legislation to allow this as quickly as possible.

With respect to non-residents' entry into Canada's domestic securities markets, Schedule B banks and other non-resident-controlled federally regulated financial institutions will be allowed to buy 50 per cent of a securities dealer as of June 30, 1987, and to establish, or buy 100 per cent of, a securities dealer 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.

III. Ownership Policy for Financial Institutions

Canada has diverse forms of ownership of its financial institutions. These range from widely and closely held stock institutions to mutually and co-operatively owned institutions. The banking and trust sectors are largely composed of stock companies – but co-operatives also compete for retail banking business. The insurance sector has mutuals – which are not unlike co-operatives – in addition to stock companies.

Canada's financial system has grown and prospered with this diversity of ownership forms and the market has not clearly favoured one form over another. Moreover, financial difficulties have been visited upon firms with various forms of ownership.

Rules regarding the form or degree of ownership of financial institutions have not for the most part been used to implement public policies. In the 1950s, mutualization of insurance companies was facilitated to protect that industry from non-resident takeovers, and the wide ownership rules for banks introduced in 1967 had the same purpose of preventing takeovers of Canada's major banks by non-resident interests.

The scope exists for greater use of ownership policy to help achieve the public policy goals that are unique to the financial industry. For example, in the recent policy debate, the possibility has been raised of using ownership restrictions to strengthen policy in the areas of self-dealing, concentration of power, the integrity of the credit allocation process, and Canadian control of the financial sector. At the same time, arguments have been advanced that institutions' access to capital should not be foreclosed and that there are benefits to institutions from having interested, watchful majority shareholders.

The government does not believe it is appropriate to adopt a broad general ownership policy for uniform application to all financial institutions, particularly in view of the differing ownership circumstances that have developed over time and now exist in the Canadian financial services industry. In a dynamic and competitive financial system, there is room for both widely held and majority controlled financial institutions. Each form of ownership brings its own strengths; both now exist and have served Canadians well; neither is inherently better than the other.

The government proposes to retain the ownership distinction between banks and non-banks that now exists and reflects the Canadian reality. Changes in the ownership regimes for banks and non-banks are proposed that will reinforce and support those aspects of the overall policy that promote competition and protect solvency. For banks, the changes will increase the scope for closely held banks, allowing for greater access to capital and majority shareholder direction in smaller institutions' development and growth. For non-banks, to provide a firm foundation for the proposed new regime of corporate governance, changes will arrest ownership linkages between the financial and commercial sectors of the economy and require significant minority shareholdings where commercial links exist.

Ownership Rules for Chartered Banks

The Bank Act now permits the creation of a domestically owned bank on a closely held basis. However, such a bank must attain widely held status within 10 years. This rule may dissuade entry into banking and hamper small banks in growing to become sources of new competition. Consequently, the government will permit small banks to be closely held by domestic investors as long as they have no commercial interests. Such banks will be permitted to remain closely held until they attain a capital base of $750 million, at which time they will become subject to the following ownership rules:

- Shareholders with 10 per cent or more of any class, or any series of any class, of shares will not be permitted to acquire any additional shares of that class or series, so that as the institution grows through the issue of new voting equity it will become widely held.

- Shareholders with less than 10 per cent of any class, or any series of any class, of shares will not be permitted to increase their holdings to more than 10 per cent of that class or series.

- At least 35 per cent of the voting shares of the bank must be publicly traded and widely held within five years of the bank's reaching that capital threshold. The penalty for non-compliance with this rule would be a constraint on the bank's ability to grow.

For existing banks with capital in excess of $750 million, the rule prohibiting shareholdings in excess of 10 per cent will continue to apply.

These measures will ensure that the major existing banks will remain widely held and any new banks that may attain substantial size will, as they continue to grow through new equity issues, become widely held as well.

Ownership Rules for Trust, Loan and Insurance Companies

Trust, loan and insurance companies currently have no domestic ownership rules. The majority of these companies (apart from the mutual insurance firms) are closely held, many of them by conglomerates with major commercial interests.

In the government's view, it is desirable to constrain ownership linkages between the financial and commercial sectors of the economy and – where these linkages now exist or where institutions without such linkages grow beyond a certain size – to encourage a significant minority holding. The public distribution of a significant shareholding has an important role to play in protecting the interests of the institution through disclosure requirements which lead to market scrutiny, and through the resulting influence on the fiduciary responsibilities of the board of directors, enhanced by cumulative voting for the election of directors. For this reason, the government feels that minority shareholdings in financial institutions with commercial links should account for at least 35 per cent of the voting rights in the institution.

As of December 18, 1986, approval for the incorporation of new trust, loan and insurance companies will not be granted to applicants with significant commercial interests. For existing non-bank financial institutions with capital in excess of $50 million, commercial interests will not be permitted after December 18, 1986 to increase ownership positions of more than 10 per cent, or to acquire ownership positions exceeding 10 per cent. With the approval of the Minister, an exception may be provided where non-marketable rights to acquire shares in a non-bank were in existence prior to December 18, 1986 and evidenced in writing.

Commercial interests will not necessarily be precluded from acquiring or increasing significant positions in existing trust, loan and insurance companies with less than $50 million in capital. This exception is motivated by the desire not to diminish the ability of such companies – which may not always have access to the public market – to raise capital.

Commercially linked trust, loan, and insurance companies with more than $50 million in capital 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.

These measures will arrest the trend towards greater financial-commercial integration, while recognizing Canada's current ownership situation in the non-bank financial sector.

The government is of the view that a significant minority shareholder presence is important for large financial institutions, even if they have no commercial links. Such institutions can exert an important influence on the economy and a significant minority shareholder presence will help to ensure the effectiveness of the system of corporate governance and to provide a measure of public scrutiny over their affairs, while preserving benefits that may come from majority ownership.

Accordingly, trust, loan and insurance companies with more than $750 million in capital and no 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 $750 million capital threshold.

For non-bank financial institutions with capital in excess of $750 million, no shareholders will be permitted after December 18, 1986 to increase ownership positions that exceed 10 per cent or acquire ownership positions exceeding 10 per cent.

For these purposes, "publicly traded" means an institution having its voting shares listed and posted for trading on a recognized stock exchange in Canada, and "widely held" means no shareholder holding in excess of 10 per cent of such listed voting shares.

Shares held by a minority shareholder who holds in excess of 10 per cent, but less than 50 per cent, of an institution's listed voting shares as of December 18, 1986 will be included in the "widely held" category for the purpose of meeting the 35 per cent test. Such exempted shareholders will not be permitted to acquire additional shares until the institution has met this test. Thereafter, such exempted shareholders will be permitted to acquire additional shares in an amount sufficient to maintain their then-current percentage ownership in the institution.

Acquisition of Banks or Conversion to a Bank

A non-bank financial institution that wishes to convert to a bank or acquire a bank as a subsidiary must commit to the Minister of Finance that it will comply with the ownership policy for banks within an acceptable time frame. A holding company that wishes to acquire or start a bank must make the same commitment.

Application of Ownership Rules to Financial Conglomerates

The policy enunciated earlier regarding the powers of financial institutions provides an important extension of an institution's powers to hold financial subsidiaries or to be part of a group of financial institutions under a holding company. It is not the intent of the ownership rules to interfere with or constrain the arrangements that institutions choose for such affiliations. Therefore, provision will be made in the ownership policy for compliance with the rules pertaining to banks and trust, loan and insurance companies, at either the company level or through a holding company that links the group of related financial companies. Regardless of the route chosen to comply with the ownership rules, the capital of all related financial institutions will be aggregated for purposes of assessing the size of the group against the threshold amount.

Influence of Minority Shareholders

The measures proposed above will ensure a significant public shareholding, to provide a counterbalance to the influence of the majority shareholder. To ensure that the public shareholders are effective in this capacity, the make-up of the board of directors must reflect their influence. Consequently, financial institutions having a shareholder owning more than 10 per cent of any class, or series of any class, of voting shares will be required to introduce mandatory cumulative voting procedures for the election of directors.

Definition of a Commercial Interest and a Commercial Link

For the purpose of this policy, the term commercial interest or commercial company refers to corporations engaged in the production and distribution of goods and non-financial services, or financial services on an unregulated basis. Companies registered under the Investment Companies Act will be considered commercial entities.

Regulated financial institutions – including banks and federally regulated trust and loan companies, insurance companies, and financial co-operatives and their permitted ancillary business subsidiaries – will not be considered to be commercial companies. Similarly, provincially regulated trust, loan and insurance companies and registered investment dealers will not be considered commercial entities unless their holdings or ownership structures include significant links with commercial entities.

Individual investors, agents or representatives of individual investors (such as holding companies and trusts) and pension funds will not be considered to be commercial entities – although they could serve as a commercial link if they have major shareholdings in both a federally regulated financial institution and commercial enterprises.

The level of a person's shareholdings in a commercial company that will be considered as linking the person to the company – a "significant interest" – will be 10 per cent of any class, or of any series of any class, of the outstanding shares.

Finally, there will be a *de minimis* test to ensure that significant shareholders of financial institutions whose total commercial interests are small relative to their financial interests do not serve to bring their financial institutions within the purview of the foregoing ownership rules. Total commercial interests will be measured as the aggregate book value of all ownership interests involving holdings of 10 per cent or more in commercial corporations. The *de minimis* test will exempt shareholders whose commercial interests are 5 per cent or less of their total interests in regulated financial institutions, measured in a similar fashion.

In applying these rules, indirect links (e.g. through chains of holding companies) will be taken into account.

IV. Regulation of the Financial Services Industry

The Control of Self-Dealing

Self-dealing refers to transactions between a financial institution and persons who are in positions of influence over or control of the institution (non-arm's-length transactions). Self-dealing is particularly dangerous to financial institutions because it can threaten their solvency. Existing legislation reflects concern about this practice; however, existing regimes to control self-dealing are inadequate. The current rules do not apply to all who could be considered as having influence or control, nor do they cover some important transactions such as the transfer of assets from a financial institution to its affiliates or controlling interests.

The policy proposed is based on a three-tiered approach – involving a ban on most types of transactions, internal controls for permitted classes of transactions, and pre-clearance with supervisors for unusual transactions.

Persons in a Position of Influence or Control

The following are the persons that will be considered as being at non-arm's length to a financial institution:

- shareholders who beneficially own, directly or indirectly, 10 per cent or more of any class, or any series of any class, of shares ("significant shareholders");
- directors and officers of the financial institution;
- auditors of the institution;
- directors and officers of corporations that beneficially own, directly or indirectly, 10 per cent or more of any class, or any series of any class, of shares of the financial institution;
- members of the immediate family of the above;
- the significant business interests of the financial institution or of the persons described above.

Legislation will permit the Superintendent to designate individuals or corporations as being not at arm's length, or to exempt individuals from such designation.

Banned Transactions

The danger in a non-arm's-length transaction is the lack of objectivity in assessing the price or terms at which the transaction takes place. Where such a transaction is exempted under the following rules, clearance by independent directors will be required prior to approval by the full board. The definition of an independent director is provided in the discussion of corporate governance proposals.

The following transactions will be prohibited with the exception of the exemptions noted below, and subject to the special provisions that will apply to transactions between affiliated regulated financial institutions:

- Loans to and investments in non-arm's-length persons.
  - Exceptions will be provided for mortgage loans secured by the borrower's residence and personal loans of a limited amount. The aggregate of the above types of loans must not exceed 5 per cent of the institution's capital and each loan must be approved by the board (including pre-clearance by independent directors).
  - In the case of banks, loans will be permitted to companies whose significant shareholders are on the bank's board of directors, provided the loans are at terms and conditions applying in the normal course of business, the aggregate of all such loans does not exceed 50 per cent of the bank's capital, the loans are approved by a committee of the board consisting of independent directors, and the total amount of such loans is published in the bank's annual statement.
  - A *de minimis* rule will permit standard personal financial services (e.g. deposit facilities and credit cards) to non-arm's-length persons, without board approval.
- The sale of assets to, or purchase of assets from non-arm's-length persons.
  - A general exemption will be provided for asset transactions involving federal and provincial government securities, or assets fully secured by such securities, transferred at market value.
  - Exemptions will be provided for the purchases of goods used in the normal course of business, provided there are no special terms or conditions, and provided that beyond a minimum size there is approval by the board of directors (including pre-clearance by the independent directors).
  - Additional exemptions may be provided by regulation for further categories, and by the Superintendent for specific transactions in unusual circumstances, where there is clear evidence that no influence is being exerted.

Capital and corresponding dividend flows, as well as directors' fees and officers' compensation (including pension benefits and stock options), will not be considered to be self-dealing.

Controlled Transactions

While loans, investments and asset transactions can bring a company to insolvency, the same is not generally true of service transactions. Consequently, contracts with non-arm's-length persons for the sale or purchase of business services will be permitted subject to the following controls:

- approval of contracts, beyond a minimum amount, by a committee of the board of directors consisting solely of independent directors, provided that the price and terms are at least as favourable as comparable products available from arm's-length parties (this would preclude contracts for vaguely described services that could not be compared as to market prices);

- maximum term to the contract of five years, although it could be renewed with approval of the committee of independent directors;

- clear identification of the related-party nature of the transactions in reports to supervisory authorities.

Transactions Between Affiliated Regulated Financial Institutions

To permit the exploitation of synergies by financial institutions seeking to market financial services, it is proposed that transactions between related regulated financial institutions be subject to a less restrictive regime than would apply to self-dealing between regulated financial institutions and related non-financial concerns. The following transactions that would otherwise be banned will be permitted where the non-arm's-length party is a federally regulated financial institution that is either a parent, a subsidiary or an affiliate.

- A general exemption will apply to transactions between a regulated financial institution and a wholly owned subsidiary all of whose liabilities are guaranteed by the parent.

- Asset transactions will be permitted provided that assets acquired from related financial institutions do not exceed 20 per cent of the capital of the institution, and provided the following conditions are met:

  - In the case of securities, there must be a well-defined market for the security exchanged (i.e. the security is actively traded and there is a well established price), the transaction is conducted at market value and the securities are not in default.

  - In the case of loans, the assets acquired may not be impaired in any way.

- Transactions involving low-quality assets, such as non-performing loans, will not be permitted except as part of a restructuring (e.g. with capital injections) where there is pre-notification and supervisory approval.

- There must be clear identification of such transactions in returns to the Superintendent.

Inter-affiliate loans will be permitted without limit in the following cases:

- loans fully secured by government securities;

- loans that are in the nature of deposits, made at market terms and for purposes ancillary to the business of the depositor.

Conflict of Interest

Abuses of conflict of interest will be handled by a multi-faceted approach which includes greater disclosure to the consumer, the use of techniques to prevent the dissemination of inside information within an institution (commonly known in financial circles as "Chinese Walls"), and enhanced internal scrutiny through creation of a monitoring group within each institution. The purpose of these elements is to identify potential conflicts, to provide for an appropriate internal process to deal with conflicts, and to require that proper disclosure be made.

Insider Information

The key function of internal controls is to ensure that decisions taken with regard to specific transactions are based on information generally available to the marketplace and are not influenced by "inside" information, obtained as a result of the financial institution's activities in providing different types of financial services. Regulated financial institutions will be required to put into place reasonable procedures to restrict the flow of "inside" information. A committee of the board of directors will be charged with reviewing compliance with these procedures.

Enhanced Disclosure

Enhanced disclosure will be required through amendment of the appropriate statutes. The disclosure rules will include:

(1) clear identification of the institution with which the client is contracting, including the presence or absence of CDIC coverage of deposits;

(2) clear description of the role played by the corporation in contracting with the client, including whether the corporation is a principal or an agent for other parties;

(3) a statement that fees and commissions are earned by the institution in networking situations; and

(4) disclosure to the client of any material facts coming to the knowledge of the institution in the course of a business transaction with or on behalf of a client.

Enhanced Corporate Governance

The Role of Directors

A number of measures are proposed to strengthen the role of directors of regulated financial institutions.

The make-up of the board of directors will be subject to rules to ensure that the board has access to the views and judgment of individuals who neither are officers or employees of the corporation nor have other significant associations with the corporation.

First, the number of board members that may be drawn from among the officers and executives of the firm or its affiliates (inside directors) will, in accordance with the Bank Act rule, be limited to 15 per cent, subject to regulatory exemption for small boards for which this constraint would be burdensome. The legislation will also provide for a minimum number of directors.

Second, at least one-third of the directors will be required to meet stringent criteria establishing their independence of the corporation. These criteria include:

- that they are not officers, employees or significant shareholders of the financial institution or companies related to it;
- that they do not have significant business links with the institution or companies related to it, directly or indirectly (which includes being a director and/or officer of a significant borrower);
- that they do not belong to firms acting as major legal advisers to the institution; and
- that they are not immediately related by birth or marriage to any person in the above categories.

Independent directors have an important role to play in the audit process and in reviewing corporate practices of particular concern to supervisors. Accordingly, institutions will be required to establish a committee of the board consisting solely of independent directors to carry out the following duties:

- to establish general procedures for review, and to review particular instances, of related-party transactions, conflicts of interest, financial irregularities, malfeasance, apparent fraud, transactions or practices that may have a material effect on the health of the financial institution, and transactions apparently beyond the powers of the firm;

- to provide specific guidelines to auditors in respect of their reports on such transactions and situations, and to review such reports and interview auditors.

As recommended in the Estey report, institutions will be required to file the mandates of these committees with the Superintendent of Financial Institutions. The committees themselves will be required to make an annual report to the Superintendent.

In view of the greater responsibilities that will be placed on directors and particularly on independent directors, comprehensive indemnification provisions will be permitted, as in the Bank Act, to ensure that qualified people are willing to serve in this important capacity.

The Role of Auditors

In reviewing the role of auditors, the Estey Commission concluded that the auditor's role in the tripartite system of supervision should not be fundamentally changed. The Commission did, however, see scope for additional measures to strengthen the role of auditors and to enhance communication among auditors, directors and supervisors.

A number of measures will be introduced to improve the quality of information flowing to the external auditors, to enhance communication with directors and supervisors and to bolster auditors' independence from firms' management.

There will be a review of the guidelines used for the reporting of non-performing loans, loan losses, fees associated with loans and "creative financing" techniques which may disguise the true extent to which interest or principal is being paid. An Advisory Committee to the Superintendent, as proposed by Mr. Justice Estey, will be constituted and charged with this review.

To improve the flow of information to the external auditors, measures applying to all financial institutions will be introduced to improve the functioning of the internal audit/inspection systems. Specific guidelines will be developed for the examination of the loan portfolio, lending practices, credit limits and control systems, including the management information system, by the internal audit and inspection groups. The chief internal auditor/inspector will be able to report directly to, and be required to be available for interview by, the external auditor as well as the chief executive officer, the audit committee of the board of directors and the Superintendent of Financial Institutions.

In addition, the Superintendent will be required to inform the external auditor, as well as the chief executive officer and the board of directors, as to any adverse findings on regular inspections conducted by the Superintendent's office or the placing of the institution on a watch list.

To promote better communication between the auditors, the board of directors and the supervisor, the Superintendent of Financial Institutions will interview the auditors and the audit committee of the board of directors as part of the regular inspection of the institution.

To introduce greater openness in the circumstances surrounding the appointment and removal of particular external auditors, financial institutions will be required to maintain a panel of experienced auditors from whom shareholders would make their appointments. This panel would include only firms who can provide, as the auditor in charge, persons with a minimum five years' experience in performing audits of significant financial institutions at a senior level. If a firm is dismissed or removed from this list, the financial institution will be required to notify the Superintendent and the board of directors. The Superintendent will also be required to interview any auditor resigning or being dismissed.

Investment Rules

The existing investment rules for non-bank financial institutions (the so-called "legal-for-life" qualifications) will 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.

The investment rules for trusteed pension funds will also be based on the "prudent portfolio" principle. However, given the differences in the nature of pension fund liabilities and obligations, the application of this principle will result in different rules than are proposed for the non-bank financial institutions.

Institutions and pension funds will be required to observe the investment limits or restrictions set out in the Appendix.

V. The System of Supervision and Deposit Insurance

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

- the Office of the Inspector General of Banks (OIGB), which supervises the banks;

- the Department of Insurance, which supervises 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 functions as a lender of last resort.

The smooth functioning of the supervisory system depends not only on the effectiveness of each organization in performing its own special role, but also on the maintenance of good lines of communication among them and a clear understanding of their respective responsibilities. The measures outlined below address each of these areas.

The Structure of the Supervisory System

Office of the Superintendent of Financial Institutions

The Office of the Superintendent of Financial Institutions, to be created by combining the Department of Insurance and the Office of the Inspector General of Banks, will assume all duties of these organizations. The Minister of Finance will have overall responsibility for the new Office.

The Superintendent of Financial Institutions will have responsibility for the administration of the federal financial institution statutes, the execution of supervisory actions and the assessment of the solvency of supervised institutions. The Superintendent will be appointed, for a renewable seven-year term, on good behaviour.

The new Office will have full supervisory responsibilities for federal bank and non-bank financial institutions. This will be clearly advantageous in view of the greater similarity between banks and non-bank financial institutions that will come into being with the broadening of institutional powers. Supervisory problems and issues will increasingly cut across the present financial sector groups and the new Office will be well placed to respond with consistent solutions. Moreover, this structure will ensure that the Superintendent has a comprehensive overview of all the federal institutions in a financial conglomerate.

The senior members of the new Office will include three Deputy Superintendents to whom the Superintendent can delegate certain duties and responsibilities in relation to the banks, non-bank deposit-taking financial institutions, and insurance companies and pension funds, respectively. This will preserve the specialized expertise required to deal with the separate needs and situations of these institutions.

The new Office will have branch offices in Canada's financial centres to promote close contact with supervised institutions. The operations of the new Office will continue to be funded through an appropriate system of charges on supervised institutions.

The CDIC will remain a separate body. This approach will allow the retention of private sector expertise on the CDIC's board of directors. Moreover, it will preserve the CDIC's established relationship with provincial authorities responsible for the supervision of CDIC-insured provincially chartered institutions. The CDIC's relationship to the federal and provincial supervisory authorities will, however, be strengthened.

Co-ordination with the CDIC and the Bank of Canada

The proposed supervisory structure assigns interdependent – but not overlapping – roles and responsibilities to the Office of the Superintendent of Financial Institutions, the CDIC and the Bank of Canada. Close consultation and good information flows are necessary for this approach to work.

Accordingly, the government will propose legislation to create a committee consisting of the heads of these agencies and the Deputy Minister of Finance. This committee will ensure information exchange and consultation on supervisory matters that have implications for solvency, last-resort lending and the risk of deposit insurance payout. These matters would include:

- issues of prudential regulation;
- the practices and condition of individual institutions; and
- the co-ordination of action when solvency comes into question.

The Governor of the Bank and the Chairman of the CDIC will be empowered to require the Superintendent to carry out special inspections of institutions.

By ensuring that the views and concerns of the deposit insurer and lender of last resort, who have financial exposure to troubled institutions, are given full weight in decisions on the nature and timing of supervisory actions, this approach will strengthen the supervisor's "will to act" – an important concern raised by Mr. Justice Estey.

Advisory Committee

The Superintendent's ability to carry out his duties requires full awareness of developments in financial markets and changing financial practices.

A technical committee consisting of experts in various areas, including persons from the accounting, auditing and legal communities, will be formed to advise the Superintendent on new developments. The Advisory Committee's mandate will include advising on the types of financial indicators to be used in strengthening "early warning systems" for detection of problems in financial institutions, and on the development of uniform guidelines for financial accounting in general and for the treatment of non-performing assets in particular.

Federal-Provincial Co-ordination

In addition to maintaining good co-ordination and clear lines of communication within the federal supervisory system, it will be important to ensure that similar co-ordination exists between the federal and provincial supervisory authorities. This reflects the likelihood of increasingly important links being formed between federally and provincially supervised institutions. Moreover, as the CDIC will continue to insure provincially chartered institutions, that organization will require timely and reliable information on such institutions.

There have been intensified efforts by federal and provincial supervisors to promote standardization of procedures (e.g. reporting forms, inspection procedures) and better co-ordination of supervisory activities. The federal government is committed to see this process continue.

Supervisory Powers

The Canadian approach to regulation of financial institutions relies to a considerable extent upon the system of corporate governance, particularly on the boards of directors and external auditors, to ensure that institutions are well managed, meet regulatory guidelines and comply with their governing statutes. At the same time, supervisors are provided very broad powers to obtain information from institutions, to impose restrictions on their operations and, in extreme circumstances, to assume control.

For the most part, the range of powers available to supervisors is adequate. However, particular weaknesses in some areas have been identified in the course of dealing with problem institutions in the recent past. It is important to rectify these weaknesses.

Some action has already been taken. Legislation is now before Parliament to provide federal supervisors with the power to issue "directions of compliance" (often referred to as "cease and desist" orders). These measures will provide a process for supervisory intervention when institutions undertake unsafe and unsound business practices. They will also provide for penalties that reflect the seriousness of the breaches if compliance is not forthcoming.

Assumption of Control

The government will standardize the procedures for assuming control of a financial institution.

There will be two processes for assumption of control. One is intended for use in emergency situations where there is danger of dissipation of an institution's assets. In such a case, the Superintendent of Financial Institutions may initiate action to take control of an institution's assets for a maximum of seven days and with conservatory powers limited to a veto of the institution's actions in order to preserve these assets.

The second process is intended for use when it is necessary to take control of the institution itself by assuming the powers of the management and board of directors. This process will require a ministerial order which may only be made following a hearing. It will provide the Superintendent with full powers to manage the affairs of the institution in the normal course of business. The period of control will not be subject to time limit.

Financial Institutions Restructuring Program

A conclusion reached by Mr. Justice Estey on the basis of his examination of the Canadian Commercial and Northland bank failures was that the present procedures and powers available for effecting the rehabilitation of an institution, the sale of its assets, or its merger with another institution are not adequate or effective in certain situations. The government will adapt the principles of Mr. Justice Estey's proposed Bank Assistance Program to permit its application to all federally regulated deposit-taking institutions.

Where a regulated financial institution is confronted with a situation of actual or imminent insolvency, the Governor in Council will be given the authority to vest all of the capital of the institution, by Order in Council, in the CDIC. Capital, for this purpose, will include subordinated debentures. The legislation will set out the conditions precedent, such as substantial capital impairment, where this authority could be exercised. The objective will be the rehabilitation of the business of the financial institution.

The CDIC will have not only full powers to manage the affairs of the institution, but also all the powers of a shareholder to effect a merger or sale of assets. The value of the interest of the former holders of capital will be subsequently determined by an assessor and any value so determined will be paid out to the former holders. The assessor will make a final and binding determination in accordance with the terms of his mandate.

These powers are critical to permitting the resolution of situations where an institution has suffered substantial impairment of its capital relative to regulatory requirements, has lost the confidence of the public and is generally no longer a viable concern – but where resort to liquidation would result in the loss of whatever going-concern value remains. Solutions short of full liquidation would be especially useful in terms of preserving established business relationships and in terms of reducing the cost to depositors and/or the deposit insurer.

Deposit Insurance

Mandate of the CDIC

The CDIC has historically served to promote a number of public policy goals, in addition to providing deposit insurance.

The government believes this role for the CDIC is sound and will reaffirm it by clarifying in legislation that the CDIC operates on behalf of depositors to further the following public policy goals: to protect depositors, to enhance the standards of member institutions, and to contribute to the stability and competitiveness of the financial system. The CDIC will seek to minimize its costs within this frame of reference.

Issuing and Terminating Insurance Coverage

The deposit insurer's perspective and concerns will be taken into consideration in determining whether or not institutions should be allowed to take deposits on an insured basis. The CDIC currently has discretion as to whether to provide deposit insurance to a provincially incorporated deposit-taking institution. Moreover, it may terminate, through a phased process, deposit insurance coverage of a provincial member institution for unsound business or financial practices.

However, by contrast, the CDIC has no similar role in the issuance or termination of insurance for federal institutions.

The government proposes to provide the CDIC with a responsibility for federal institutions similar to the one that it has for provincial institutions. The CDIC will be given discretion as regards the issue of deposit insurance coverage to federal institutions and will work closely with the Superintendent of Financial Institutions to establish consistent standards for initial licensing and insurability. In addition, the CDIC will be given the power to initiate, after consultation with the Minister, a process for termination of insurance coverage for these institutions. The Minister's authorization will be required before coverage is terminated.

Information on Institutions

Legislation will provide that the insurance by CDIC of provincially chartered institutions is conditional on adequate access by CDIC to information held by the provincial regulator. This will serve to maintain parallel treatment of federal and provincial institutions and ensure that the CDIC is well placed to protect the Deposit Insurance Fund.

Additional Powers of the CDIC

The government intends to broaden the powers available to the CDIC to include the power to levy premium surcharges on institutions that violate CDIC by-laws. The CDIC will be able to assess a surcharge, subject to a ceiling that total premiums paid will not exceed a level that is twice the statutory ceiling on regular premium levels.

Financing

The deficit in the Deposit Insurance Fund requires higher levels of premiums and the government is proposing to allow premium levels to be set by regulation, subject to a new statutory ceiling of one-sixth of one per cent of insured deposits.

The level of CDIC premiums upon expiry of the present regime in April 1987 will be established in light of the need to amortize the present deficit over a reasonable period of time.

The maximum amount which the CDIC may borrow from the Consolidated Revenue Fund will be increased from $1.5 billion to $3 billion.

VI. Further Proposals

The proposals outlined earlier constitute the main elements of the federal government's framework for financial sector policy. They are not exhaustive; full detail will be available when legislation is made public.

The legislation will also deal with additional issues. Some of these are highlighted below.

Review of the Cooperative Credit Associations Act

The federal government's role in regulating the co-operative credit movement is limited to supervision of the Canadian Co-operative Credit Society – the national umbrella organization for the credit union movement outside Quebec – and the several provincial central credit unions registered under the Cooperative Credit Associations Act.

This legislation will be amended as part of the general revision of financial institutions legislation. In general, the same principles as apply to the banks, trust, loan and insurance companies will also apply to the co-operative credit associations.

- They will have the power to own other regulated financial institutions.
- The investment rules will be modified in line with the changes proposed for the trust, loan and insurance companies, taking account of the special role of co-operative credit associations in providing liquidity support for credit unions.
- Their borrowing restrictions will be eased to provide greater financing flexibility.
- The regulatory framework for such institutions will be toughened as regards self-dealing and conflicts of interest, with account taken of the unique nature of co-operative institutions.
- The legislation will be modernized in line with the principles reflected in the Canada Business Corporations Act, with account taken of the unique nature of co-operative institutions.

Regular Review of Financial Institutions Legislation

The government will introduce provisions into the non-bank financial institutions legislation to ensure periodic review on the same cycle as the Bank Act. The next such review of all financial institutions legislation will be in 1996.

Natural Person Status for Non-Bank Financial Institutions

The non-bank financial institutions will be given the status of natural persons and the formulation of their powers will be adjusted accordingly.

Deposit-Taking by Trust Companies

The guaranteed trust concept which underlies the formulation of trust companies' deposit-taking power will be replaced by the debtor/creditor concept, in line with the practice in the Bank Act and the Loan Companies Act.

Ban on Non-Voting Common Shares

Regulated financial institutions will be restricted from issuing non-voting common stock.

Consolidation of Statutes

The Trust Companies Act and Loan Companies Act will be consolidated into one statute, the Trust and Loan Companies Act. The two federal insurance companies statutes, the Canadian and British Insurance Companies Act and the Foreign Insurance Companies Act, will also be consolidated.

Corporate Governance Provisions in the Canada Business Corporations Act

The corporate governance rules and procedures of the Canada Business Corporations Act will be incorporated into the trust, loan and insurance company statutes as part of the overall modernization of these statutes. These changes will include the introduction of derivative actions and oppression remedies for the protection of minority shareholders.

Appendix

Investment Rules: The Prudent Portfolio Approach

Trust, Loan and Insurance Companies

When reference is made below to shareholders' equity, the comparable concept for mutual insurance companies is the excess of assets over liabilities.

Subsidiaries

Investments in permitted ancillary business subsidiaries will be subject to an aggregate portfolio limit of 3 per cent of the parent's assets and to an individual limit of 1 per cent for each subsidiary investment.

Investments in venture capital corporations will be limited to 10 per cent of shareholders' equity.

Real Estate and Common Equity

Investments in real estate, including real estate for own use, common equity, and non-income-producing property, are not generally a good match for interest-bearing liabilities and, for trust and loan companies, will be limited to 100 per cent of shareholders' equity.

In addition to this overall limit, there will be separate limits on the amount that may be invested in each of these categories. In terms of shareholders' equity, these limits will be 70 per cent for real estate, 50 per cent for common equity and 5 per cent for non-income-producing property. The additional limits on real estate and common equity will circumscribe the exposure of institutions to fluctuations in either of these markets.

Of the maximum total that may be invested in real estate, not more than one-quarter (17.5 per cent of shareholders' equity) may be in non-income-producing real estate, defined as real estate which does not produce a positive cash flow equal to at least 50 per cent of the yield on long-term Government of Canada bonds.

Moreover, of this same maximum total, not more than 15 per cent (10.5 per cent of shareholders' equity) may be in any particular real estate investment.

In applying these limits, the value of investments will be calculated on a gross value basis (i.e. before deduction of related indebtedness, such as encumbering mortgages held by third parties). Moreover, the total value of the real estate will be calculated as the sum of all real estate in the corporation, real estate held in real estate subsidiaries, or through methods such as participation in joint ventures, partnerships and unit trusts.

For life insurance companies, somewhat greater flexibility is desirable, reflecting the long-term nature of their insurance-related liabilities. Life insurance companies will be able to support up to 25 per cent of their participating policyholder life insurance liabilities with common stock investments and 25 per cent with real estate investments, subject to an aggregate limit of 40 per cent. Further, companies will be able to support up to 15 per cent of their non-participating policyholder life insurance liabilities with common stock investments and 15 per cent with real estate investments, also subject to an overall limit of 20 per cent. These amounts would be additional to the amounts that life insurers may invest in real estate and common stocks on the basis of shareholders' equity, using the same percentages outlined above for trust companies. The other rules noted for trust company investments in real estate would also apply.

For property and casualty insurance companies, the concern is not so much one of ensuring a proper matching but rather one of ensuring a sufficiently liquid balance sheet to permit the institution to respond to fluctuations in its payout stream. For this purpose, real estate is not as suitable an investment as are common stocks which are readily marketable. Common stock investments do, however, raise a concern because of instability in share values. For these reasons, real estate investments will be limited to 10 per cent of their portfolio while common stocks will be subject to a 25-per-cent portfolio limit. An overall limit of 30 per cent will be set for both of these classes of investments.

Mortgages

Mortgage loans are a staple investment for the non-bank financial institutions and, provided they meet the "qualitative" criteria outlined below, will not be subject to any aggregate investment limit, although particular mortgage loans will be subject to a maximum limit equal to 15 per cent of shareholders' equity. Mortgage loans that do not meet these criteria will be limited in aggregate to 5 per cent of total assets, in addition to the 15-per-cent individual loan constraint.

The following mortgage loans will be considered as meeting the qualitative criteria:

(a) where the security is owner-occupied residential property, first mortgages that do not exceed 75 per cent of the value of the underlying real estate unless the excess is insured or otherwise guaranteed by a government agency or an approved private insurer;

(b) where the security is real property other than owner-occupied residential property, first mortgages where the cash flow from the mortgaged property is sufficient to service the mortgage payments and other expenses on the property (e.g. taxes), or where the mortgage is fully insured or otherwise guaranteed by a government agency or an approved private insurer; and

(c) in respect of properties referenced in (a) and (b), second and junior mortgages that are fully insured or otherwise guaranteed by a government agency or an approved private insurer.

In the case of a junior-ranking mortgage loan, the amount of debt ranking ahead of the loan will be added to the amount of the loan for purposes of compliance with the 15-per-cent limit on the maximum size of a single loan.

Exposure to Individual Investments

As an important element of the diversification rules, the non-bank financial institutions will be subject to limits on their exposure in the form of either loans or investments to any single individual, corporation, or group of related corporations. This limit will be set at 25 per cent of shareholders' equity. This threshold is the same as that now applied to domestic banks.

Portfolio Investment

Investment in the voting shares of a corporation by non-bank institutions will be limited to 10 per cent of that corporation's outstanding voting shares.

Assets in Default

Except to protect a security position, there will be a prohibition on investments in assets in default as regards interest, principal or preferred dividend payments.

Trusteed Pension Funds

The trustee of a pension fund will be required to establish investment criteria in accordance with the duty of prudence and consistent with the rules and objectives set forth in the contract governing the pension fund between the plan sponsor and its members. The trustee will also be required to establish procedures to ensure compliance with such rules and criteria.

In addition to this broad requirement, trusteed pension funds will be subject to a number of portfolio restrictions.

Real Estate and Resource Properties

The amount that may be invested in real estate and resource properties combined will be subject to an overall limit of 25 per cent of the total assets of the pension fund. In addition to this limit, investments in resource properties will be subject to a limit of 15 per cent of total assets. Moreover, investments in any one parcel of real estate or any one resource property will be limited to 5 per cent of the total assets of the pension fund. This latter restriction will apply to groups of contiguous parcels or properties.

Exposure to Individual Investments

The present limit of 10 per cent of a pension fund's assets that may be invested in the securities of one corporation will be retained and will also apply to the securities of a group of related corporations.

Portfolio Investment

There will be no change to the existing 30-per-cent limit on investment in the shares of a corporation by a pension fund.