The Regulation of Financial Institutions: Proposals for Discussion

Technical Supplement

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Canada

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Department of Finance
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Ministère des Finances
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Preface

In the paper, *The Regulation of Canadian Financial Institutions: Proposals for Discussion,* the federal government set out a number of proposals for regulatory change in the financial sector. These were intended to serve as the basis for a round of consultations with provinces, financial institutions, consumers and business that in turn would serve as the basis for legislative action. Since the release of this paper, many important consultations have already been held. These have focused on the principles that the government believes should form the basis of policy, and on the broad directions of change described in the discussion paper.

The present paper is intended to further this process. It presents supplemental information on the proposals in the discussion paper to aid in the consultations and in the development of draft legislation.

Interested parties are requested to send their comments and suggestions concerning this paper to the Minister of State (Finance), House of Commons, Ottawa, by August 15, 1985, so that their views can be considered in the consultative process.

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A. Summary of Policy Approach

Principles and Directions

As outlined in the discussion paper, the federal government is committed to a number of fundamental principles as the basis for financial sector policy. These principles are as follows:

(1) improve consumer protection;

(2) strictly control self-dealing;

(3) guard against abuses of conflicts of interest;

(4) promote competition, innovation and efficiency;

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

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

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

(8) promote international competitiveness and domestic economic growth;

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

The proposals summarized below, and developed in greater detail in the balance of this technical supplement, represent the government's judgement as to how these principles can best be implemented in framing public policy for the financial sector.

Overview of Proposals

Consistent with the principles outlined above, the government is proposing to permit a greater degree of flexibility in institutional arrangements. One way would be to allow the combination of bank and non-bank financial institutions under the umbrella of a financial holding company. The government believes that these new arrangements would enhance competition among financial institutions and result in improved services for users and greater efficiency of financial markets. Small and medium-sized businesses would have broader access to funds when borrowing, which would in turn improve the prospects for economic growth and renewal. In addition, financial institutions would have greater flexibility in developing and packaging financial services to best meet business and individual needs. It is hoped that the proposals would have the same effect of expanding choice and lowering costs in the field of business lending as legislative changes in the 1950s and 1960s had in the mortgage and personal loan markets.

These proposals, however, should not be interpreted as the "deregulation" of financial institutions. Indeed, while they would, as described below, provide additional opportunities for financial institutions, there would at the same time be new, tougher rules to ensure consumer protection and the soundness of individual financial institutions and of the financial system as a whole. In addition, the standards required in the formation of new financial institutions would be enhanced. The failures of some financial institutions in recent years have underlined the dangers to which institutions can be exposed where self-dealing, or non-arm's-length transactions, are permitted. The government is therefore proposing to strictly control self-dealing as part of its effort to ensure that federally incorporated financial institutions are safe places for Canadians to keep their money. The government will consider various alternative methods to provide the strict control over self-dealing that is essential, but considers a ban on self-dealing as the option that inspires the greatest confidence in this regard.

Some of the failures have also highlighted the fact that regulators may not always have sufficient authority to take action even after problems or difficulties have been detected. This situation is addressed in the proposals, which outline a number of possible ways that supervisors' powers could be enhanced to enable them to discharge their duties properly.

The regulatory changes that are being proposed would allow most types of federally incorporated financial institutions greater scope for offering financial services than in the past. Some commonly controlled non-bank financial institutions have already been organized under the umbrella of a financial holding company. This is essentially the model that the government would like other financial institutions to use if they seek to offer their customers broader services. The approach would permit different types of financial institutions to be commonly owned by a financial holding company. It would, in addition, ensure that federal legislation does not constitute a barrier to such common use of distribution and marketing systems as provincial regulations and licensing policies would permit.

However, in light of the government's policy concerns related to solvency, financial institutions and financial holding companies would have to meet a number of specific structural requirements. They would have to remain distinct corporate entities with their own boards of directors and financial statements. This would be particularly important from a supervisory point of view for assessing capital adequacy and liquidity and in the application of deposit insurance.

With respect to commercial lending, increased competition could be facilitated in two ways: (1) widening the commercial lending powers of trust companies and other non-bank financial institutions, or (2) allowing holding companies to own a bank (to be known as a Schedule C bank). The government is disposed to the second approach. This would ensure that commercial lending would be conducted under a consistent regulatory regime. Institutions wishing to establish a Schedule C bank would, of course, have to meet rigorous criteria for financial soundness.

To permit them the same opportunity for diversification as other institutions, provisions would be made to enable Canadian mutual insurance companies and co-operative credit associations to take full advantage of the financial holding company approach. Mutual companies would also be subject to appropriate limitations on the amount of policy-holders' funds used for diversification purposes.

The proposed changes relating to financial holding companies do not generally include Schedule A and B banks. It should be noted that extensive changes were made to the Bank Act in 1980. The government intends to focus at the present time on making changes to other financial legislation. Substantial changes to banking legislation are not being contemplated until the 1990 decennial revision of the Bank Act. However, amendments are now being proposed to the rules governing reserve requirements and there will be consequential amendments required if some of the other proposals are implemented. In the meantime, the government is prepared to begin consultations on the 1990 Bank Act review.

One issue this raises is the implications for the competitive position of smaller, regional Schedule A banks in the period between passage of legislation associated with the proposals in this paper and subsequent amendments to the Bank Act. The government is concerned that the proposals in this paper do not disadvantage such institutions, and it will enter into discussions regarding ways of ensuring that they are able to maintain a healthy competitive position in the markets they serve. One way could be to allow such Schedule A banks, where circumstances warrant, to become Schedule C banks which would allow them, under a holding company framework, to be associated with other, non-bank, financial institutions.

With respect to investment dealers, the federal government recognizes that these institutions traditionally have been regulated at the provincial level. In recent years, a number of provincial governments have been reviewing their policies for this sector and in the process have considered the possibility of greater participation of financial institutions in the ownership of securities dealers. The federal government does not want to interfere with provincial policies in respect of the ownership of securities dealers and, therefore, proposes to allow investment in securities dealers' equity by financial holding companies to the extent permitted in the various provincial jurisdictions.

The regulatory approach the government is proposing is expected to produce benefits to consumers and the economy. Financial institutions should have greater scope to react to market forces and to pursue cost efficiencies. In turn, consumers should benefit from a more competitive marketplace, more convenient financial packages, and possibly lower prices. The government recognizes that the proposed changes would make it easier for non-bank financial institutions to provide "one-stop shopping". This should be interpreted, however, as facilitating such a trend, not promoting it. The government is confident that a sufficient variety of choice will continue to exist for those who wish to diversify their sources of financial services.

As previously noted, one of the areas that will require a tougher set of rules is non-arm's-length transactions, or self-dealing. This is of particular concern in the case of closely-held institutions where a single shareholder or a group of associated shareholders can potentially exert influence or control. There currently are rules prohibiting non-arm's-length lending in trust, mortgage loan and insurance company legislation. Thus, the concept of a ban on self-dealing is already well established. However, the rules do not cover all types of situations or transactions. In the government's view, the best way to provide the strict control over self-dealing that is essential is to broaden this ban and to apply it rigorously to all types of financial transactions. This would be an essential feature of the government's proposals to protect Canadians who entrust their savings to financial institutions.

Another of the government's regulatory concerns is the potential for conflicts of interest to occur in the provision of different types of financial services within a single institution or within a conglomerate. The government intends to enhance significantly protection for consumers in this regard. It is therefore proposing, among other things, the creation of a new public body to investigate complaints and represent consumer interests where abuses of this nature occur or are suspected. In addition, where trust and other financial activities are carried out in the same institution, or group of related institutions, the government is proposing that a clear separation be maintained between trust investment decision-making and other operations.

In recognition of the increased complexity of the financial system, and the possibility of closer ties among institutions, the government will consider changes in its system of supervision. At present, the Office of the Inspector General of Banks supervises the chartered banks while the Department of Insurance supervises the trust, mortgage loan and insurance companies and other federally regulated financial institutions. It may be appropriate to consolidate these functions into a comprehensive supervisory body.

With respect to the ownership of financial institutions, the government's view is that, while restrictions limiting individual shareholdings to 10 per cent have helped to minimize the potential for self-dealing in the banking industry, they are not the only method of achieving such an objective. Strict controls on self-dealing can accomplish the same goal. It is therefore not the government's intention to propose a retroactive restructuring of the ownership of non-bank financial institutions. Such a policy would waste effort and inhibit managerial innovation and efficiency, without being essential to the achievement of public policy goals.

With regard to foreign ownership, the government proposes to leave the present rules unchanged. In addition, financial holding companies would be subject to the same general principles as currently exist in the trust and insurance legislation, i.e.

that transfers of ownership would be restricted (on the basis of a maximum limit of 10 per cent for individual non-residents and 25 per cent for total foreign ownership), but new entry would be freely allowed. However, because Schedule C banks would be subject to the same foreign ownership restrictions as Schedule A banks, they could not be part of a foreign-controlled financial holding company.

Ministerial discretion over the formation of new financial institutions has been a traditional feature of financial institutions legislation. It has become apparent that there are also circumstances where Ministerial control over the transfer of shares is equally important. It is, therefore, the government's intention to require Ministerial approval of transfers of significant blocks of shares of financial institutions.

The need for a review of policy regarding deposit insurance has been underscored by the recent failures of some small insured deposit-taking institutions. A private sector group, headed by Robert Wyman, Chairman of Pemberton Houston Willoughby Incorporated, was formed recently by the Minister of State (Finance) to review the Canada Deposit Insurance Corporation and its operations, and to produce a report. That report has now been released to the public and its proposals are being considered.

The government is considering the simplification of investment rules for insurance, trust and mortgage loan companies, financial corporations and pension funds. The idea suggested by these institutions is to shift the nature of the rules from the current mainly "qualitative" approach (based on permitting investments in companies that meet earnings and dividends tests) to a "quantitative" or "portfolio" approach (based on limiting the proportion of a portfolio that can be invested in each type of security). Such a change would provide these institutions with greater leeway to choose the investments they feel are appropriate while still protecting against undue risk. Not only would this broaden the range of investments for financial institutions but it would enhance the ability of small and medium-sized businesses to issue new securities. The government is interested in discussing this matter further with interested parties.

Changes of the magnitude described above would, of course, require a transition period during which financial institutions would have time to adjust. The government intends to consult with the financial sector to ensure that a reasonable time frame is provided for institutions to comply with new legislative requirements.

The proposed changes would affect the following federal laws: Trust Companies Act, Loan Companies Act, Canadian and British Insurance Companies Act, Foreign Insurance Companies Act, Quebec Savings Banks Act, Co-operative Credit Associations Act, and the Pension Benefits Standards Act. Moreover, new financial holding companies legislation would be written and consequential changes to the Bank Act would be made.

The government additionally proposes to introduce a cycle for the regular review of financial institutions legislation. The various acts would be reviewed at the same time every 10 years, with the review triggered by a "sunset" clause in each act. The decennial revision of the Bank Act would be shifted after 1990 to make it coincide thereafter with the decennial review of legislation for non-bank financial institutions. The government will also seek to have discussions with the provinces with the aim of harmonizing the federal review process with provincial reviews.

B. Regulated Financial Holding Companies

Regulated financial holding companies could, through their group of affiliated financial institutions, provide a broad range of financial services to their customers. These financial holding companies would be required to register under, and comply with the provisions of, new legislation that would be created for this class of institutions.

There would be restrictions as to the types of corporations that could be part of a financial holding company's group of related institutions. By and large, these restrictions would reflect the government's desire to use the financial holding company as a focal point for the joint supervision of regulated financial institutions that have broad dealings with the general public and that are or may become affiliated. The types of corporations that are **not** contemplated as being part of financial holding companies include: (i) non-regulated financial institutions, (ii) financial institutions registered under the Investment Companies Act, (iii) non-financial corporations, and (iv) regulated financial institutions that are incorporated and regulated abroad. (The latter restriction would not, however, preclude financial institutions related to financial holding companies from having such foreign subsidiaries as their legislation would permit.)

Regulated financial holding companies could hold equity only in the following types of financial institutions:

Federally regulated
- Schedule C bank
- Trust company
- Mortgage loan company
- Life insurance company
- Property and casualty insurance company

Provincially regulated
- Trust company
- Mortgage loan company
- Life insurance company
- Property and casualty insurance company
- Investment dealer

Defining Relationships

Before providing details on the financial holding company concept, it will be useful to give several terms precise meanings so as to simplify the discussion. These definitions are for the purposes of this paper and their usage in the literature or legislation dealing with the financial services sector may vary. Where the term "capital" appears in the definitions or the balance of this paper, it should be understood to mean shareholders' equity. As noted later, a definition of capital that would be common for all regulated financial institutions is a subject the government wishes to discuss.

1. Affiliated Companies

The concept of affiliation as used in this paper will be reserved for regulated financial institutions that could be owned by a regulated financial holding company. Two regulated financial institutions would be deemed to be **affiliated** if one person, corporate or natural, or group of associated persons:

(1) holds more than 10 per cent of the voting shares of each of the companies; this rule would apply even if the right to vote some or all of these shares had been transferred to an unassociated party;

(2) holds the right to vote more than 10 per cent of the voting shares of each of the companies; this rule would apply even if the beneficial ownership of these voting shares was in the name of an unassociated party.

2. Related Companies

The concept of affiliation as defined above is usefully distinguished from another concept, defined for the purposes of this paper as **relation.** Two persons, corporate or natural, or groups of associated persons will be considered to be **related** in the following cases:

(1) one of them owns more than 10 per cent of the other's voting shares; this rule would apply even if the right to vote some or all of these shares had been transferred to another, unassociated person;

(2) one of them holds the right to vote more than 10 per cent of the voting shares of the other; this rule would apply even if the beneficial ownership of these shares was in the name of another, unassociated person.

Thus, where a financial holding company holds more than 10 per cent of the voting shares of a financial institution, these two companies would be considered to be **related** institutions. But two financial institutions that were linked because a financial holding company owned more than 10 per cent of the voting shares of each would be considered to be **affiliated.** The term **affiliated** is thus reserved for regulated financial institutions held by a common regulated financial holding company whereas the term **related** is reserved for the ownership of a significant amount of shares of a regulated financial institution by a regulated financial holding company, or the ownership of a permitted subsidiary by a regulated financial institution.

3. Associated Companies

It is useful to distinguish a third term that will be used in a particular way in this paper: two persons, corporate or natural, will be considered **associated** if they are not at arm's length to one another but do not fall within the meaning of **affiliated** or **related** as defined above.

(a) A person is associated with a corporation where the person, singly or together with other associated persons,

  (i) can exercise, directly or indirectly, 10 per cent or more of the total number of voting rights attached to the issued and outstanding shares of any series or class of shares of the corporation,

  (ii) has the ability to influence the selection of 10 per cent or more of the number of members of the board of directors or 10 per cent or more of the officers of the corporation, or

  (iii) has the right to make a decision that, in the absence of such right, would be made by the board of directors or the officers of the corporation.

(b) A person is associated with another person if

  (i) one person is a corporation of which the other person is an officer or director,

  (ii) one person is connected to the other by blood relationship, marriage or adoption, or

  (iii) both persons are members of a voting trust where the trust relates to shares of a corporation.

(c) Where a person is associated with a corporation, the corporation is associated with the person.

(d) Two or more corporations that are associated with the same person are associated with each other.

4. Significant Business Interest or Exposure

An ownership interest in a corporation of more than 10 per cent of its capital stock, or control of more than 10 per cent of the voting rights associated with the capital stock, will be called a **significant business interest** of a person.

5. Substantial Shareholder

An investor with an ownership interest in, or control over, more than 10 per cent of the voting shares of a financial institution will be termed a **substantial shareholder.**

Necessary Conditions for Incorporation

The regulated financial holding company represents a vehicle for the shareholders of a regulated financial institution to create a diversified group of financial institutions. Where a regulated financial institution is completely independent (i.e., neither affiliated with nor related to other regulated financial institutions), the shareholders could incorporate a non-regulated holding company to hold their shares in that institution. They could then seek, through the holding company, to start up new financial institutions, or to acquire existing financial institutions, incorporated under different legislation. At the same time, application would be made to register the holding company as a regulated financial holding company. If all the various applications and acquisitions were approved, the regulated financial holding company would then come into existence.

A regulated financial holding company would be required whenever a federally regulated financial institution was among a group of two or more regulated financial institutions (of a type identified above) operating under different legislation and sharing a common substantial shareholder. In such a case, each substantial shareholder or group of associated shareholders would be required to form a holding company through which to channel their equity interests.

Given the often complex patterns of inter-corporate ownership that exist, it would be difficult to anticipate the precise circumstances that might trigger the financial holding company requirement in each and every case. Indeed, it is easier to state the precise conditions under which a financial holding company would not be required or permitted.

Obviously, individual investors or groups of associated investors that held substantial equity interests in only one financial institution would not come under this requirement and, even if that institution were related to a financial holding company owned by unrelated investors, could continue to maintain their holdings directly in the financial institution rather than going through the holding company. As well, where a financial institution had a substantial shareholding in a permitted regulated financial subsidiary, that arrangement would not come under the holding company requirement. Finally, where financial institutions were governed by the same legislation, the existence of a common substantial shareholder would also not require the institutions to come under a financial holding company.

As a general rule, regulated financial institutions would not be permitted to own the shares of regulated financial holding companies. However, as noted above, the government would consider exceptions to this rule on an individual basis, e.g., for mutual or co-operative institutions whose corporate structure might not be suited to the formation of financial holding companies.

Implications of the Rules for Incorporation

The rules for formation of regulated financial holding companies outlined above imply that a variety of financial holding companies could result.

First, in some instances financial holding companies would exist essentially only on paper and would have no ability to effect any co-ordination of the activities of their related financial institutions. This would seem to be the case, for example, where a financial holding company was created because a shareholder owned, say, 11 per cent of the shares of two financial institutions that were controlled by other investors.

However, in other cases, the financial holding company could be the body through which the activities of the related financial institutions would be co-ordinated. In either case, the holding companies could create or acquire a Schedule C bank and, moreover, the company would have to meet all requirements to provide an appropriate reporting structure to supervisors.

In a further variation, an individual financial institution could become related to two or more regulated financial holding companies. This could come about, for example, if it shared one substantial shareholder with one financial institution, another substantial shareholder with a second financial institution, still another substantial shareholder with a third financial institution, and so forth. In such circumstances, the financial holding companies related to the same financial institution could be described as interlocking.

Non-Resident Ownership of Financial Holding Companies

The rules for non-residents in respect of the formation of regulated financial holding companies would be the same as those for Canadians. That is, non-resident investors or groups of associated non-resident investors who have substantial shareholdings in two or more regulated financial institutions of the types identified above, at least one of which is federally regulated, would be required to channel these shareholdings through regulated financial holding companies. At the same time, there would be no restriction on the formation of financial holding companies by non-resident investors who otherwise qualify.

The transfer to non-residents of shareholdings in Canadian-owned regulated financial holding companies would be subject to controls similar to those that apply in respect of banks, trust companies and life insurance companies. That is, there would be a restriction on the transfer of shares if those transfers would place more than 10 per cent of the voting shares in the hands of any individual non-resident or 25 per cent of the voting shares in the hands of non-residents in total.

A distinction would be made between Canadian-owned regulated financial holding companies and those that would be considered foreign-owned. The definition of foreign ownership for these purposes would depend on the facts of each individual case. The general guideline would be that where the controlling interest in a financial holding company was normally domiciled abroad, that holding company would be considered foreign-owned. The definition would be based on the residence status of the ultimate controlling interest, not necessarily the immediate controlling interest. For example, where the immediate controlling interest was a Canadian subsidiary of a foreign company the ultimate controlling interest would clearly be non-resident.

Foreign-owned financial holding companies could hold voting shares in regulated financial institutions of the types identified above but could not hold more than 10 per cent of the equity of any class of bank, domestic or foreign-owned. As well, the transfer of shares of existing Canadian-owned institutions to foreign-owned financial holding companies would be subject to the restrictions that currently exist in financial institutions legislation. Foreign-owned financial holding companies could, of course, start up new institutions on their own initiative or acquire substantial shareholdings in existing foreign-owned institutions in order to create a diversified group of institutions. Such actions would be subject to existing controls including, as in the case of all start-ups, Ministerial approval.

Under the proposals, foreign-owned non-bank financial institutions that are operating abroad could have an ownership position in a regulated financial holding company. Foreign-owned banks' access to the Canadian financial market will continue to be through the Schedule B bank route. Where a non-resident non-bank financial institution has a substantial shareholding in a regulated financial holding company and then acquires or is acquired by a bank abroad, it would have to divest itself of its shareholdings in the regulated financial holding company. This is a requirement that exists under the Bank Act and is a consequence of rules governing non-resident entry into banking and the entry of foreign banks into the Canadian market. It applies and would continue to apply to all foreign institutions operating in Canada through a non-bank financial subsidiary.

Canadian branches of foreign insurance companies could not in their present form be a part of a financial holding company group. To enter into such an arrangement, they would have to be restructured as domestic subsidiary corporations.

Transfer of Shares or Control

Transfers of substantial blocks of voting shares of regulated financial holding companies, domestic or foreign-owned, as well as mergers of regulated financial holding companies would be subject to Ministerial approval. This would complement the Ministerial control that would apply to transfers of shares of operating regulated financial institutions or mergers of such institutions.

To ensure that financial holding companies remain independent of each other and of unrelated financial institutions, the shareholders of a regulated financial holding company would not be allowed to enter into voting agreements, voting trusts, or similar arrangements that would transfer effective control of one regulated financial holding company to the shareholders, directors or officers of another or to those of an unrelated financial institution.

Application of Existing Corporate Law

Except as otherwise indicated in the legislation, regulated financial holding companies would be subject to the laws governing corporate structure and powers contained in the Canada Business Corporations Act (CBCA). The differences from CBCA provisions outlined in this paper should not, however, necessarily be considered exhaustive. The government will welcome suggestions as to modifications that may be useful or necessary.

Corporate Structure

Regulated financial holding companies would be required to adhere to a certain structural form. In the structure that the government has in mind, the operating financial institutions would be linked to each other solely through a common shareholder which itself would be an "inactive" holding company. Under this structure, the operating financial institutions would not have equity interests in each other.

The inactive model for a holding company contrasts, for example, with a structure in which an operating financial institution acts also as the parent corporation to one or more operating subsidiaries, including chains of subsidiaries and downstream holding companies. In this case, the holding company is also an active financial institution. While the federal government, for supervisory reasons, generally prefers the inactive form, it recognizes that this form may not be accessible to all types of institutions. As discussed below, for institutions organized as mutuals or co-operative associations that might not be able to make use of the inactive form, the government would consider the use of the active form under carefully controlled conditions.

The primary purpose of requiring financial holding companies to be inactive as defined above would be to prevent any possibility of "contagion" of operating financial institutions arising from difficulties that a levered holding company could encounter. As well, it would help maintain a clear capital structure for the group of related institutions and minimize supervisory difficulties in respect of the double counting of capital. (The "double-counting" problem arises when capital is counted once as an investment by the parent corporation supporting its own liabilities and once as capital supporting the activities of the subsidiary. Where the parent corporation is inactive, the capital unambiguously supports the activities of the subsidiary.)

Financial institutions related to a financial holding company could continue to own such operating subsidiaries as their legislation permits, including foreign subsidiaries. Thus, for example, where a trust company that owned a mortgage loan subsidiary became related to a regulated financial holding company, neither divestiture nor any rearrangement of the ownership of the subsidiary would be required, i.e., it would not be required that the mortgage loan company be held directly by the regulated financial holding company as a sister corporation to the trust company.

Regulated financial holding companies would be generally restricted to holding equity in only one of each type of institution. However, more than one of a kind could be held where (i) the institutions were regionally specialized (e.g., one provincially-incorporated life insurance company per province); (ii) several companies of a particular type were already associated for historical reasons (as is now the case with some property and casualty insurance companies); and (iii) a bona fide amalgamation of the institutions concerned was planned.

Finally, it is worth noting explicitly that a regulated financial holding company could not hold equity, directly or indirectly, in another regulated financial holding company.

Capital Structure and Dividend Payouts

Regulated financial holding companies would face restrictions on their capital structure. This would reflect the desire to maintain a clear capital structure for the financial holding company group of institutions. The intent of these restrictions would be to limit the holding company to issuing only instruments that could qualify as capital, not debt. This would prevent the holding company from raising funds with debt instruments for subsequent investment as capital in one of its related financial institutions, giving the illusion of greater capitalization of the group than in fact would be the case.

To define capital for the purposes above is not, however, a straightforward matter. At present, a variety of financial instruments can be included in the capital base of financial institutions and, moreover, there is some variation in the rules for different types of financial institutions. Thus, what is considered "capital" for a bank may not always be considered "capital" for an insurance company or a trust and loan company, and vice versa.

The possibility of moving to a common definition of "capital" for financial institutions will be discussed below in the section on modernization of financial institutions' legislation. Following the formulation of such a definition, it is proposed that the definition of capital for the purposes of financial holding companies' regulations be the same as the definition of capital for operating financial institutions.

One idea that may be worth exploring is the possibility of requiring regulated financial holding companies to inject capital and to provide guarantees for their related companies. In general, it would only apply to those financial holding companies in a position to provide direction and co-ordination to their related financial institutions.

It may be useful in this connection to place controls on the declaration of dividends by regulated financial holding companies in circumstances where the solvency of any of their related institutions was being threatened. Such controls would clearly have to be at the discretion of the supervisors and would complement the similar powers that supervisors have to stop the declaration of dividends by some types of regulated financial institution if their solvency is threatened.

Powers and Activities

The concept of an "inactive" holding company essentially means that the holding company would not carry on any trade or business with the general public. As noted, it would be permitted to raise funds only by issuing securities that would qualify as part of its capital base. This would generally preclude it from issuing debt securities or any other kinds of financial liabilities including guarantees, acceptances and the like, except for guarantees for its affiliates.

On the other side of its balance sheet, it would be restricted, by and large, to holding equity in the types of financial institutions specified above. It could also hold retained earnings, which could be invested in liquid assets. Otherwise, however, it would not be empowered to carry on a portfolio investment business.

In other respects, it would be an ordinary corporation. It would have a board of directors and could have its own staff to provide some services to its related financial institutions, although payments for these services would be subject to strict control (i.e., they would have to be less than 1 per cent of total expenses or revenues as outlined below in the provisions concerning self-dealing).

Non-Arm's-Length Transactions in a Financial Holding Company Group

The government's preferred option for the control of self-dealing is a general ban on non-arm's-length transactions. If such a ban were implemented, it would apply to all federally regulated financial holding companies and all of their related financial institutions. Concern over self-dealing has been expressed by the various provincial jurisdictions and the government will be consulting with the provinces on the implementation of this ban.

If such a ban were implemented, certain limited exemptions from these controls may have to be considered to allow affiliated financial institutions to maintain normal business relationships with each other and to allow them to co-ordinate their activities and possibly rationalize some aspects of their operations. It is stressed, however, that such exemptions would not mean that self-dealing between related or affiliated institutions would be considered generally permissible.

Obviously, a general exemption from the self-dealing ban would apply to capital investments by financial holding companies in related financial institutions and to dividend payments made by the latter in respect of those investments. There could also be, as discussed earlier, discretionary supervisory controls over dividend payments by both regulated financial holding companies and regulated financial institutions where the solvency of the financial institutions might be impaired. These controls would, however, be unrelated to the self-dealing ban.

Other exemptions might have to be considered. For example, a general exemption could apply to transactions between a regulated financial institution and one of its wholly-owned subsidiaries, in cases where all of the subsidiary's liabilities were guaranteed by the parent. In such a circumstance, the two institutions would be regulated on a fully consolidated basis and, from a solvency perspective, the movement of assets or fees between the balance sheets of the two institutions would be immaterial. (One specific group of companies for which this exemption might not be appropriate would be life insurance companies with participating policy-holders. In this case, the transfer of assets between parent and subsidiary could lead to inequities for these policy-holders.)

Further, a general exemption could be considered for regular and continuing payments relating to resources and central support services used by financial institutions in common such as: premises, central computer facilities, accounting and legal resources, treasury operations, communications facilities, and services provided by payroll and personnel groups, research, advertising and marketing groups. This exemption would permit some rationalization of operations for a group of affiliated institutions. However, there would clearly have to be controls and safeguards, to reflect the fact that the possibility of "stripping" an institution would always exist where such arrangements are permitted.

One important control would be to limit the availability of this exemption to institutions that were affiliated under a common regulated financial holding company that was clearly providing central direction and co-ordination. To give effect to this control, it would be necessary to limit the exemption to the operating institutions in regulated financial holding company groups where all the operating financial institutions were subsidiaries of the holding company (i.e., where the holding company owned more than 50 per cent of the shares of each of the institutions).

To provide a basis for effective supervision of these transactions where permitted, institutions wishing to take advantage of the exemption would have to comply with certain requirements. Some requirements that could be considered are as follows: (i) to file with regulatory authorities a plan under which these transactions would be made; (ii) to demonstrate that the planned transactions were made at reasonable transfer prices (e.g., on a cost-recovery basis) and would not threaten the solvency of either institution; and, moreover, (iii) to implement internal regulatory mechanisms to scrutinize the transactions on a regular basis (these internal controls could be similar to those described in the section on institutional regulation of self-dealing).

Several features of the above classes of transactions exempt from the controls on self-dealing are:

(1) They would all fall within the category of transactions made between affiliated or related financial institutions. There would be no special exemptions for transactions involving associated financial or non-financial corporations, substantial shareholders of any of the financial institutions or the financial holding company, or the significant business interests of parties not at arm's length to the group.

(2) All payments in respect of transactions made under the above exemptions would remain internal to the group of regulated financial institutions and their regulated financial holding company. This would be an important aspect to supervisors since, if leakage of funds occurred through abuses, the supervisors could exert some control, including the requirement to reverse transactions.

(3) In the case of the exemption relating to the sharing of resources and central support services, all transactions would be in respect of services, not assets, and payments in respect of "managerial" services would not

qualify. Payments for managerial and other such services between affiliated or related institutions could be made only within the context of the general 1-per-cent exemption from the controls on self-dealing described below.

Self-Dealing and Conflict of Interest Violations

Where a regulated financial holding company is involved in breaches of the controls on self-dealing, it would be liable to statutory penalties, subject to normal rights of appeal.

The regulated financial holding company might also be liable for damages arising from abuses of conflicts of interest involving its related financial institutions where the conflict of interest arose through their common connection to the financial holding company. Such a circumstance could arise if, for example, the conflict of interest involved the fiduciary activities of a trust company and the commercial lending of the affiliated Schedule C bank. In this case, neither institution operating in isolation would encounter the conflict and it is only through their common relation to the financial holding company that the conflict of interest could arise. There would thus be at least a logical inference that the directors and officers of the financial holding company may have been involved. While the individual financial institutions would not, of course, have their liability diminished as a consequence, the financial holding company and its directors and officers may then also be held liable. For these latter persons to be held individually liable in such cases, it would have to be demonstrated in the courts that they had knowingly directed or participated in the breach of conduct.

Consolidation for Supervisory Reporting

In the supervision of financial institutions, there are a number of reasons for requiring both consolidated and unconsolidated reports from the financial holding company and its group of affiliated financial institutions. In essence, these two approaches to reporting should be considered as complementary rather than as alternatives.

The need for consolidated reporting upon the affairs of the financial holding company and its affiliated institutions as a whole reflects the fact that such a group would be in some measure functioning as a co-ordinated unit. Thus, only the complete picture offered by a consolidated report would reflect the scope of its activities and the risks that the related group of financial institutions as a whole may be incurring, for example in terms of its exposure to any one individual borrower.

The need for unconsolidated reports, on the other hand, reflects in the first place the fact that institutions would be regulated and supervised on an individual basis and the appropriate documentation would be needed on that basis. To some extent, supervision on an individual basis is necessitated by the conceptual difficulties of regulating on a consolidated basis activities as different as insurance and deposit-taking, to give one example. A more fundamental reason for individual supervision, however, would be that each individual company related to the financial holding company is itself a separate legal entity with separate obligations to its shareholders, who may be a different group than the equity holders of the regulated financial holding company itself. Moreover, while the holding company would be looked to as a means of support, in the event of the liquidation of one of the related institutions, only the resources of that particular institution would be available to compensate its shareholders and creditors. This would be a particularly important consideration in the case of insured deposit-taking institutions. Each individual institution must, therefore, have sufficient capital to sustain its own operations and supervisors should be able to satisfy themselves that that is indeed the case.

The government realizes that there are difficulties in ascertaining the full extent to which consolidation of reporting of corporate structures should apply for supervisory purposes. For example, regulated financial holding companies would, in some cases, themselves be part of much more complicated organizations. In this case, the question would be raised as to where to draw the line for the consolidation requirements. In the government's view, the structural requirements for financial holding companies described above should go a long way to simplifying the task for supervisors in gaining a clear picture of the health of the regulated financial holding company and its related group of financial institutions. Therefore, consolidation beyond the financial holding company itself would not be considered necessary in terms of reports submitted to regulatory bodies.

It is the government's aim that, where necessary, there be a high degree of standardization and comparability of information concerning financial institutions and financial holding companies. Regulated financial holding companies, therefore, would be required to submit reports to regulatory authorities. These reports would be in addition to those required of the related financial institutions. In these reports, the activities of the holding company and members of its related group would be presented on a consolidated basis to reflect any activities carried on by the holding company through its controlled corporations.

The requirement to make these reports could be waived by supervisors in situations where such consolidated reports would not contribute to the supervisory process. One example of such a circumstance would be where the formation of the regulated financial holding company was formally required, and where the rules against self-dealing would still apply, but where the respective equity holdings resembled more closely portfolio investments than investments in indisputably controlled subsidiaries. It is recognized that the distinction between a portfolio investment (where the investor has no significant influence on the activities of the investee) and an equity position in a subsidiary (where the investor does have control) is not clear when the investment consists of more than 10 per cent of the voting equity of the investee but less than 50 per cent. In this realm, where the investor can potentially exert significant influence on the investee, but does not necessarily control it, an actual determination of the degree of control, and therefore of the need for full consolidation, can only be made on a judgemental basis. For this reason, the government proposes to require full consolidation in all such cases except where an explicit exemption has been made.

The foregoing discussion focuses on consolidated reporting for supervisory purposes, which is quite distinct from the preparation of consolidated financial statements for presentation to investors, regulators of securities markets and other users of financial statements. Such statements are normally prepared in accordance with generally accepted accounting principles to which the proposed regulated financial holding company structure may not lend itself in all situations.

One example of the technical issues in this area concerns the method of consolidating the accounts of life insurance companies with those of other financial institutions. Life insurance companies, unlike most other financial institutions, do not formulate their financial reports according to generally accepted accounting principles. At present, a joint task force from the Canadian Institute of Actuaries and the Canadian Institute of Chartered Accountants is studying the special problems that life insurance companies have in complying with generally accepted accounting principles. The government intends to consult with the professional bodies, the provincial regulatory authorities and financial institutions to agree on methods of consolidation that either accord with generally accepted accounting principles, or that deviate from these principles in ways that can be supported or justified by considerations of relevance to investors, consumers and supervisors.

A second outstanding issue is the method of consolidation of financial statements of firms that are linked by ownership of less than 50 per cent. This issue will be explored as well.

Transition and Conversions

A number of holding companies already exist that group together several individual financial institutions incorporated under different legislation. A holding corporation that included a federally regulated financial institution among its affiliates would be required to form a regulated financial holding company.

In such a case, there are two general options: (i) the holding company could form a new corporation, in accordance with all the rules and regulations applying to regulated financial holding companies, through which its equity interests in the regulated financial institutions would be held; or (ii) it could itself register under the financial holding companies statute and arrange its corporate affairs in accordance with the provisions therein. In any event, each individual situation will have its own complexities and will have to be considered individually.

It is recognized that existing holding companies choosing the second option may have difficulties in bringing their capital structure into line with the requirements. In such cases, the government would provide a reasonable period in which to effect the transition and would also be prepared to discuss the possibility of providing special provisions that would permit supervisory authorities to deal with particular situations on a case-by-case basis. It is worth noting explicitly, however, that there would be no special provisions considered for debt issued by such holding companies during the time between the announcement of the government's policy intentions in the discussion paper issued April 15, 1985 and the subsequent passage of legislation.

Corporations may also seek, as part of the transition, to restructure institutions in ways that would involve the movement of assets and liabilities from the balance sheets of one corporation to those of another. Since, in general, the movement of assets and liabilities between the balance sheets of regulated financial institutions would be prohibited by the controls on self-dealing, such restructurings could proceed only subject to special approval.

While the government is generally disposed to facilitating such restructurings to allow institutions to participate in the financial holding company approach, there would be some difficult questions to resolve. For example, there is the issue of gaining the acquiescence of creditors in the proposed restructuring. And there may be tax complications raised by restructurings.

The conditions under which conversions of existing non-bank financial institutions into Schedule C banks would be permitted would be similar to those that currently apply to conversions of non-bank financial institutions into Schedule A banks. This is discussed in more detail in the section on Schedule C banks.

Mutual Insurance Companies

Because of the structure of mutual insurance corporations, their "shareholders" are in fact their participating policy-holders. As a consequence, these companies would not generally be able to be part of a financial holding company group along the lines set out above. The government does not wish to preclude mutual insurance companies from participating in developments in the financial services sector and so will seek ways to accommodate them.

Some of these companies may wish to "de-mutualize". The government is prepared to discuss this route and will consider practical and equitable options for de-mutualization put forward by the industry.

Others may not wish to go that route but may still wish to take advantage of the financial holding company approach. The government is prepared to consider various alternative approaches to accomplishing this. One way would be to allow these institutions to continue to be operating financial institutions and to have direct investments in the equity of financial institutions incorporated under other legislation. A second way would be to allow them to hold shares in a financial holding company that could, in turn, have its own operating subsidiaries.

One idea that could be considered in respect of downstream subsidiaries or holding companies owned by mutual companies would be to require that some proportion of the shares of these subsidiary companies be sold to the public. This would provide the basis for applying market valuation to the shares of these companies carried on the books of the mutual companies.

In capitalizing subsidiaries or a financial holding company, a mutual insurance company would have to make use of its policy-holders' funds. Certain limits would, therefore, have to be observed. These would reflect, in part, solvency concerns but also considerations for the equitable treatment of participating policy-holders.

Financial Co-operatives

Co-operative credit associations would face a problem similar to that of mutual insurance companies in attempting to take advantage of the holding company approach. In effect, co-operative credit associations are owned by other co-operatives which in turn are owned by their members who are, in effect, their customers.

The government does not wish to preclude these institutions from participating in this approach. One obvious way to facilitate their participation would be to allow institutions registered under the Co-operative Credit Associations Act to create, individually or jointly, a financial holding company that in turn could have operating subsidiaries.

There would be limits as to the proportion of their assets that could be invested in a financial holding company (these limits will be discussed later in the section on investment rules). Moreover, investments in financial holding companies could be made only provided these investments did not impair their own liquidity or their ability to fulfil their roles as suppliers of liquidity to other financial co-operatives. Additionally, the authority of a provincial central to invest in a holding company would be subject to any restrictions in its provincial charter or the governing provincial law dealing with ownership of subsidiaries.

In addition, the rules regarding non-arm's-length transactions as they would apply in a co-operative setting need further consideration. Because the main goal of financial co-operatives is to serve their owners (i.e., their members), a normal application of self-dealing regulations to these financial holding companies and their financial subsidiaries would not seem workable.

The government will discuss these and other issues raised by the possibility of the participation of financial co-operatives in the holding company approach should they express interest in pursuing this route.

C. Schedule C Banks

General

The proposed Schedule C bank is viewed by the government as a vehicle for providing financial holding companies with access to a broad range of powers and for broadening the base for commercial lending in Canada while maintaining a consistent regulatory framework for this activity. The government does not view it as a means of starting up independent banks on a closely-held basis. Investors seeking to form new, independent banks would continue to do so under Schedule A of the Bank Act, or under Schedule B if the bank is to be initially formed on a closely-held basis.

In keeping with this policy, the government would ensure that Schedule C banks are part of bona fide financial holding companies holding other financial institutions that are legitimate operating concerns and not pro-forma "shell" companies. One way to ensure this would be to apply a revenue test, i.e., a significant proportion of the group's gross revenues would have to come from the proposed affiliates of the Schedule C bank. Another possibility might be to require that would-be affiliates of the proposed Schedule C bank have a record of at least five years' operation as a legitimate going concern before application for the creation of the Schedule C bank would be considered.

Schedule C banks would in general have the same powers and be subject to the same regulations, including those pertaining to capitalization, leverage and liquidity, as Schedule A banks. There would, however, be some exceptions. These are described below.

Licensing

Schedule C banks would require renewable licences to begin and continue operations as a bank. The granting or renewal of these licences would be subject to Ministerial discretion. Some considerations that would be relevant in reviewing applications to start up Schedule C banks, as well as other regulated financial institutions, which would be in addition to those put forward in the Bank Act, are discussed in the section on the use of discretionary power by Ministers and supervisors.

Ownership

In the case of Schedule A banks, shareholdings of individual investors or groups of associated investors are limited to a maximum of 10 per cent each. This rule would generally apply to Schedule C banks as well with the following important exceptions: (i) regulated financial holding companies would be exempt from the restriction, (ii) mutual life insurance companies and financial co-operatives may be exempt from the restriction if they are permitted to hold financial subsidiaries directly rather than through a financial holding company. Regulated financial holding companies could, therefore, own up to 100 per cent of the shares of a Schedule C bank.

In addition, it would be required that the regulated financial holding company hold more than 50 per cent of the voting shares of the Schedule C bank. This would establish a clear subsidiary-parent relationship between the Schedule C bank and its parent financial holding company. In the case of Schedule C banks that are created by conversion of existing institutions and that initially have no majority owner, a transition period could be provided in which to comply with this requirement, subject to Ministerial approval.

The transfer of significant blocks of shares of Schedule C banks would be subject to Ministerial approval. If a regulated financial holding company wished to dispose of its shares in a Schedule C bank to persons other than a regulated financial holding company, the ownership restrictions as well as all other regulations pertaining to Schedule A banks would come into force and application would have to be made to register the bank under Schedule A of the Bank Act. Subject to Ministerial approval, a transition period for compliance could also be granted.

The rules regarding foreign ownership of Schedule A banks would apply to Schedule C banks. Thus, individual non-residents would be restricted in their shareholdings to a maximum of 10 per cent, and total shareholdings by non-residents would be restricted to a maximum of 25 per cent. As a consequence, Schedule C banks could not be formed or acquired by foreign-owned financial holding companies. Foreign banking institutions wishing to do business in Canada could continue to do so through Schedule B of the Bank Act.

Powers

The business powers of Schedule C banks would be substantially the same as those of Schedule A banks. The restrictions on the use of those powers would also generally be the same. Schedule C banks would face certain additional restrictions, however. These are as follows:

(1) Like other banks, Schedule C banks could not, without special permission, hold more than 10 per cent of the shares of individual non-financial corporations. In the case of Schedule C banks, however, this restriction would apply to the aggregate of shares held by themselves and their affiliates. Special exemptions similar to those available to Schedule A banks could be provided at Ministerial discretion.

(2) Schedule C banks could not lend to their directors or to the significant business interests of their directors.

(3) Schedule C banks would be subject to the same restrictions regarding non-arm's-length transactions as generally apply to other federally regulated financial institutions and financial holding companies.

To enable Schedule C banks to "network", the following powers would be made available to them, to the extent that they are not already available to banks incorporated under Schedule A of the Bank Act:

(1) The power to act as agents, or otherwise in a representative capacity, on behalf of other financial institutions to market the following services and products: discretionary fiduciary services, investment counselling and portfolio management services, insurance services, the purchase and sale of securities, and mutual fund shares or units. As outlined below, the ability to do this will be dependent on the relevant provincial licensing requirements.

(2) The power to offer data processing services as required to provide support to the bank's agency function in networking arrangements.

(3) The power to advertise these new arrangements and to provide supporting services to operations conducted on behalf of other financial institutions. In this latter regard, they would be able to provide (and charge for) telephone, data terminal, courier and related support services to sales agencies located in bank branches, including invoices in account-statement mailings and the like.

(4) The power to rent space in their branches to other financial institutions on normal commercial terms, including terms involving a sharing of profits from the operations in these branches.

The foregoing amendments would merely remove the impediments to networking presently contained in the Bank Act. Before Schedule C banks could engage in networking arrangements of these types, a number of additional steps would have to be taken and certain conditions met. For example, Schedule C banks would have to qualify or otherwise obtain the necessary personnel and, in addition, meet all the applicable regulatory laws controlling entry into the businesses involved. Naturally, where the relevant laws were provincial, such entry would be possible only if consistent with the policies of the respective provincial governments.

Corporate Structure and Governance

In general, Schedule C banks would be organized in the same way, and function according to the same rules and regulations, as Schedule A banks. Naturally, there would be some differences arising from their affiliation to financial holding companies. For example, the rules for directors' responsibilities would be in accordance with those of regulated financial holding companies. However, the differences that are contemplated would not, in general, extend to business powers.

Conversions

The authority and procedures to issue letters patent converting an existing institution to a Schedule C bank would be the same as in conversions of institutions into new Schedule A banks. Converting institutions would, like *de novo* Schedule C banks, require licences to begin operations. The granting of licences to converting institutions would be at Ministerial discretion.

To facilitate such conversions, converting institutions would be permitted to continue their business operations while making adjustments necessary to bring their structures and operations into full conformity with all of the provisions of the Bank Act. To do this, they would need, in most cases, certain exemptions. These exemptions, which parallel those in the Bank Act, would include:

(1) the power to continue to undertake activities and acquire or hold assets otherwise ineligible under the Bank Act in respect of prior contractual arrangements, for periods to be specified in the plan for conversion;

(2) the authorization to be not fully in accordance with Bank Act provisions concerning corporate organization and governance for a period of up to two years.

The conversion of existing institutions to Schedule C banks would not, by and large, raise issues that are not already contemplated in existing provisions governing conversion of institutions to Schedule A banks. However, there are some foreseeable issues that deserve comment. One such situation would involve a trust company wishing to transfer its commercial lending business into a Schedule C bank.

One of the difficulties would involve the valuation of the shares of the two new companies relative to the shares of the converting company. In such cases, the plans for conversions would have to address these issues explicitly. One option would be to provide each shareholder of the original company with shares in each of the two new companies.

Another area of concern would be the capital adequacy of the new companies so formed. As part of the conversion plan, therefore, institutions would have to provide such additional capital as would be necessary to meet the legislated capital requirements of both of the new institutions.

D. Control of Self-Dealing

The need to control self-dealing reflects the dangers to which financial institutions can be exposed as a result of this activity. There are rules currently in place to control some forms of self-dealing. Existing rules do not, however, cover a number of important types of self-dealing, including the transfer of assets between a financial institution and its affiliates or controlling interests.

Identifying Non-Arm's-Length Parties

In concept, an arm's-length relationship is one in which both parties to a transaction are equally capable and vigilant in the protection of their own interests, conduct their relations without in any way relying upon the other's indulgence, and are not subject to the other's control or influence. In the discussion paper, it was proposed that a person or group of associated persons would be considered to have an ability to control or influence a financial institution if they were related to it in one of the following ways:

(1) they had an equity interest of more than 10 per cent in the financial institution or in its holding company;

(2) they were directors of the regulated financial institution or of the related financial holding company;

(3) through their equity or debt holdings, they were in a position of influence or control, or were deemed by supervisors to be in a position of influence or control, directly or indirectly.

It may be useful to review some of the types of relationship that might be considered under the third category. One example of a relationship that would come under this category would be the chain of holding companies, each controlling the next, through which the company at the top of the chain can exercise control over the company at the bottom of the chain even though, on a fully diluted basis, its shareholding in that firm may be well below 10 per cent.

The types of relationships among individuals that would lead to the inference that dealings between them were not at arm's length have been defined in a number of statutes including the Income Tax Act and the Bankruptcy Act. In these applications, persons having specified relationships through shareholdings in the case of corporations (as above), or through birth or marriage in the case of individuals, are deemed not to deal with each other at arm's length. For persons not in these specified relationships, it is a question of fact whether dealings between them were or were not conducted at arm's length. There has been some recognition of such tests in Canadian case law.

It is noteworthy that where there is a specified relationship (e.g., through birth or marriage or through share ownership) the dealings are presumed not to be at arm's length even if the facts of the particular transaction do not indicate the use of influence of one party on the other. In cases where no specified relationship exists (e.g., where the transaction was between a corporation and a person who was a personal friend of a director or officer of the corporation), the determination of non-arm's-length dealing would rest solely on the facts of the case: for example, the terms of a loan would be assessed for differences from terms normally offered to other individuals in the same circumstances and representing a similar business risk but lacking the same factual relationship to the corporation.

Options for the Control of Self-Dealing

There are various approaches to controlling self-dealing. The available options range from requiring institutions to be widely held, to allowing them to control self-dealing through self-regulation. Four general approaches are described below.

1. Ownership Restrictions

The restrictions limiting individual holdings of shares of chartered banks to a maximum of 10 per cent have helped limit the potential for self-dealing in the banking industry. This approach has also been considered for other financial industries. For example, the 1982 federal discussion paper on trust and loan legislation raised that option for trust and mortgage loan companies. The Ontario government also considered implementing ownership restrictions for the trust and mortgage loan companies in its 1983 White Paper on trust and loan legislation.

From a supervisory perspective, dispersed ownership of financial institutions clearly has its attraction, particularly in respect of the checks and balances to the use of power that tend to exist within widely-held institutions and the separation of the financial and non-financial sectors that it provides. However, from the business perspective it has not always been considered to be advantageous. It has been argued, for example, that shareholders who hold substantial amounts of a corporation's equity and take an active interest in the direction of the company can help maintain its competitive drive. Moreover, it is suggested, major shareholders would have a greater stake in the survival of the company and would be more prepared to provide additional capitalization if that were needed.

Regardless of the reason, there has clearly been an increase in the last several years in the proportion of the financial services industry that is closely held. Where until recently most of the largest trust companies were widely held, now they are almost all closely held. Moreover, in the past few years, the rapid development of a number of financial conglomerates has brought many institutions not only under control of major shareholders but also into affiliation with each other.

In the current circumstances, a policy aimed at requiring regulated financial institutions to have dispersed ownership would clearly be disruptive. It would generate much activity in financial markets in trading of shares, creation of financing packages for share purchases etc., and absorb much of the time, effort and creativity of management. In the view of the government, such a policy would be counter-productive at this juncture when the focus should be on economic growth.

It is therefore the government's intention to pursue other options for the control of self-dealing. However, recognizing the value of dispersed ownership in the banking industry, the government does not propose to remove such ownership restrictions as already exist on Schedule A banks.

2. Institutional Regulation

One approach to control of self-dealing that has been suggested in the consultation process is to develop procedures that would be followed by institutions and that would attempt to ensure that any transactions involving non-arm's-length parties are within the normal range of business activity in terms of price, terms and conditions.

In considering this approach, it is useful to bear in mind that risk and uncertainty are present in varying degrees in all business transactions. At one extreme, a simple transaction involving the purchase or sale of a Government of Canada Treasury bill would typically involve relatively little if any risk or uncertainty. The instrument itself is a safe investment and there is virtually no uncertainty about the appropriate transaction price. At the other extreme are complex acquisitions of major firms or of large blocks of real estate. Such transactions would involve risk partly because the investments themselves might be risky. Moreover, there would be uncertainty with respect to the appropriate price and terms of the transaction even if the transactions involved arm's-length parties. Where such transactions involved non-arm's-length parties, the uncertainties as to whether the price and terms were those that would prevail on the market would be substantially heightened.

The issue raised by an approach that relies on institutional regulation is whether it is possible to develop procedures that ensure that transactions involving non-arm's-length parties approximate the terms and conditions of market transactions. One suggestion that has been made is that a well-developed self-regulatory approach could provide the necessary assurances. Such a system would be an adjunct to supervision by regulatory authorities and to policies aimed at ensuring that individuals interested in gaining control of financial institutions were bona fide. It would also be additional to such monitoring of the firm's affairs as would be provided by its auditors. In this last respect, consideration could also be given to expanding the powers of auditors and requiring uniform auditing standards for all types of regulated financial institutions.

The major onus of responsibility would, however, fall on the boards of directors. Under this approach, institutions would be required by law to establish formal internal committees composed of outside directors to review all non-arm's-length transactions. These committees would have to determine that the institution's interests, and in addition those of its depositors, policy-holders and other creditors, were not being damaged as a consequence of these transactions. Moreover, in the event that they were, these committees would have to ensure that the transactions were stopped or restructured.

A key feature of this approach would be to ensure that the directors comprising the internal control committees were independent. Some conditions would be necessary as regards eligibility of directors. The committee could be chosen, for example, from among directors who:

(a) were neither officers nor employees of the financial institution or of its affiliates;

(b) had no significant financial interests in the financial institution or its affiliates;

(c) were not significant borrowers from the institution or its affiliates, either directly on their own account or indirectly through their significant business interests;

(d) did not belong to a firm supplying auditing or legal services to the institution or its affiliates;

(e) were not immediately related by birth or marriage to any person within (a) to (d).

An additional concern would be raised with respect to corporations whose shares were held wholly or predominantly by one individual or group of associated individuals. In such firms, it would clearly be problematic whether truly independent directors would be elected from which a control committee could be selected.

To increase the effectiveness of such committees, procedures could be developed to ensure (i) that non-arm's-length transactions actually came under scrutiny by the committees and (ii) that some comparison of those transactions to market transactions could be made.

Under such an approach, some consideration would have to be given to providing some safeguards in law for directors and officers of financial institutions in respect of legal actions brought against them as a consequence of having engaged in self-dealing which had been approved through this process but which nevertheless had led to losses being suffered by the firm's customers or shareholders. Such protection as could be offered in these circumstances would seem dependent upon the ability to show that the committee had acted in good faith and in accordance with the proper principles and all due precautions in approving particular transactions involving self-dealing.

The government is skeptical that the above approach would be suitable as the principal mechanism for controlling self-dealing. However, there are some relatively narrow applications where it may be a helpful addition.

3. Selective Ban on Non-Arm's-Length Transactions

A third approach to controlling self-dealing is to identify and ban those non-arm's-length transactions that are considered especially dangerous. This approach might be called a selective ban on non-arm's-length transactions.

This option presumes that only some forms of self-dealing are potentially harmful and, moreover, that it is possible to sort out those non-arm's-length transactions that are harmful from those that are not. In addition, this option assumes that it is possible to define the harmful transactions in regulations sufficiently well to enable regulators to stop them. A third implicit assumption underlying this approach is that it is possible to identify non-arm's-length parties; this assumption underlies the very concept of a ban on non-arm's-length transactions and is not unique to the selective ban.

In general, the weaknesses of this approach lie in the first two of these assumptions.

In the government's view, it is generally not possible to distinguish in advance between harmful and harmless forms of self-dealing. Depending on the circumstances, most forms of self-dealing may be harmful. The extent of possible damage to the institution involved would then depend not on the form of self-dealing but on the amount.

The second assumption is equally fraught with difficulties. In the modern financial system, there has been a proliferation of financial instruments and financial arrangements. It is evident that a ban formulated in terms of specific instruments or arrangements is likely to be circumvented over time, eroding its effectiveness.

The third assumption also raises questions. Given the complex corporate structures and associations possible in the modern economy, there is clearly a major difficulty in identifying all parties that might not be at arm's length to a particular financial institution or group of institutions.

4. The Preferred Option: A General Ban

The problem of self-dealing admits to no easy solution. There will be difficulties no matter what approach is taken. Nevertheless, the problems that have arisen in the financial system in the past as a result of self-dealing indicate that the problem must be confronted. In the government's view, the approach that inspires the greatest confidence is a general ban on non-arm's-length transactions with limited exceptions.

The following are measures that could be considered in implementing a general ban on non-arm's-length transactions:

(1) Subject to a limited list of specific exceptions, a financial institution would be prohibited from engaging in transactions with any person or group of associated persons to which it is not at arm's length (where the class of non-arm's-length parties is as defined above.)

(2) The ban would apply to the transfer of assets, the granting or receiving of credit, the provision of financial services, the granting or receiving of guarantees, acceptances and the like, and other business services within the powers of financial institutions.

(3) In addition, the financial institution would be prohibited from engaging in transactions with the significant business interests of any person not at arm's length to it.

(4) The ban would apply to all federally incorporated financial companies and their subsidiaries that are independent of financial holding companies and, as well, to federally incorporated financial holding companies and all financial institutions, federally or provincially incorporated, related to them.

(5) Any transaction that would be banned if made directly would be similarly banned if conducted through a third party, or through a sequence of transactions involving third parties.

In the government's view, the value of the ban would depend on its generality. Pending the outcome of consultations, the government anticipates keeping the exceptions to a minimum. The only general exceptions that are contemplated for federally regulated financial institutions are as follows:

(1) Purchases or sales of services would be permitted between affiliated, related or otherwise associated financial institutions or non-financial corporations subject to (i) the approval of the boards of directors of the respective institutions, (ii) a limit of 1 per cent of total expenses or revenues per annum, and (iii) the requirement that they be carried out on a cost-recovery basis and do not threaten the solvency of either of the contracting institutions.

(2) Loans to officers and employees of affiliated, related or otherwise associated institutions would be permitted subject to conditions and limits similar to those in existing financial institutions legislation: (i) personal loans would be limited to $25,000 or one year's salary, whichever is greater; (ii) mortgage loans secured by ordinary residence could be made, subject to a limit of $500,000 or one-half of 1 per cent of total assets, whichever is lesser, and provided no special terms or conditions were granted; and (iii) the above types of loans would also be subject to a portfolio restriction (e.g., they could not exceed 5 per cent of the capital of the company).

However, a number of exemptions could be made available to financial institutions in particular circumstances. For example, as outlined earlier in connection with financial holding companies, there could be an exemption from the ban for transactions between a financial institution and a subsidiary which is wholly owned and all of whose liabilities are guaranteed by the parent. As well, capital investments in subsidiaries and dividend flows from subsidiaries to parent corporations would not be covered by the ban. And finally, transactions in respect of central services between affiliated financial institutions would also be exempt from the ban provided they met other requirements that would apply in their particular case.

Certain other exemptions from the ban may be needed in particular cases. For example, fees in respect of networking where such arrangements are made between affiliated or related companies would seem to require a separate treatment. Similarly, special considerations may be necessary for reinsurance arrangements between affiliated or related insurance companies as well as for the management of non-discretionary estate agency and trust funds on behalf of related parties. The government is prepared to discuss these and other such cases with interested parties.

Penalties for Violations

Where corporations or their officers engaged in self-dealing despite the controls, there would be a need for penalties. In the government's view, there should be a wide-ranging, graduated set of sanctions available to professional bodies, supervisory authorities and eventually the courts to provide appropriate responses according to the nature and seriousness of the transgression.

The prohibitions against self-dealing would impose binding statutory obligations upon institutions and their directors, executives and officers. Violations would, therefore, be subject to penalties applied by the courts. These could involve criminal charges. Where third parties implicate themselves in the violation, the liability could apply to them as well. Persons subjected to such penalties would, of course, have all the usual rights of appeal before the appropriate courts.

A second order of sanctions would be available to supervisory bodies. In addition to the powers to require stoppage of prohibited actions through cease and desist orders, to force divestiture of prohibited investments or loans, to require restoration of assets illegally paid out of an institution and the imposition of restrictions on the company's activities as a condition for renewal of its licence, consideration could be given to the subtraction of non-arm's-length loans or investments from the institution's capital base in the case of trust and loan companies and Schedule C banks, and from the non-par fund in the case of insurance companies.

Finally, engaging in prohibited self-dealing should be regarded as a breach of professional conduct, ethical standards and personal integrity. The financial community, through its professional and industry associations, should seek to repudiate such behaviour and to apply such sanctions as fall within its powers. In the government's view, it would be in the financial community's own self-interest to take such actions as it can against those whose activities would tarnish its reputation and damage public confidence in the financial system.

E. Control of Conflicts of Interest

In a modern financial system, where financial institutions are active in many markets and provide a broad range of services to a diverse group of customers, conflicts of interest are bound to occur. To prevent their occurrence, a narrow specialization would have to be imposed upon institutions. This would be incompatible with giving market forces rein to help shape a dynamic and efficient financial services industry. However, the government strongly believes that consumers should be protected and intends to strengthen safeguards against abuses of conflict of interest situations.

There are three areas in which protection for consumers could be enhanced: (i) greater control of the flow of confidential information within institutions that could give rise to conflicts; (ii) greater disclosure to consumers and to regulators to enable assessments of whether conflicts were arising and, if so, whether they were being abused; (iii) enhanced access to remedial action in the courts in the case of suspected or apprehended abuses. The government intends to explore means of enhancing protections in all three areas.

Control of Inside Information Flows: the "Chinese Wall"

The risk of conflicts of interest occurring is commonly considered to be greatest when different financial services are performed within a single institution. One area that has been the focus of particular concern in the past is the combination of trust functions with other financial services and particularly with commercial lending. The government is therefore proposing that legislation require the creation and maintenance of a "Chinese Wall" between fiduciary operations and all other financial operations of the trust company and its affiliated companies. Over time, there may become apparent a need to require Chinese Walls in other areas as well.

The term "Chinese Wall" is a metaphor for a group of rules and procedures designed to prevent the passage of information between groups that are either performing separate functions for a mutual client, or performing functions for different clients but where the information may be confidential in nature and may have material effect upon the advice given to or action taken by the clients. Chinese Walls may be created by a financial institution to prevent the passage of material, confidential information between (a) departments or segments of its internal organization, or (b) between itself and other, separate but related or affiliated financial institutions.

Essentially, Chinese Walls are rules against deliberate disclosure, and arrangements designed to prevent accidental disclosure, of such information.

Clearly, there is no certainty that Chinese Walls would prevent abuses of conflicts of interest. The rules could be broken and the procedures might not always work. Nevertheless, it is the government's view that Chinese Walls may be a useful element of an overall approach to the control of conflicts of interest and would help set an appropriate tone for institutional conduct in that regard.

Chinese Walls could be created by institutions on their own initiative wherever they felt that such arrangements would enhance their ability to resolve properly conflicts of interest. The government would require, however, that Chinese Walls be created to separate fiduciary activities from all other financial activities. In these cases, supervisors would ensure that they were in fact in place and constructed appropriately.

The following are examples of possible rules and procedures that institutions might use in constructing Chinese Walls:

(1) Employees of financial institutions would be prohibited by institutional guidelines to disclose or to cause to be disclosed to any related person, any material confidential information concerning the affairs of a mutual client. Similarly, it would be made clear to employees that it would be in breach of that duty to receive any such information.

(2) There could be physical separation of the group dealing with trust functions from the other parts of the institution.

(3) Separate files could be maintained for functions separated by Chinese Walls. Employees on one side of the Wall would not have access to files dealing with operations on the other side.

(4) The transfer of personnel between groups separated by Chinese Walls could be done under controlled circumstances. For example, there could be a required interval between the leaving of duties on one side and the assumption of duties on the other side. As well, institutions could ensure that employees being so transferred would be assigned duties that would not risk giving rise to conflicts of interest as a result of knowledge obtained in the course of duties on the other side of the Wall.

(5) Internal committees could be structured so as to limit the interaction of personnel on opposite sides of the Chinese Wall. Obviously, beyond some level of the internal hierarchy within an institution, senior executives would be in a position to "see over" the Wall, regardless of controls on committee membership. However, such controls could be helpful with respect to lower-level committees that otherwise also would have the potential to straddle the Wall.

(6) Institutions could restrict the internal circulation across the Wall of reports that typically contain confidential information.

(7) Lines of communication between institutions and their parent firms could be structured so as to restrict the levels within the corporate group's reporting hierarchy having access to confidential information flowing from both sides of the Wall. Similarly, spheres of responsibility of senior executives within a corporate group could be arranged so as to minimize the scope for conflicts to occur.

While the government would ensure that appropriate Chinese Walls have been put in place where required, it does not intend to monitor their functioning. Given the myriad trackless ways in which information could conceivably pass between individuals, between departments of the same institution or between two related institutions, it is evident that supervisory oversight could serve neither to apprehend wilful breaches of the rules nor to reinforce institutions' own internal vigilance.

Chinese Walls must, therefore, be an element of institutional self-regulation. The following guidelines, patterned on some proposed in the United Kingdom for the internal monitoring of Chinese Walls, may be worth considering in the Canadian context:

(1) Institutions would create a group that would be a point of reference for identifying conflict of interest situations but that would not be in a position to undermine the Chinese Wall.

(2) The group would ensure that where conflicts exist and have been identified, proper disclosures are made.

(3) The group would monitor compliance with the rules and procedures constituting the Chinese Wall.

It should be clear that where institutions are privy to confidential information concerning their clients, or have fiduciary duties towards them, it is their duty to prevent disclosure and improper use of material, confidential information. A Chinese Wall would merely be a means by which an institution's management would attempt to fulfil this duty. The creation, maintenance and even the dutiful internal supervision of such a Wall by an institution would not by itself constitute a fulfilment of that duty.

Civil Remedies

Financial institutions may become subject to legal duties and financial obligations towards their customers in ways that could lead to abuses of conflicts of interest. For example, financial institutions may be privy to confidential information concerning the affairs of their customers and under express obligation to maintain that confidentiality. In other circumstances, financial institutions may owe fiduciary duties to their customers with respect to information in their possession or coming to their attention by reason of the fiduciary relationship. If a financial institution violates either of these duties it may subject itself to potential claims for damages or restitution by its customers. Where the breach of duty by a financial institution has resulted in a significant loss to a customer, the existing law makes remedies available through the ordinary courts.

In the opinion of the government, the existing law would probably continue to provide adequate protection in the altered circumstances created by the development of regulated financial holding companies. However, the government has given consideration to ways of facilitating the public's access to adequate redress.

For example, the government is considering the possibility of legislation modifying the legal requirements for demonstrating a *prima facie* case so as to remove or lessen the barriers which might inhibit private remedial litigation. One such suggestion is to incorporate in the financial holding companies legislation a presumption that any transaction entered into at less than arm's length was also not at fair market value. The effect of this would be to relieve a customer or shareholder litigant from any responsibility of establishing the fair market value of the transaction by evidence, and to place the onus of demonstrating the fairness of the transaction upon the financial institution whose actions have given rise to the appearance of an abuse of a conflict of interest. The government would be interested in comments from informed persons on the desirability of such legislative provisions together with specific recommendations of the circumstances in which such an approach could be applied.

In addition to the foregoing, minority shareholders in financial holding companies and their affiliates would have the normal derivative rights of action to seek redress (i.e., through law suits against the corporation), under enabling orders of the court, for wrongs committed against the corporation by those having a control position, through the abuse of their power.

Financial Conflicts of Interest Office

While existing law would provide for redress in cases of abuses of conflicts of interest, it is recognized as a slow, cumbersome and expensive process for individuals to make a claim for damages against financial institutions which do not lack for legal and financial resources. The government feels it would be appropriate, therefore, to provide some assistance to individuals seeking redress in cases of suspected abuses of conflicts of interest.

The government proposes, therefore, to create a new public body to review complaints related to conflicts of interest. This would be a public body, funded by the government. It would be staffed by lawyers and individuals experienced in the area of financial institutions so that complaints would receive thorough and expert investigation and evaluation. Although actions by public bodies on behalf of the public are not common in Canada's legal system, they are not unknown. Furthermore, only a trained and experienced organization would be in a position effectively to investigate cases involving a complex set of conflict of interest rules. This consideration is particularly relevant in the context of the highly technical financial industry and in matters such as the relations between associated corporations.

The body the government proposes to create would be known as the Financial Conflicts of Interest Office. This organization would not oversee the financial holding company structure or any independent financial institution, nor have any power to regulate institutions. Rather, the Office would complement the regulatory structure by providing assistance to individuals in their efforts to gain redress for losses that may have been suffered as a consequence of abuses of conflicts of interest. The Office would receive complaints concerning suspected conflict of interest abuses and would be empowered to investigate these complaints. If in its view the claims might be meritorious, it would be able to make representations to financial institutions on behalf of plaintiffs and to launch civil suits in the courts to recover losses. The Office would not have any powers to compel institutions to make restitution except insofar as it would be successful in convincing the courts of the need to do so.

Specific instances of suspected abuses could be brought before the Office by individuals. As well, where information disclosed to regulators might give rise to a suspicion of an abuse of a confidential or fiduciary relationship, the case could be forwarded to the Office for investigation, even if no significant damage or loss to individual customers or investors were immediately apparent.

The government appreciates that there would be difficulties involved in establishing appropriate ground rules for the functioning of such an Office. The government welcomes submissions on the possible scope of the role that could be usefully played by this Office. Moreover, in cases involving provincially regulated financial institutions, the government recognizes that consultation and co-operation between the Office and provincial authorities will be needed for co-ordinated actions.

Disclosure Requirements

The ability of litigants to take private action depends upon their ability to discover the material facts disclosing an abuse of a conflict of interest by a financial institution. It is evident that the difficulties in the way of their doing so are large.

There are, first, the problems involved in providing customers with greater access to relevant information. The volume of information that would have to be delivered on a timely basis would likely prove to be overwhelming. For example, the relevant information would include the timing of transactions, the identity of the parties to the transactions, and the business relationship of those parties to the financial institution at any point in time. Even given the resources afforded by modern information management systems, it would appear that the provision on a regular basis of this kind of information would be genuinely impossible. Thus, where there is no pressing reason to examine for the possibility of conflicts having occurred (for example, where no significant losses have been suffered by clients), the very notion of seeking disclosure of this nature would seem to be ruled out.

In cases where customers or investors have suffered significant losses, the question arises of whether institutions could be required to make available such information as would allow the customer to make a determination of whether conflicts of interest had been involved. The chief difficulty would appear to be the problem of not violating customer confidentiality with respect to the institution's other clients. No easy solution seems to be available.

Thus, the types of disclosure that would likely be of most use to customers would provide such information as would help them to make informed decisions before the fact: i.e., about the terms of the contract into which they may be entering or about the corporation with which they may be contracting. The following types of disclosure could be helpful in this area:

(1) Clear identification of the corporation with which the client is contracting. This would include identifying all financial institutions that may be associated or affiliated with, or related to, the contracting institution. This would be especially important in situations where the officers of one corporation may be acting on behalf of another corporation, as in the example of networking.

(2) Clear disclosure of the role the corporation is playing in contracting with the client. This would include whether the institution is acting as agent for the client, as principal on its own behalf or whether it is also at the same time acting as agent on behalf of another client.

(3) Where networking is involved, a clear statement of fees and commissions earned by the institution on all transactions with or on behalf of a client.

(4) Where Chinese Walls exist in an institution, a caution to the client that relevant material information that the institution may possess may not be used on the client's behalf if that use would involve a breach of the Chinese Wall.

(5) Disclosure of material facts coming to the knowledge of the institution in the course of a business transaction with or on behalf of a client. Where the institution would be unable to disclose the facts because they are confidential or because such disclosure would otherwise be a breach of regulations, the institution would have to inform the client of its possession of such information, the possibility of a conflict of interest, and the client's option to have the institution cease to act on his or her behalf.

(6) Advice as to the recourse that the client has to the Financial Conflicts of Interest Office.

Disclosure of particulars of transactions can be required of financial institutions by regulatory authorities. Thus, where confidentiality of client information would preclude disclosure to the public, regulators could investigate on the public's behalf. Investigations could also be made by regulators at the request of the Financial Conflicts of Interest Office. Such recourse, however, would be taken only in instances where representations to financial institutions had not satisfied the Office as to the facts of the case.

The government is interested in exploring these ideas with the public and with institutions. It is also interested in other types of disclosure that would be both helpful to clients of financial institutions and, at the same time, feasible for financial institutions to provide.

F. The System of Supervision

As part of the goal of ensuring the soundness of institutions and the stability of the financial system, the government intends to review its approach to the supervision of institutions within its own jurisdiction. This review will encompass the powers of regulators, the methods of supervision, and the organization of the supervisory structure. Part of this review is already underway. Earlier this year, the Minister of State (Finance) formed a committee under Robert Wyman, Chairman of Pemberton Houston Willoughby Incorporated, to examine the role of the Canada Deposit Insurance Corporation and to produce a report. The committee's report has now been published and its recommendations are under consideration. Other aspects of the intended review are described below.

Ministerial and Supervisory Discretionary Powers

The experience with failures of financial institutions in the recent past has indicated that, in some cases, even after problems or difficulties have been detected, supervisors may not always have sufficient authority to take appropriate action. As well, given the foregoing proposals that would introduce greater flexibility to institutional arrangements within the financial sector, there would be an additional need to ensure that supervisors have adequate powers to discharge their duties properly.

The power of supervisors to exercise discretion is supplementary, of course, to the general exercise of discretion at the Ministerial level.

1. Licensing of Financial Institutions

Because the owners and managers of financial institutions primarily use the public's funds in the operations of these institutions, a higher standard of conduct is expected of them than may be the case in other types of business. In granting or renewing licences to operate a financial institution, regulators have regard to this higher standard of conduct. Factors that enter into the decision to grant or renew a licence include the following:

(1) The sufficiency of the skills, knowledge and experience of the directors, controlling shareholder(s), and senior management to operate an institution to which the public has entrusted funds. Where controlling shareholders have other business interests, the Minister will examine the shareholders' business record in these areas, the financial strength

and soundness of the shareholders' other interests and the range of activities encompassed by these other activities with a view to considering the appropriateness of associating a regulated financial institution with those other business interests.

(2) The pattern of past behaviour of the individual is reviewed. Such things as prior bankruptcy judgements, fraud convictions, or association with previous difficulties of financial institutions or other businesses would be particularly important considerations. However, other types of criminal offences would be important considerations as well since it is vital that those responsible for managing regulated financial institutions have demonstrated a very high level of integrity.

(3) In the case of existing licence holders, the Minister considers the performance of those managing the institution with a view to examining any conduct which may have threatened the interests of the general public. Both single occurrences and the history of such events is taken into account in determining whether the renewal of a licence would be appropriate. The Minister, through supervisors, would expect to be kept informed of any material changes in the circumstances of directors, controlling shareholders or managers.

(4) More generally, the Minister would consider whether it is in the public interest to issue or renew the licence for which application has been made.

2. Mergers and Significant Transfers

As a necessary complement to the authority to control the formation of new companies, a similar exercise of discretion would be needed to prohibit significant transfers of shares of supervised institutions to persons who could not meet the criteria for forming a new institution. Ministerial approval would be needed for transfers of blocks of shares where such transfers would involve the acquisition of a significant business interest in a federally regulated financial institution.

The approval of the Minister of Finance would also continue to be required for mergers involving federally regulated financial institutions. This control would extend as well to mergers of federally regulated financial holding companies. As a general rule, mergers or takeovers that would combine firms that are already large or that would significantly increase the degree of concentration in any market would generally not be approved. Given Ministerial discretion, however, such mergers could be allowed to take place where the mergers would enhance the stability of the financial system, for example in cases where such a merger would resolve difficulties involving a weak or failing institution.

In certain circumstances, shareholders who are unable to or refuse to comply with the legislation could be required to divest themselves of some or all of their shares.

3. Assumption of Control by Supervisors

In some instances in the past, supervisors have not had sufficient powers to take action until too late, even when problems had been clearly identified. It is proposed therefore that:

(1) supervisors be given the new power to issue cease and desist orders to enable them to require stoppage of questionable practices pending resolution of their propriety;

(2) supervisors be given authority similar to that in the Bank Act to appoint an official, e.g., curator, who would have full authority to operate the affairs of a financial institution that is considered unable to meet its obligations, pending all hearing processes or the disposition of court applications seeking rehabilitation or liquidation orders; and, in addition

(3) supervisors be given increased grounds to take immediate control of the assets of supervised institutions, if these institutions are endangered by insolvency or illegal actions by controlling interests.

As a general rule, supervisors should be in a position to take action in anticipation of a problem situation rather than being placed in a strictly reactive position.

4. Control of Self-Dealing

To be able to enforce controls on self-dealing, supervisors will need clear authority to require disclosures of information about parties related to financial institutions and to take prompt action where self-dealing transactions (or indeed other illegal transactions) are taking place. The government proposes to clarify the powers that supervisors would have in these respects. These are as follows:

(1) the right to obtain information on the ownership of a financial holding company and its group of institutions, including information on the ultimate ownership of companies or trusts that are substantial shareholders of a financial holding company;

(2) the right to require the declaration of other interests of substantial shareholders to enable the enforcement of the controls on self-dealing; this would complement and extend existing powers to gain access as deemed necessary to the records and accounts of financial institutions (including financial holding companies);

(3) discretionary authority to deem specific transactions to be not at arm's length;

(4) authority to force the divestiture of prohibited investments or loans;

(5) the power to require restoration of assets illegally paid out of an institution to persons knowingly participating in the wrongful conduct or in cases where no value is received by the corporation in return.

5. Reviewing Supervisory Methods

The government intends to review the methods and procedures used by supervisors to see where improvements may be possible. The primary goal would be to ensure that supervisors have access to all information they need on a timely basis to ensure that they will be able to fulfil their mandate and responsibilities. The changes that are being proposed will mean that supervisors' need for access to timely information will not diminish in future but will likely grow more important.

One area where there may be some scope for modernization is in placing the financial accounts of regulated financial institutions on a fully computerized basis with enhanced access by supervisory authorities. Although there are cost implications and it is clear that there would be many technical difficulties to resolve, other countries are moving in this direction and the government wishes to explore the possibilities in this area.

6. Consolidation of the Supervisory Structure

At present, the Office of the Inspector General of Banks supervises the banks while the Department of Insurance supervises the trust, mortgage loan, insurance companies and other federally regulated financial institutions. In recognition of the increased complexity of the financial system, and the possibility of closer ties developing among institutions, the government will consider consolidating these functions in one body responsible for supervising all federally regulated financial institutions and financial holding companies.

G. Review of Investment Rules

Rationale for Change

Investment rules governing non-bank financial institutions and pension funds have existed for quite some time. To date, they have consisted of qualitative rules which attempted to focus on the soundness of individual investments and secondarily of quantitative rules which focused on the soundness of the asset portfolio.

Financial institutions face a number of potential risks in carrying on their business. Liquidity risks, credit risks, vulnerability to interest rate or foreign exchange volatility, funding risks, and many other forms of risk must be recognized by these institutions and decisions must be made as to the amount of each type of risk that an institution is prepared to accept. The government feels that it would be appropriate to shift the focus of the investment rules governing financial institutions away from the qualitative rules towards a quantitative or portfolio approach. The government feels that this approach would be more in keeping with the general approach to managing risk at financial institutions. While such an approach would allow non-bank financial institutions increased flexibility in making individual portfolio investments, it would also be appropriate to have some ultimate limits on various types of risk that an institution may assume. Hence, in the approach detailed below, the emphasis of the quantitative rules is to propose ceilings on the amount of particular types of assets which would be appropriate for different types of financial institutions, recognizing that different types of institutions tend to have different liability structures.

The Nature of the Existing Rules

As there are similar concerns regarding the solvency of the various types of regulated non-bank financial institutions and the soundness of registered pension funds, generally similar principles have been applied in formulating their existing investment rules.

The most important aspect of these rules has been the stress that is placed on the quality of individual investments. For example, mortgages must meet specific tests to qualify. Corporate securities must also typically qualify on the basis of their earnings and dividend histories or other criteria generally linked to the security backing the investment. The primary goal of these "quality" rules is to prevent investments in securities that are poor risks.

Of secondary importance has been the quantitative limits that apply to certain types of investments, e.g., in real estate, in eligible subsidiaries, in the shares of corporations that are not eligible subsidiaries and in common shares. These quantitative limits have as a primary goal the limitation of investment in assets that generate irregular income streams and that may, therefore, expose the institution to a solvency problem. These rules are often formulated with a view to maintaining a reasonable matching between the nature of assets and liabilities.

Another aspect of the current rules is that categories of acceptable investments and loans are set out in legislation in "positive" terms, i.e., investments must meet specific criteria to be eligible. By contrast, investment powers for banks are set out on an "exception" basis, i.e., investments are eligible unless specifically prohibited in the legislation.

The Direction of Change

In broad terms, the approach developed below would involve the following:

(1) emphasizing the fiduciary duty of institutions' boards of directors and pension fund trustees in maintaining prudent investment practices;

(2) stressing portfolio diversification as a means of ensuring solvency and soundness;

(3) moving to an "exception" basis for identifying eligible investments;

(4) modifying and reducing the emphasis on "quality" rules; this would involve, principally, largely eliminating the qualifying earnings and dividend tests for individual investments;

(5) emphasizing quantitative limits that take into account the nature of the liabilities that specific types of investments are to support; this would mean, for example, that assets backing fixed-interest liabilities would themselves have to be, by and large, of the fixed-interest variety with appropriate security, yield and term;

(6) requiring all investments, other than those in authorized subsidiaries or venture capital, to be of a passive nature; and

(7) in accordance with the control on self-dealing, applying a general ban on non-arm's-length investments.

The discussion below develops these basic objectives. Subsequently, there is a discussion of the way in which these objectives would be achieved in the case of the individual institutional groups and pension funds.

1. The Fiduciary Duty of Prudent Investment

Non-bank financial institutions and pension funds would be enjoined to make their investments in a "prudent" manner. This by itself would not be new since both the fiduciary duty and the requirement of prudent investment already exist for the non-bank financial institutions and pension funds alike. To give force to this objective, therefore, it would be necessary to make clear that prudence would involve not only full compliance with all the binding investment restrictions in the regulations, but also would involve adhering to the principles of modern business practices in deciding what constitutes a prudent investment strategy.

In the case of financial institutions, the duty to ensure compliance would fall on the board of directors who have an existing fiduciary duty to ensure that the business affairs of their corporations are undertaken in a prudent manner. In the case of trusteed pension funds, this duty would fall on the trustees who have a similar fiduciary capacity with respect to the funds they manage.

The new element in this proposal is the fact that the prudence requirement would explicitly go beyond mere compliance with specified rules. In other words, compliance with the investment restrictions, while a necessary condition, would not be a sufficient condition.

2. Diversification

Diversification should be one of the principal objectives of investment strategies undertaken by federally regulated non-bank financial institutions and pension funds. Where appropriate, institutions would be required to diversify their investments in the following general ways:

(1) by type of instrument (e.g., stocks, bonds, loans etc.);

(2) by industry group;

(3) by region;

(4) by unrelated groups of individuals or corporations.

Diversification could not be implemented solely through quantitative restrictions. An element of judgement would always be involved, and attempts to codify this judgement would tend to introduce excessive complications and rigidities. For example, "diversifying" across industries with very similar experience of business fluctuations would result in little risk reduction and would not be considered a sound strategy. A similar consideration would apply to "diversifying" between regions whose economies depend largely upon the same industry group. The complications involved in attempting to provide quantitative rules in these respects are obvious.

3. Matching

A perfectly matched institution would have an asset with the same term to maturity and same type of income stream (e.g., interest earnings, dividends etc.) as each one of its liabilities. It would earn its income purely on the spread between the rates paid and the rates earned.

Such perfect matching, however, is neither practical nor necessarily desirable. For example, one of the legitimate functions of a financial intermediary can be to provide some term intermediation or maturity transformation (i.e., borrowing and lending at different terms). Moreover, because they are able to pool their risks, financial intermediaries perform a useful role by investing in assets that carry a higher risk than the liabilities they issue.

There would have to be careful attention paid to the extent to which assets and liabilities could be mis-matched. In order to frame such restrictions, classes of assets would have to be developed. For example, the following would seem to be useful distinctions:

(1) interest-bearing assets (e.g., debt securities, preferred shares and mortgages, business and consumer loans);

(2) non-interest-bearing but income-earning assets (e.g., common shares, income-producing real estate);

(3) assets carried for capital gains (e.g., non-income-produoing real estate, other property).

From the perspective of matching, deposits and deposit-like liabilities (e.g., short-term annuities etc.) could be backed by assets in the first group. Assets in the second group, however, could be appropriate investments when backing liabilities that are essentially long-term in maturity (e.g., long-term savings policies through life insurance contracts where only limited immediate cash flows are needed). Assets in the third category would generally not be suitable investments for most types of financial institutions. Within fairly narrow limits, they could, however, represent allowable investments for those institutions and pension funds whose financial commitments are also primarily deferred. This would have the effect of reducing considerably permissible investment in non-income-producing property from what is possible under the existing legislation.

Matching would be a major rationale for quantitative limits on these classes of investments. Restrictions introduced for this purpose would thus have to be stated in terms of the nature of the underlying liabilities.

4. Passive Investment

The difference between a "passive" and an "active" investment lies in the extent of control and direction exercised by the shareholder. This in turn is partly a function of the proportion of the outstanding shares of a company that is held by the investor (since this is the basis of control) and also partly a function of the attitude of the investor. As a broad generalization, a passive investor would seek to maintain dividend streams and would be readily prepared to sell shares to realize capital gains or cut losses. As a similarly broad generalization, an active investor would be more patient with regard to extraction of earnings from the investment in the form of dividends and would tend to hold the investment through rough periods. In some sense, the active investor enters into the business of that company.

It has been a fundamental tenet of policy in Canada that the investments of regulated financial institutions should generally be of a passive nature. In part this reflects the view that, for most types of liabilities carried by institutions, "patient" investments do not represent an ideal match. This is essentially a solvency concern. In part, as well, it reflects the desire to maintain a general separation of the financial and commercial spheres of activity. Regulated financial institutions are not generally viewed as being in commercial businesses and, moreover, there is a sharp awareness of the potential for financial institutions and pension funds, through their control of depositors', policy-holders' and pensioners' funds, to exercise control over the commercial sphere.

As a consequence of these concerns, regulated financial institutions and pension funds would continue to be restricted from owning more than a specified percentage of the voting stock of any corporation except where specific exemptions are provided. The two exceptions that are contemplated are:

(1) permitted subsidiaries;

(2) venture capital investments in small businesses under specified conditions.

In view of the solvency concern arising from the nature of these active investments, there would be quantitative limits on the proportion of a portfolio that could be thus invested. These limits could vary depending on the nature of the liabilities of the institution or pension fund.

One important issue in this area concerns the threshold (in terms of ownership of the shares of a corporation) at which "control" becomes possible. The current legislation governing non-bank financial institutions incorporates a figure of 30 per cent as the limit on ownership of common shares of a corporation. When this figure was formulated a number of years ago, the prevailing thinking was that it represented an appropriate threshold below which control was not generally possible. However, in light of the more intricate methods of exercising control that have developed over time, it seems appropriate as a general rule to lower this limit to l0 per cent.

Where regulated financial institutions have subsidiaries or are affiliated with other financial institutions through a regulated financial holding company, the 10-per-cent limit would apply in aggregate to the entire group of related companies. Consideration would naturally be given to ways of easing problems that institutions might encounter in the transition to the new rules.

5. Investments in Subsidiaries

Permitting financial institutions to have subsidiaries serves two main purposes. It provides a vehicle for the extension of financial powers where it is desirable that those powers be exercised separately from the main functions of the institution itself, and it provides institutions with a way of furnishing various types of business services ancillary to their main financial functions and for which they have developed special capability. These considerations have resulted in financial institutions being allowed, subject to certain restrictions, to hold the following types of subsidiaries:

(1) certain other financial institutions;

(2) real estate corporations;

(3) mutual fund corporations;

(4) corporations that provide advisory, management or sales services to such mutual fund corporations or to certain other segments of the institution's business; and

(5) corporations that carry on business activities that are in other ways ancillary to the principal business of the financial institution.

These considerations are still valid. The government intends, however, to review all of the existing limits with the objectives of ensuring, so far as possible, consistency of treatment of the various kinds of financial institutions and achieving an appropriate balance between the exercise of additional powers by such institutions and the risks associated with such investments. It will also be necessary to take due account of the double counting of capital that arises when highly levered financial institutions have other highly levered financial institutions as subsidiaries. In this regard, the government recognizes the special situation and concerns of mutual insurance companies.

6. Investments in One Corporation

There is a further solvency concern stemming from the amount that institutions invest in any one corporation. This relates to the degree of exposure of the financial institution or its related group to a single corporation or group of related corporations in the event the latter should fail or default.

Institutions would, therefore, face an aggregate limit (20 per cent of capital is proposed) on the funds they could extend to any one individual, corporation, partnership, or group of associated persons. This limit would encompass all ways of advancing funds including holdings of debt and equity securities, loans, guarantees and other forms of credit such as financial leases. It would apply to the institution, its subsidiaries, and companies to which it may be affiliated through a regulated financial holding company.

7. Quality Rules and Lending Restrictions

In the past, the focus of investment rules was mainly on the quality of individual investments. While the proposals would shift the focus to other objectives, it is desirable to retain certain kinds of quality rules.

First, in view of the fact that the types of liabilities that financial institutions typically acquire are not suited to highly speculative investments, assets that are in default on interest or principal would not generally be considered to be appropriate investments.

Second, there would seem to be a need for rules covering investments for which secondary markets do not exist and for which there is, as a consequence, no market valuation of the securities involved.

To formulate rules for "lending", it would be necessary to differentiate this activity from "investing". To the extent that a useful distinction can be drawn between these concepts, it would seem to rest on the non-traded character of the former and the tradeability of the latter. Conceptually, therefore, the major differences between loans and investments would lie in the liquidity of the latter instruments and the fact that their value can be established in the market.

These features would provide the main rationale for maintaining quality rules with respect to acquisitions of certain kinds of non-traded instruments. These rules would serve to some extent as a safeguard in view of the fact that non-traded instruments are less liquid and of less certain value.

The most important category of assets to which eligibility rules would apply would be mortgage loans. It is proposed that the following kinds of mortgage loans would be considered "quality" loans:

(1) 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,
- second and junior mortgages that are fully insured or otherwise guaranteed by a government agency or an approved private insurer.

(2) 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,
- second and junior mortgages that are fully insured or otherwise guaranteed by a government agency or an approved private insurer.

In addition, the following rules are contemplated:

(1) There would be a maximum size to any single mortgage loan expressed as a percentage of shareholders' equity, e.g. 15 per cent.

(2) In the case of a junior ranking mortgage loan, the amount of debt ranking ahead of the loan would be added to the amount of the

mortgage loan for purposes of compliance with the limit on the maximum size of a single mortgage loan.

No aggregate limits are proposed for the proportion of institutions' portfolios that could be composed of "quality" mortgage loans made in accordance with these rules. Investments in mortgages not meeting these requirements would, however, be subject to portfolio restrictions. A limit of 5 per cent of total assets is being proposed.

The other major classes of loans are consumer and commercial loans. In general, federally regulated non-bank financial institutions have had only limited formal powers to undertake consumer and commercial lending.

With respect to commercial loans, despite their lack of formal powers many non-bank financial institutions currently have substantial investments in a variety of instruments, such as debentures and other evidences of indebtedness, which represent lending to companies at terms and conditions effectively the same as corporate term and demand loans issued by banks. In the government's view, it would be useful to arrive at a definition of commercial lending so as to permit the effective application of investment rules to these institutions. Such a definition would have to be based, it would seem, on the principle of the tradeability of the security. Some useful distinctions that can be made in this respect are given below. In general, it is proposed that "commercial loans" be defined to include all means of advancing funds, credit, or guarantee of funds to businesses other than the following:

(1) securities issued under prospectus;

(2) securities issued in private placements with a sufficiently large and varied subscribing clientele as to be virtually the equivalent of a market offering;

(3) commercial paper that meets criteria similar to those in the preceding point;

(4) corporate mortgage loans that meet the 75-per-cent loan-to-value ratio, or are insured.

As noted in the discussion paper, the government wishes to broaden the base for commercial lending. The preferred option for achieving this goal is to provide non-bank financial institutions with the option of affiliation with a Schedule C bank which would have full freedom to make commercial loans. The advantage of this would be that commercial lending by federally regulated financial institutions would be done under a consistent regulatory regime. However, for non-bank institutions that would not belong to financial holding companies and would still desire to retain some flexibility to make some commercial loans, it is proposed they be allowed to continue to do so on a limited basis. (There would be no limits, however, on loans guaranteed under the Small Businesses Loans Act.)

While commercial lending has been traditionally associated with the banking system, consumer lending has been undertaken by a wide variety of financial and non-financial institutions. Trust and mortgage loan companies have had only limited powers in consumer lending as consumer loans have come under the 7-per-cent "basket" restriction. As this activity raises no serious solvency concerns, non-bank institutions could continue to be active in this market. As a transitional measure, the existing "basket" restriction of 7 per cent would be eased and these institutions could place up to 10 per cent of their assets in consumer loans.

8. Real Estate

As noted before, real estate investments can be broken down into two categories, income-producing and non-income-producing. Non-income-producing investments are not generally appropriate investments for financial institutions because of the matching concern. Income-producing real estate would be a better match but, in this case as well, there would be concerns flowing from the matching principle. Further special quantitative restrictions may therefore be appropriate for real estate investments. In formulating limits, it seems important that the following additional considerations be taken into account:

(1) Non-income-producing real estate would be defined as real estate not producing a positive cash flow equal to at least 50 per cent of the yield on long-term Government of Canada bonds.

(2) In cases where properties are encumbered by mortgages held by third parties, the value of the investments would be calculated on a "gross value basis", i.e., before deduction of the related indebtedness.

(3) In complying with portfolio rules, the value of the real estate would be calculated as the total carrying value inclusive of real estate held through investments in real estate subsidiaries or through methods such as participation in joint ventures, partnerships and unit trusts.

9. Other Property

In recognition of the non-interest-producing nature of other forms of property in which corporations would normally invest it appears necessary to impose a very modest aggregate limit on these investments. It is proposed that investments in personal property (excluding personal property that is the object of a financial lease arrangement) should not exceed 5 per cent of an institution's capital.

Investment Rules for Financial Institutions and Pension Funds

In general, the investment rules for federally regulated non-bank financial institutions and pension funds would be based on the considerations outlined above. Naturally, given the differences in the nature of the liabilities of the various groups, there would be differences expected in the investment strategies that they could undertake. Moreover, there would be some differences in the restrictions applying to them arising out of the same considerations.

1. Trust and Loan Companies

As discussed later, it is intended that the legislation governing these institutions be amalgamated. Consequently, the same investment rules would apply to both types of companies.

The following proposals have been formulated in the context of the objectives enunciated on the previous pages. Of particular importance is the fact that almost all of the liabilities of trust and loan companies bear interest at market rates. As a consequence, the proposed rules have been developed on the basis that almost all of the assets of trust and loan companies likewise should be invested in investments that pay interest at market rates.

The proposed rules are as follows:

(1) a company would be required to invest its funds prudently;

(2) the investments would have to be appropriately diversified;

(3) the investments would have to be reasonably well matched to the nature of the liabilities;

(4) investments in instruments that carry market rates of interest would face no special restrictions;

(5) investments in instruments that are income-producing but that do not carry market rates of interest would be restricted in total to 100 per cent of shareholders' equity with the following sub-limits:

real estate for own use	:	35 per cent of shareholders' equity
real estate for investment	:	35 per cent of shareholders' equity
common stocks (no more than 10 per cent interest in any one corporation)	:	50 per cent of shareholders' equity
common stocks of venture capital corporations (10 per cent to 50 per cent interest)	:	10 per cent of shareholders' equity

In addition, no more than 25 per cent of the maximum permissible amount that could be invested in real estate could be invested in non-income-producing real estate and not more than 15 per cent of the maximum permissible amount could be invested in one parcel or project, both limits to be determined on a gross basis, i.e., before deduction of related indebtedness.

(6) investment in preferred shares would be limited to 10 per cent of total assets;

(7) loans would be subject to the following restrictions:

- mortgages meeting the "quality" tests would face no restrictions;
- other mortgages would be restricted to 5 per cent of total assets;
- commercial loans would be restricted to 5 per cent of total assets;
- consumer loans would be restricted to 10 per cent of total assets;

(8) the maximum amount that could be invested in or lent to any single individual or corporation or to any related group, except government and government-guaranteed entities, would be limited to 20 per cent of the shareholders' equity;

(9) investments in non-income-producing property, other than real estate and common shares, would be restricted to 5 per cent of shareholders' equity;

(10) except to protect a security position, investments in assets in default as regards interest or principal or preferred dividends would be prohibited;

(11) investments in subsidiaries would be restricted to 5 per cent of total assets, and in any one subsidiary, to 2 per cent of total assets with the following conditions:

- double counting of capital will not be permitted when a subsidiary is a financial institution, either domestic or foreign;
- compliance with authorized borrowing ratios will have to be determined on a consolidated basis, thereby eliminating the effect of any double counting of capital;
- in the case of foreign deposit-taking institutions operated as subsidiaries, double counting of capital could be prevented either by requiring compliance on a consolidated basis as suggested above, or by a requirement that would limit the carrying value of the investment in the subsidiary in the balance sheet of the parent to the amount of shareholders' equity of the subsidiary in excess of the minimum equity required by the regulatory authority in the jurisdiction in which the subsidiary is incorporated; this rule against double counting of capital invested in foreign deposit-taking institutions will apply only to future investments;
- for the purpose of limits on investments in real estate described in (5) above, real estate held through a real estate subsidiary would be treated in the same manner as if it were directly held.

In considering the above proposals, it should be borne in mind that the quantitative restrictions represent necessary but not sufficient conditions to meet the general requirements of prudence, diversification, and a reasonable degree of matching. These limits, therefore, could only be approached by institutions that otherwise were in accordance with sound principles governing their investments.

The following panel provides some perspective on the broad implications of the rules suggested above for a company levered about 20 times:

	Per cent of assets
Non-quality mortgages	Maximum 5
Consumer and commercial loans	Maximum 15
Subsidiaries	Maximum 5
Real estate, common stock and non-income-producing property other than real estate and common stock	Maximum 5
Preferred shares	Maximum 10
Debt securities and quality mortgages	Minimum 60
Total	100

Companies whose portfolios are not in compliance with the rules that are adopted would be given a reasonable transition period to comply.

It is not possible to provide a detailed comparison of these proposed limits with the various quantitative limits in the existing legislation because these proposals reflect a categorization of assets that is not present in the existing legislation. For example, at present the investment rules do not address specifically the terms "non-quality mortgages" or "non-income-producing" property. However, for broad comparative purposes, it might be noted that: (i) consumer and commercial loans are now generally limited to the "basket clause" (i.e. 7 per cent of assets) compared to the proposed limit of 15 per cent of assets, (ii) the aggregate of investment in subsidiaries roughly approximates the proposed limit of 5 per cent of assets, (iii) there is currently no maximum limit on preferred shares, and (iv) at present there is no minimum percentage of assets required to be in the form of debt securities and quality mortgages.

2. Life Insurance Companies

The rules for life insurance companies would generally be the same as the rules for trust and loan companies. However, because a significant portion of the liabilities of life insurance companies are different in nature from those of deposit-taking institutions, there appears to be justification for allowing life insurance companies more freedom to invest in assets that do not pay interest at market rates, such as common stocks and real estate.

Participating policies, under which policy-holders agree to share some of the mortality and investment risk in exchange for potential gains, guarantee interest rates significantly below market. While the expectation of participating policy-holders is that they will receive market rates or better through payment of policy dividends, the dividends themselves are not guaranteed. As a consequence, there is justification for choosing common stocks and real estate to match against some proportion of participating policies.

The limits for investments in common stocks and real estate by life insurance companies would be considered as a function of three factors, namely, shareholders' equity (unappropriated surplus in the case of mutual companies), participating life insurance policy liabilities, and non-participating life insurance policy liabilities. The following limits are proposed for discussion:

	Common stock of venture capital corporations	Common stocks	Real estate	Total common shares & real estate combined
		(maximum percentage)		
Shareholders' equity	10	35	35	70
Participating life insurance policy liabilities	–	25	25	40
Non-participating life insurance policy liabilities	–	15	15	20

As with trust and loan companies, investments in real estate by real estate subsidiaries of life insurance companies would be treated as direct investments of the life insurance companies for purposes of determining compliance with the above limits.

Similar rules will apply to the assets that non-resident companies operating on a branch basis in Canada must maintain on deposit with the Minister. The one significant difference would be that limits expressed in terms of a percentage of shareholders' equity would have to be expressed in terms of a percentage of total assets on deposit.

Regarding subsidiaries, as in the case of trust and loan companies, stock life insurance companies would be restricted to investing in the types of subsidiaries currently permitted, namely, domestic property and casualty insurance companies, foreign life insurance companies, real estate corporations, certain specialized types of service corporations, mutual fund corporations, and ancillary business corporations. Investments in all subsidiaries by stock life insurance companies would be restricted to 5 per cent of total assets and in any one subsidiary to 2 per cent of total assets. Similar rules as noted earlier will also be adopted that will prevent double counting of capital invested in subsidiaries that are financial institutions. However, in recognition that stock companies have already made investments in foreign life companies in circumstances when there were no rules against double counting of capital, investments made in foreign life companies prior to the publication of this paper will be "grandfathered" insofar as the rule against double counting of capital is concerned. All subsequent investments in foreign life companies will be subject to the rule against double counting of capital and will be required to be made out of funds other than participating funds.

Diversification through an upstream financial holding company is not available to mutual life insurance companies. As suggested in the discussion paper, a mutual life insurance company would be permitted to establish a financial holding company as a subsidiary in addition to being permitted to continue to invest in the type of subsidiaries authorized under the current legislation. The financial holding company could then, in turn, own other financial institutions.

However, in response to the concerns for solvency and in the interests of some consistency with the rules suggested for stock life insurance companies, it is proposed that there be rather narrow limits on the amount of funds that mutual life insurance companies be permitted to invest in all subsidiaries, including financial holding companies and financial institutions that are not currently authorized as subsidiaries.

The maximum amount a mutual life company would be permitted to invest in all types of subsidiaries, therefore, would be 5 per cent of its assets. The limit on the amount invested in a particular subsidiary would be 2 per cent of assets except if a mutual company decides to hold its subsidiaries through a financial holding company. In this circumstance, the limits would apply as if the subsidiaries of the financial holding company were held directly by the mutual life company – the holdings would be combined for purposes of determining the maximum amount that could be invested in the financial holding company. However, in no circumstances could this amount exceed 5 per cent of the mutual life company's assets.

In recognition that these limits are very narrow and in order not to adversely affect dividends to participating policy-holders, a mutual life insurance company would not be required to appropriate surplus to eliminate the effect of double counting of capital invested in a financial holding company or financial institution subsidiary.

In addition mutual life insurance companies would have access to outside shareholders' funds. This would have the effect of both reducing the constraining impact of these limits on the subsidiaries and providing a useful market test of the transaction.

It might be noted that when investment limits for life insurance companies are expressed in terms of total assets, assets of segregated funds will be excluded.

3. Property and Casualty Insurance Companies

The rules for property and casualty insurance companies would generally be similar to those proposed for trust and loan companies. However, the nature of their liabilities raises the importance of liquidity considerations to a property and casualty insurance company and dictates that there should be some flexibility, although only in respect of common stock, rather than both stock and real estate which is suggested in the case of life insurance companies.

Therefore, the limits for investments in real estate and common stocks for property and casualty insurance companies would be the same as noted above for trust and loan companies, except the common stock limit would be 100 per cent of shareholders' equity, rather than 50 per cent. Furthermore, total holdings of real estate and common stocks should not exceed 150 per cent of equity.

Property and casualty insurance companies would continue to be authorized to invest in insurance company subsidiaries and in ancillary business corporations as is permitted under existing legislation. While the existing legislation eliminates the double counting of capital of a second property and casualty insurance subsidiary, new rules will be developed that will have the effect of also eliminating double counting, both in respect of past and future investment, in circumstances where the subsidiary is a life insurance company. Stock companies will be limited to investing 5 per cent of total assets in subsidiaries and 2 per cent of total assets in any one subsidiary.

Mutual property and casualty insurance companies will have the flexibility to diversify through a downstream financial holding company. However, given the volatile nature of the property and casualty business, it is proposed that there be tighter control on such investments than for mutual life insurance companies. Investments in all subsidiaries will be limited to 5 per cent of total assets and the investment in one subsidiary will be limited to 2 per cent of assets but, in addition, unlike the situation for mutual life companies, no double counting in respect of capital in a financial holding company or a financial institution subsidiary will be permitted.

4. Federally Regulated Financial Co-operatives

The investment rules for federally regulated financial co-operatives would be similar to those for trust and loan companies. One difference would be that these institutions could not make consumer loans. Another difference relates to the investments in subsidiaries. If, as proposed earlier in this paper, financial co-operatives were permitted to create a financial holding company that in turn could operate financial subsidiaries, e.g. trust company, Schedule C bank, etc., it would seem reasonable that the total invested in the financial holding company should not exceed 5 per cent of assets as in the case of mutual life companies. However, unlike the proposal respecting mutual life companies, the financial co-operatives would face rules against the double counting of capital similar to those proposed for other kinds of financial institutions.

While the rules would be essentially the same as for other institutions, it is likely that, in practice, the greater importance of liquid funds for the co-operative institutions would result in substantially different investment strategies.

5. Investment Rules for Pension Funds

The principles underlying the investment rules for registered pension funds would be similar to those for the federally regulated non-bank financial institutions. However, given the differences in the nature of liabilities, there would be room for differences in the application of these principles.

The "prudent portfolio" system for pension fund investments would consist of a number of legislated requirements. To ensure that appropriate investment strategies were in place and being observed, the following rules are proposed:

(1) Pension fund portfolios would be required to be invested in a prudent manner appropriate to the rules and objectives of the specific pension fund. Such rules and objectives would be clearly set forth in the contract governing the pension fund between the plan sponsor and its members.

(2) The trustees of the fund would be required to establish specific investment criteria in accordance with these rules and objectives and the duty of prudence, which the fund managers would then be required to observe. The duty of prudence would extend to the pension fund managers who would be presumed to be professionals in their ability and would be judged by professional standards.

(3) The trustees of the pension fund would be required to create a management committee, which would include representatives of management and of plan members, if requested by a majority of members, to oversee compliance with the rules and objectives of the plan.

To limit the exposure of the fund to individual investments that could expose the fund to undue risk, the following rules are proposed:

(1) To ensure an appropriate diversification, the amount that could be invested in the securities of any one business or group of related businesses would be lowered from the present limit of 10 per cent of the fund's total assets to 5 per cent.

(2) Regulations governing self-dealing and conflicts of interest would be strengthened in line with the overall approach for financial institutions.

(3) The aggregate amount invested in real estate and resource properties combined would be limited to 25 per cent of total assets, with investment in resource properties being limited to 15 per cent of total assets. In addition, the total amount invested in any one parcel of real estate or any one resource property would be limited to 5 per cent of

total assets (this latter restriction would also apply to groups of contiguous parcels or properties).

(4) The current limit of 30 per cent of the voting stock of any one corporation that could be held by a fund would be lowered to 10 per cent. However, special rules will be considered to allow for greater control by pension funds over venture capital investments.

(5) Except to protect a security position, investments in assets which are in default with respect to interest and principal would be generally prohibited.

To provide for proper supervision, the following rules are proposed:

(1) The portfolio of securities and the year's trades would be disclosed to the Superintendent of Insurance and to the pension fund's management committee on an annual basis. Employees will also have access to other actuarial and financial information on their plans which will have to be readily available to the authorized agents of the plan member or the spouse. Financial data also will have to be made available to the bargaining unit. In addition, immediate disclosure would be required of any transaction exceeding a value of 3 per cent of the pension fund's assets.

(2) The Superintendent of Insurance would have the power to exclude from a pension fund's asset valuation any asset whose value could not readily be determined. Where no clear market value existed, the Superintendent could call for an independent valuation, possibly at the pension fund's expense.

Finally, consequential amendments would be made to the Income Tax Act to prevent tax arbitrage.

The government recognizes that the proposals outlined above, if adopted, could create transitional difficulties for individual funds. An appropriate transition period would be provided and, on a case-by-case basis, the government would be prepared to discuss additional measures.

It is clear that full co-operation and co-ordination between the federal and provincial governments will be needed to ensure the realization of full benefits from any change to pension fund investment rules.

A more general discussion of the philosophy underlying these proposals is contained in the Appendix to this paper.

H. Modernization of Legislation

Federal legislation applicable to non-bank financial institutions, although changed on a piecemeal basis over the years, has not been revised in a comprehensive manner in many years. The legislation has not kept pace with the rapid changes in the Canadian financial system and is badly in need of major overhaul.

Therefore, in addition to dealing with the major policy issues described earlier, the government wishes to modernize and rationalize the legislation governing federal non-bank financial institutions to bring this legislation into line with modern approaches to corporate law and sound business practices.

Some preliminary steps have already been taken. The discussion paper on revision of the Trust Companies Act and the Loan Companies Act released by the Department of Insurance in July 1982 contained a number of proposals on this subject. Further, some preliminary views on the subject have already been exchanged between officials of the Department of Insurance and associations representing the members of the insurance, trust and loan and financial co-operative sectors. The discussion below builds on this base. In particular, it outlines some of areas where the government feels modernization and rationalization could be effected and provides some idea of the approach to this task that, in the view of the federal government, may be appropriate.

Consolidation of Legislation

In reviewing governing legislation, the desirability and feasibility of consolidating some of the various pieces of legislation will be considered. Possible candidates for consolidation are the acts governing federal trust and federal loan companies. The two acts governing insurance companies could also be combined into a single piece of legislation.

The existing Trust Companies Act and the Loan Companies Act historically have been substantially similar, with the major differences involving certain corporate powers and consequential issues. From the government's point of view, the consolidation of these acts into one statute would be simpler not only from a legislative point of view but also in terms of supervision and regulation. The 1982 discussion paper on trust and loan companies advanced this notion and there do not appear to be any significant reasons for not proceeding in this direction.

Insurance companies, meanwhile, have been regulated under different statutes depending on their country of origin. Domestic insurance companies and Canadian branches of insurers incorporated in the United Kingdom and other Commonwealth countries have been regulated under the Canadian and British

Insurance Companies Act. The Foreign Insurance Companies Act, meanwhile, has applied to the Canadian branches of insurers incorporated elsewhere. This separate treatment of Commonwealth and non-Commonwealth insurers no longer appears to be necessary. It is proposed, therefore, that these two statutes be consolidated and that similar provisions apply to the Canadian branches of all foreign-owned insurance companies, regardless of their country of origin.

Modernization of Corporate Governance

Much of the recent work in modernizing corporate law has involved the Canada Business Corporations Act (CBCA). With regard to financial institutions, the most modern piece of federal legislation is the Bank Act which was last revised in 1980. The government proposes to use, where applicable, these two pieces of legislation as models in updating the legislation applying to non-bank financial institutions.

The 1982 discussion paper relating to trust and loan companies broached the idea of updating corporate governance provisions using the CBCA as a model. This approach has also been discussed with the insurance industries. In general, this approach has been received favourably. The government recognizes, however, that financial institutions are unique in some ways and that the special features of many of these institutions will have to be taken into account in formulating legislation. For example, the CBCA provisions may not be appropriate for financial co-operatives in view of their unique structure. Similarly, modifications of these provisions would seem necessary to take into account the unique considerations in respect of participating policy-holders in insurance companies.

One of the most significant changes that would result from using the CBCA as a model would be that federal trust, loan and insurance companies would acquire the capacity of natural persons. At present, these institutions are or are deemed to be "special act" corporations, meaning that they have only those powers explicitly provided in their governing legislation. The proposed new status would give these institutions the same general corporate powers as have already been granted to commercial corporations and to banks: that is, subject only to such restrictions as are in their governing legislation, they would be able to engage in any business activity that would be lawful for a natural person.

Role of Directors

It is important for efficiency that the regulation and supervision of financial institutions not impose excessive rigidities on the financial system. In this respect, the stronger and more thorough is self-regulation by institutions, the smaller the role that government needs to play. It would be natural to look to the board of directors as the group within an institution that could provide such an enhanced internal scrutiny of operations. (It is of interest to note that the value of an enhanced role for boards of directors has been previously noted. Both the Porter Royal Commission on banking and the Bryce Royal Commission on corporate concentration advocated strengthening the role of boards of directors in monitoring the activities of management.)

The government wishes to move forward on this issue. It is, therefore, putting forth for discussion some proposals that might enhance the existing role of directors in the management of financial institutions.

One argument for placing a greater burden of supervision on directors is that boards of directors for financial institutions are already charged with a fiduciary duty towards their corporations. There is, therefore, an existing base in law on which to build an enhanced role. As well, there has been a development in the marketplace of professional directors who purport to, and appear actually to, exercise higher standards than those currently required in legislation. Building an enhanced role for directors in legislation would, therefore, recognize these developments and promote conformity with these higher standards.

The intent of the following suggestions is threefold.

(1) They seek to raise the standard of care that the director would be expected to exercise from that of the ordinary prudent person to that of an experienced business person qualified to be a director of a regulated financial institution.

(2) They would seek to raise the standard of supervision and attention given by directors to the affairs of their institution by requiring closer attention to those affairs. Currently, the level of diligence required of directors is one of a reasonably prudent person.

(3) They seek to improve the functioning of boards by ensuring they remain of a manageable size and maintain independent judgement.

Some of the individual suggestions provided below are already in use in some Canadian legislation and others are in use abroad. The suggestions listed should be considered as a package for general application in all financial institutions legislation.

To make it possible to require the higher standard of judgement that is contemplated, the following rules are suggested:

(1) There would be criteria for personal qualification for this office based on an appropriate blend of expertise, experience and personal suitability.

(2) Directors would be required to exercise the standard of judgement expected of a prudent and experienced business person qualified to be a director of a regulated financial institution.

To increase the standard of attention that directors would be expected to bring to their corporation's affairs, the following rules are suggested:

(1) Directors would be required to be well informed about the business affairs of their companies on an up-to-date basis.

(2) Attendance requirements would be placed upon board members. Directors would be required to attend a minimum of three-quarters of the meetings authorized by the Chairman.

To improve the functioning of boards of directors, some additional measures might be considered, including limitations on their permissible size. One recent study of the workings of boards of directors of Canadian corporations concluded that "The size of these boards reportedly makes them unwieldy, formal in approach, and largely incapable of fulfilling the purposes for which they were intended". (Canadian Directorship Practices: A Critical Self-Examination, Conference Board of Canada, December 1977, p. 149.) The following rules could be considered in this vein:

(1) Numerical limits would be placed on the size of the boards of financial institutions: a maximum of 25 members and a minimum of five. By implementing an upper bound on the size of boards, the significance of the votes of individual directors would be maintained.

(2) Interlocking directorships involving financial institutions that were not affiliated or related would be prohibited. At present, a similar prohibition applies to board members of the chartered banks. However, it is being proposed that affiliated financial institutions could have up to 25 per cent of their directors serving on more than one board, as could a financial holding company and its related institutions. The government intends to discuss the proportion of the boards that would have to consist of outside directors.

While these enhanced regulations would not apply to provincially regulated financial institutions (even though they might be related to a federally regulated financial holding company), the federal government hopes that provinces would adopt similar standards in the common interest of promoting the soundness of financial institutions and the stability of the financial sector.

It may also be useful in the course of the review of financial institutions legislation to bring uniform standards to other aspects of the regulation of directors' behaviour. Some areas where this would be particularly useful, given the enhanced role contemplated for directors, are conflicts of interest, penalties for breach of duties and indemnification against costs where penalties have been levied.

The penalties that would apply for violations of statutory duties would be reviewed with the objectives of providing similar standards for directors of all types of federally regulated financial institutions and ensuring that those standards would reflect the greater responsibilities contemplated for directors. One penalty that could be considered would be to allow the regulators to suspend or remove directors for persistent violations of statutes, regulations or guidelines.

Directors could not be held responsible for decisions or inaction where, for example, fraudulent information had been supplied, although prudent directors would be expected, as a matter of course, to question the accuracy of information where the business experience of an experienced and competent director would suggest that information provided was open to question. In respect of such circumstances, the Bank Act contains comprehensive provisions for indemnification of a director against the costs and expenses incurred in respect of a civil, criminal or administrative action to which the director was a party, where the defence was successful. Even if the defence is not successful, indemnification could be provided if the director acted honestly and in good faith with a view to the best interests of the institution, and if the director had reasonable grounds for believing that his or her actions were lawful. It would seem useful to provide such indemnification provisions for all directors of regulated financial institutions.

The enhanced role of directors that is contemplated for operating financial institutions would also apply to directors of regulated financial holding companies. Regulated financial holding companies, through their potential influence over the decision-making of a broad range of types of financial institutions, could become an important centre of new creative energy and direction for Canada's financial system. It is important, therefore, that these institutions meet the same high standards of corporate behaviour as are expected of operating financial institutions.

A somewhat broader role could be considered for directors of regulated financial holding companies. For example, these directors could be required to provide the same type and degree of supervision of the management of a controlled financial institution as could be expected of a prudent director of the subsidiary institution itself.

Another similar concept that may be relevant and worth exploring is that of giving recognition in law to a "corporate group responsibility" that would be placed on directors of controlled subsidiaries of a regulated financial holding company. The usefulness of such a concept can be illustrated by a case where some members of a group of related institutions are cash rich while others in the same group are in need of a capital injection. In this case, the narrowly-defined interests of the cash-rich institutions might be to utilize their strong position to expand. In law, this would be the interest that their directors would have to serve. However, the interests of the group as a whole might be better served if the healthy institutions were to declare dividends to the financial holding company for injection as additional capital into their ailing affiliates. It should be clear, however, that dividends could only be paid to the financial holding company if there is no threat to the capital base of the healthy institution, and any dividend payments would be disclosed to the supervisory authorities. The concept of group responsibility could be invoked in such circumstances to permit directors to vote against the narrowly-defined interests of their own corporation.

To implement such a concept, it would be necessary to recognize in law the possibility of duties on the part of directors to corporate or natural persons other than those normally considered within the directors' duty to the corporation of which they are members of the board. It is recognized that, in practice, it would generally not be possible to apply such a principle for controlled companies that have significant minority shareholders since the directors' duty to these minority shareholders would then be in conflict with their responsibility to the group.

Defining "Capital" for Regulated Financial Institutions

It is clear that with ongoing developments in the market, a continuing review of the definition of capital for regulated financial institutions is appropriate. At present, a wide variety of instruments can be, and indeed often are, counted as capital on financial institutions' balance sheets. This reflects the development over time of a varied group of instruments whose characteristics include some associated with "capital" and some associated with "debt". In a general sense, equity-like (i.e., capital-like) instruments would be those which:

(1) never have to be repaid, except in the case of liquidation (i.e., there is no maturity date and the instrument is not redeemable) and on liquidation would be subordinated to the claims of depositors and policy-holders;

(2) permit the suspension of the payment of income (in the form of interest or dividends) should changes in the income stream of the issuing company require such action;

(3) contain no restrictive covenants which could prevent the company from making future equity issues.

It is recognized that the types of instruments that are counted as capital at present may not always meet these conditions. Naturally, if changes are made to the definitions, institutions whose capital base would not conform with the new rules would be provided with suitable transition periods or other arrangements to achieve compliance over time.

Networking

The term "networking" when used to describe arrangements between financial institutions means a contractual arrangement under which one of the institutions provides the public with access to an investment, contract or service issued by the other, either alone or in conjunction with some other investment, contract or service of its own or of the other institution. It has been suggested that these arrangements could add flexibility to financial institutions and facilitate the offering of more comprehensive financial services packages to individuals and corporations. Moreover, it has been suggested that networking arrangements could contribute to a more effective use of distribution systems already in place and thus increase the efficiency of the financial system as a whole.

In general, the government believes that, provided appropriate safeguards are in place, permitting financial institutions to "network" each other's services represents one way of providing flexibility to the financial system and is consistent with allowing market forces greater sway to shape the structure of the industry. The government proposes, therefore, to remove existing legislative impediments to the networking of financial services. The inference should not, however, be drawn that the government is promoting such arrangements or the concept of "one-stop shopping". The proposed changes only permit such development since there seems to be no fundamental reason to prevent them. Customers would always have the option of diversifying their purchases of financial services among several companies.

Rule changes to permit networking would not supersede any provincial regulations regarding the distribution of financial services. Moreover, they would apply at this time only to the non-bank financial institutions and the Schedule C banks. Policy for the existing banking institutions would be reviewed during the revision of the Bank Act scheduled for 1990.

For trust and mortgage loan companies, insurance companies, and co-operative credit associations, the current impediments to networking result from the fact that this activity was not expressly considered at the time their legislation was drafted or subsequently amended and hence no explicit power to engage in this activity was provided in the respective acts. These institutions are generally limited to those powers explicitly bestowed by their governing legislation owing to the fact that they are or are deemed to be "special act" corporations.

This situation would be remedied by the proposed modernization of the legislation, one aspect of which involves granting these institutions all the powers of a natural person subject to such restrictions as are contained in the respective legislation. With this change in the status of these institutions, networking would be permissible unless explicitly prohibited. The government proposes therefore not to include restrictions on the ability of these institutions to network except to reinforce the proscription in competition policy on tied-selling, which would be explicitly prohibited in the legislation governing the respective institutions.

For Schedule C banks, as previously noted, any restrictions in the Bank Act that now restrict networking would not apply.

The removal from the law of impediments to networking would constitute only part of the task. Before institutions could engage in networking, they would have to qualify the necessary personnel and to meet all applicable regulations, including those of the provinces, controlling entry into the businesses involved. As well, appropriate arrangements would have to be laid down under which this activity could take place. The following are some examples:

(1) Arrangements would have to be made to avoid the commingling of the funds of different institutions.

(2) Where the personnel of one institution was providing access to the products or services of another institution, the role of those persons would have to be stipulated precisely in the contractual arrangements between the two institutions. For example, the role could be one of agent on behalf of the institution whose products were being marketed through the networking arrangement. Alternatively, institutions could establish formal "seconding" arrangements whereby personnel would be shared by the two institutions, working for the particular institution whose products they might be marketing at the moment.

(3) Customers would have to be informed clearly as to the identity of the contracting party and its affiliated and related institutions, in all transactions arranged through networking arrangements.

(4) Where savings instruments were offered, customers would also have to be informed clearly as to the types of instruments which are not insured.

The government will discuss with institutions these and other ground rules for this activity.

Initial Capitalization

The government considers that the minimum amounts of initial capital required to establish new institutions in the trust, loan and insurance industries should be substantially increased. The table below provides the proposed minimum levels for the various types of institutions, compared to the current minimum levels stipulated in existing legislation. The government would consider allowing a trust company doing only fiduciary business and no savings deposit business to be formed for less than indicated. Additionally, the government proposes to stipulate that higher amounts may be required by the Minister if the proposed business activities of a company seem to warrant such action. For example, higher amounts would probably be necessary in the case of an insurance company that expected to concentrate its business in highly specialized risk areas, e.g., mortgage insurance.

Proposed Minimum Levels of Start-up Capital

	Current statutory levels	Proposed statutory levels
Trust companies	$1 million	$5 million
Loan companies	$0.5 million	$5 million
Life insurance companies	$2 million	$6 million*
Property and casualty insurance companies	$1.5 million	$5 million

* A somewhat higher level of start-up capital seems appropriate in the case of life insurance companies because the cost of developing a portfolio of life insurance business generally places considerable strain on capital resources in the initial years as a result of the marketing and distribution system used.

It also appears that minimum continuing capital requirements should be enhanced where such measures exist and implemented for those institutional groups where they are lacking. The existing legislation applicable to trust and loan companies establishes minimum continuing capital requirements through the mechanism of a prescribed "borrowing ratio". At present, the maximum borrowing ratio that can be prescribed is 25 times and companies seeking approval for a borrowing ratio in excess of 20 times must meet certain specified financial standards. Property and casualty insurance companies are also subject to minimum continuing capital requirements, commonly known in the industry as the Section 103 requirement. In simplified terms, property and casualty insurance companies are required to maintain capital of at least 115 per cent of claims reserves and a proportion of unearned premium reserves, the proportion varying depending on the company's claims experience.

It may be desirable to refine or strengthen these requirements. The government intends to pursue this matter with the industries concerned. Some discussion has already taken place between the Department of Insurance and the property and casualty insurance industry in regard to strengthening the Section 103 requirement.

There have been no minimum continuing capital requirements for life insurance companies, the justification being that the margins in the actuarial reserves would provide adequate protection. With the rapidly changing nature of the life insurance business and increased freedom for valuation actuaries to choose assumptions, it appears that it would be desirable for the legislation to give the Minister the authority to prescribe minimum continuing capital requirements by regulation. A possible minimum standard has already been proposed to the life insurance industry by the Department of Insurance, and the government intends to continue discussions in this regard.

Industry-Specific Proposals

In addition to these general proposals for updating the existing legislation applicable to trust, mortgage loan and insurance companies as well as financial co-operatives, the government will also be addressing matters of particular relevance to each group. A summary of the more significant of such matters follows.

1. Trust and Mortgage Loan Companies

The 1982 discussion paper concluded that, for a number of reasons, it would be useful to replace the guaranteed trust concept for trust companies' deposit-taking with the debtor/creditor concept which applies to deposit-taking by mortgage loan companies and banks. These reasons still appear valid.

2. Life Insurance Companies

There are several issues of concern to life insurance companies arising from the fact that individual companies may have both participating and non-participating policy-holders.

One of these issues concerns the segmentation of assets. The existing legislation requires life insurers to maintain separate and distinct accounts as respects their participating insurance business on the one hand, and their non-participating business on the other hand. The legislation further specifies a minimum percentage of distributable profits arising from participating business that is to be allocated to participating policy-holders. Although separate accounts are required to be maintained for participating and non-participating business, the legislation does not permit the allocation of specific assets between the two types of business. As a consequence, investment income and realized gains and losses have to be allocated between the two types of businesses using a "mean fund" or similar allocation method. As the life insurance business changes, the difference in the nature of participating and non-participating liabilities is increasing and it is becoming exceedingly important to appropriately match assets and liabilities. The fact that specific assets cannot be allocated to each of participating and non-participating business hampers the achievement of appropriate matching of assets and liabilities. This difficulty could be eased if segmentation of assets (i.e., separate allocation of assets to the non-participating and the participating accounts) were permitted. Segmentation of assets would, however, raise other concerns, as there might be a tendency to allocate lower-yielding assets to the participating account. The government will be seeking the views of interested parties in developing detailed proposals relating to this matter.

A separate issue of importance for mutual insurance companies, particularly as regards their possible participation in the proposed financial holding company approach, is the criterion for determining their residence status. In the case of a stock company, it is generally accepted that its residence status depends on the residence status of the holders of the majority of its outstanding stock: if the majority of the voting stock is held by non-residents, then the company is considered to be non-resident as well, even though it may be incorporated in Canada. In the case of a mutual insurance company, however, the situation is less clear.

In effect, the "owners" of a mutual life insurance company are its participating policy-holders. As a result, a mutual life company that does an extensive amount of business abroad could be in a position of having at any point in time the greater proportion of its voting participating policy-holders residing abroad. At issue is whether this situation would necessarily imply that the company be considered non-resident for the purposes of foreign-ownership rules in legislation relating to financial institutions.

There are, in this connection, a number of possible considerations. First, under the Canadian and British Insurance Companies Act, the majority of the board of directors must be made up of Canadian residents normally resident in Canada, and in practice the proportion of Canadian resident directors for Canadian mutuals tends to be much higher. Moreover, under federal law, the head office of a federally incorporated company must be situated in Canada. These factors, it would seem, should also be weighed when determining the residence status of mutual companies.

To clarify the situation, the government proposes the following rule for determining the residence status of mutual life insurance companies incorporated under the Canadian and British Insurance Companies Act: a Canadian mutual life insurance company shall be considered a resident corporation regardless of the residence of the majority of its policy-holders provided that 75 per cent or more of the board of directors is composed of Canadian citizens normally resident in Canada. Such a rule would not be considered relevant for other types of corporations.

The government is sympathetic to the concerns of non-resident companies and Canadian companies controlled by non-residents about certain restrictions in federal legislation, other than insurance legislation, that effectively preclude these companies from investing in some sectors of the Canadian economy (e.g., provisions under the Broadcasting and Communications Act and the Canadian Ownership and Control Determination Act, and others such as restrictions on investment in newspapers etc.) even though such investments might be made with the funds of and for the benefit of the Canadian policy-holders of these companies. Accordingly, the government will be giving consideration to possible ways to respond to the concerns of these companies.

3. Property and Casualty Insurance Companies

In recognition of the fact that some companies have experienced financial difficulties as a result of ceding excess amounts of their business to reinsurers not authorized to do business in Canada, the government proposes to place some limits on the access of federally regulated direct writing insurers to the unauthorized reinsurance market. In general, it is proposed that direct writing companies not be permitted to place more than 50 per cent of their reinsurance with reinsurance companies not authorized to do business in Canada.

It also must be recognized that a direct writing company remains ultimately liable in the event that a reinsurer is unable or unwilling to pay and this should be taken into account in considering continuing capital requirements. The government is proposing, therefore, that the new supplemental continuing capital requirements being discussed with the industry not be permitted to be reduced, by virtue of business ceded to reinsurers, to less than 50 per cent of the amount that would be required were no reinsurance in place.

Further, as inadequate claims reserves appear to have been a factor in the failure of some companies, companies will be required to submit reports by an independent actuary or other qualified person certifying that the provision made for outstanding claims represents a fair and reasonable estimate of the amounts that will be required to settle the claims. A similar report will be required as respects the adequacy of a company's unearned premiums to cover claims that may be reasonably expected to occur during the unexpired periods of the policies in force.

To motivate companies to follow sound underwriting practices, it is proposed that they be required to retain for their own account a minimum percentage of gross premiums written. In addition, in the interest of improving the quality and collectability of assets, the period during which premiums due from agents can be recognized as assets will be shortened.

4. Financial Co-operatives

To broaden the sources of capital funds available to financial co-operatives, the government intends to permit these financial institutions to issue, subject to approval by supervisory authorities, such additional types of instruments as would qualify as capital instruments for other types of regulated financial institutions under controls similar to those imposed on other regulated financial institutions.

The government is prepared to discuss with the financial co-operative sector revised statutory liquidity requirements that would be based on the concept of pooling of liquidity within the entire financial co-operative system.

5. Bank Act

There would also be such consequential amendments to the Bank Act as are necessitated by the modernization of the other financial institutions legislation. In addition, there would be changes to provide for the creation of Schedule C banks. Finally, the government intends to remove the reserve requirement on bank term deposits with a term to maturity of at least a year and which are not encashable for at least a year from their date of issue. This is an action which has been considered for some time but has been delayed pending resolution of the range of business powers to be made available to competing financial institutions.

Appendix

Investment Rules for Registered Pension Funds

The thrust of pension reform has to date been directed toward the improvement of pension benefits and the enlargement of the capability of individuals to provide their own pensions through registered retirement savings plans or, in co-operation with their employers, through registered pension plans. One important element in improving pension benefits is improving investment performance. This also has the potential to reduce the cost of the pensions to be provided. As background for the discussion of investment rules for pension funds, this appendix provides a general discussion of the philosophy underlying, and the relative effectiveness of, systems of ensuring that registered pension funds are safely and effectively invested.

By and large, registered pension funds are managed under trusteed arrangements or by life insurance companies in funds segregated from their other assets. The investment rules for federally regulated registered pension plans are contained in the regulations under the Pension Benefits Standards Act (PBSA). Provincial governments also regulate registered pension plans. In some provinces, the investment rules are entirely separate (e.g. in Quebec). In others, they specify the application of certain PBSA rules (e.g. Manitoba) or rules contained in the Canadian and British Insurance Companies Act (e.g. Ontario). In addition, under Department of National Revenue administrative arrangements, plans not subject to provincial rules are subject to PBSA investment regulations. (The Income Tax Act also imposes certain investment rules on all registered pension funds. The discussion below does not, however, focus on the rules contained in that Act.)

Pension funds have now become major investors in Canada's capital markets and restrictions that in the past were of minor concern could, with the rapid enlargement of pension funds, become a significant impediment to the future functioning of capital markets. With an appropriate system to regulate pension investments, however, this growing pool of capital could contribute significantly to the efficiency of capital markets and the overall performance of the Canadian economy. It has been suggested that a "prudent portfolio" system would provide the freedom that pension funds would need to invest their funds most effectively, without reducing the safety of the assets underlying pensioners' benefits, present and future.

A prudent portfolio system of regulation is one under which the pension fund manager would be given the freedom to choose individual investments provided the portfolio is selected in a "prudent" manner – a requirement discussed in detail later. This type of system has been in operation in the U.S. for 11 years now and pension plans in that country have been able to develop balanced portfolio strategies. In Canada, on the other hand, pension fund managers now seem to be restricting their stock selection to securities of a very few large corporations. Simplifying the investment rules would permit a widening of their selection possibilities with the concomitant benefits of diversification.

In addressing the appropriateness of different approaches to investment rules for pension funds, a number of issues must be addressed. These include: (i) the safety of pensioners' funds, which is central to the choice of a regulatory system for pension asset investment and which has received considerable public attention; and (ii) the role that the registered pension funds play in the Canadian economy. It should be clear that whenever there may be a conflict between policy goals, the safety of pensioners' assets is by far the dominant goal. These issues are discussed in more detail below.

Safety of Pensioners' Funds

An understanding of how pensioners' funds are secured is essential to the discussion of possible changes in investment rules. In the case of financial institutions, such as a trust company or an insurance company, a relatively small equity base backs up their deposits or insurance policies. As a result, stringent rules are required to ensure the solvency of these institutions, including rules on their allowable investments. For registered pension funds, as discussed below, the security provided for pensioners' funds is different. This has some implications for the kinds of investment rules that need to be applied to these funds.

Registered pension plans come in several forms, each carrying different implications for the safety of pensioners' assets.

1. **Defined Benefit Plans**: These plans specify the benefits to be paid on retirement. Generally the plan members pay a contribution that is a fixed percentage of the salary during their working years, although a number of plans do not require any contributions at all from members. The employer then pays the balance of the cost of providing the stipulated benefit (or the entire cost if there are no employee contributions). The employer contributions will vary according to the composition of the workforce employed, as well as the financial results of the plan, including the rate of return realized on the fund's invested assets. Of the roughly 15,000 registered pension plans, about 50 per cent are of a defined benefit nature, covering 75 per cent of pensionable employees and accounting for about 85 per cent of the assets controlled by registered pension plans.

2. **Defined Contribution Plans**: These plans, also known as money-purchase plans, do not stipulate the amount of benefits on retirement in contrast to defined-benefit plans. Rather, the employer and employee contributions are fixed and the amount of the benefit ultimately depends in part on the size of the contributions but also on the rate of return earned on the investment of these contributions. Defined

contribution plans account for roughly 40 per cent of all registered retirement plans, but only about 5 per cent of total registered pension plan assets and 5 per cent of all pensionable employees.

3. **Multi-Employer Plans:** In this type of plan the employer contribution is fixed, generally by collective agreement, and the benefits are also fixed, usually a flat dollar amount, although there are a number of plans that are of the defined contribution type. The plan is typically administered by a board of trustees, representing both labour and management, which is responsible for the investment of the funds, among other duties. Individual employers seldom, if ever, have any responsibility to make up any shortfalls resulting from the operation of these plans, unless this is negotiated subsequently.

Each of the types of plans described above may be fully or partially managed "in-house" or by outside professional managers, such as trust companies and life insurance companies. In addition, the investment of these funds may be managed as single units or they may be fully or partially pooled with other funds. The larger pension funds are normally managed as single units while the smaller funds are generally pooled to take advantage of the benefits of diversification of risk.

As mentioned above, the vast majority of assets controlled by, and employees covered under, registered pension plans belong to company-sponsored defined benefit plans. An important source of security to current and future pensioners covered by these plans is the assets of the sponsoring company itself. Generally, the sponsoring company is responsible for ensuring that the plan is properly funded, i.e., that the value of the assets of the pension plan is adequate to meet its contractual obligations. The additional security provided by the sponsoring company means that the quality of a defined benefit pension plan's investments themselves is not the only assurance of its ability to provide the ultimate pensions. It should be kept in mind, however, that a pension plan currently may be terminated or altered by the sponsoring company in exceptional circumstances, possibly resulting in a redefinition of the agreed-upon benefits.

By contrast, in defined contribution pension plans, the size of the future pensions is dependent on the performance of the investments. The key objective in managing this type of plan, therefore, is the earning of a suitable rate of return while maintaining a reasonable level of risk of the portfolio and the diversification of that portfolio. Because of their generally small size, defined contribution plans pose a difficult challenge in setting up any system of investment rules.

The Importance of Pension Funds in Financing Canadian Corporations

Pension fund assets in Canada represent an extremely large and fast-growing pool of funds. At the end of 1984, the trusteed pension funds managed assets with a book value of $96 billion, up from $85 billion for 1983. At the same time, the life insurance company segregated pension funds controlled assets with a book value in excess of $10 billion. (These are funds segregated from the main body of the assets managed by life insurance companies. For the most part, they represent the pension funds of smaller companies which are pooled together and managed by experts employed by the life insurance companies.)

To put these figures in perspective, the total market value of the equity of companies included in the TSE 300 was $146 billion at the end of 1984, $58 billion of which comprised controlling blocks, leaving a "float" of $88 billion available to individual and institutional investors. The market value of trusteed pension fund assets invested in Canadian common equity was $22 billion at the end of 1983, representing some 25 per cent of the TSE 300 float. Life insurance company segregated funds accounted for another $3 billion, or 4 per cent of the TSE 300 float.

Trusteed pension funds have lately been placing increasing amounts of their investible funds in common equity. A breakdown for 1984 is not yet available. However, during 1983, the trusteed pension funds increased their Canadian common equity holdings by $4.7 billion (because of tax considerations, pension funds hold very little in the way of preferred shares). Trusteed pension funds also increased their holdings of foreign common equity by $1 billion in 1983.

A significant proportion of equity investments during 1983 and 1984 are reported by investment dealers to have been in new share issues and, for the new issues of the larger industrial companies, the pension funds have thus become among the most important investors. To provide some perspective on their importance in this regard, it is worth noting that net new common equity raised in Canadian capital markets in 1984 amounted to about $3.1 billion, $2.2 billion of which was raised by non-financial corporations.

Another important point to consider is that the assets held in many private sector trusteed pension plans are large in relation to the market value of the sponsoring firm's equity. As an example of the importance that a company's pension fund can attain, in 1984, Bell Canada's equity value was $8 billion, while at the same time it was responsible for a pension fund of $3.2 billion. Similarly, Canadian Pacific Railways, with equity of $3.6 billion, was responsible for a pension fund of $2.7 billion. Because most of these plans are of a defined benefit nature, the efficient investment of these funds is important to the overall financial health of the sponsoring firms. A poor rate of return on pension fund investments could result in a drain on earnings of the firms.

The Existing Investment Rules

Canadian pension fund managers operate under various sets of rules regulating how they may invest the assets entrusted to them. The following policy goals were set by the government in assessing these rules:

- safety of the pensioners' assets;
- investment performance of these assets;
- availability of capital for Canadian business;
- efficient functioning of Canadian capital markets.

Although there are a large number of rules having some bearing on pension fund investment, only the major rules acknowledged to have a potential significant impact on investment in corporate securities are reviewed below, along with some of their strengths and weaknesses.

1. Investment Eligibility Rules

Pension plans may invest their assets in a range of government and corporate securities and real estate that meet certain "quality tests". In the case of equities this test requires the company to have paid a dividend, or have earned an equivalent amount, of at least 4 per cent on capital and surplus in at least four of the five previous years, including the last year. There is a corresponding earnings test for real estate. In addition up to 7 per cent of the fund may be invested in "non-qualifying" real estate (i.e. not meeting the quality test), and a further 7 per cent in other securities that do not meet the quality test ("basket clause" investments). If the company subsequently becomes ineligible, the securities that have been purchased may continue to be held indefinitely, although additional securities of the same company may not then be purchased without recourse to the basket clause.

The objective of this rule is to provide security for the ultimate beneficiaries of the fund by attempting to ensure that pension fund managers cannot invest in risky securities. This objective is achieved, however, only to the extent that past dividend and earnings performance is a good guide to the future stability of the firm issuing the security.

One effect of this rule is that it reduces the scope for the application of modern portfolio techniques to optimize returns, at a given level of risk, through diversification. This effect is felt mostly by the larger pension plans that have large pools of funds at their disposal. As discussed below, diversification allows a fund to hold part of its assets in the normally more volatile growth industries along with "blue chip" stocks to achieve a balanced portfolio.

A second effect of this rule is that it limits the amount of equity funding available to firms that, while fundamentally healthy, are for one reason or another unable to qualify. Some firms that fall in this category include smaller firms, firms engaged in cyclical industries (for example resource companies), and firms in emerging new industries. Such firms, it is worth noting, have contributed significantly to new employment over the past decade and have the greater requirement for growth capital. Thus, to the extent that the earnings and dividends rules constrain the access these firms have to new equity, they may have adverse effects for the future growth of the Canadian economy.

2. Quantitative Limits

A number of quantitative restrictions apply to pension funds regulated under the Pension Benefits Standards Act. These are as follows:

- No more than 10 per cent of the book value of the assets of the fund may be invested in the securities of any one individual or corporation.

- No more than 15 per cent of the book value of plan assets may be invested in resource investments, including the shares of special tax-exempt resource corporations and Canadian resource properties held under the basket clauses.

- A separate limit of 10 per cent applies to holdings of both the special tax-exempt corporate vehicles created to hold resource properties and those holding real estate.

- A limit of 5 per cent applies to the total holdings of foreign government bonds.

- Up to 7 per cent of the book value of fund assets may be invested in real estate that does not qualify.

- Up to 7 per cent of the book value of fund assets may be invested in any securities, other than real estate, that do not qualify.

Quantitative limits serve as a safeguard by imposing a minimum of risk-spreading on the fund manager. These rules limit the possibility of a poor performance by one or a few investments severely eroding the value of the fund. While such quantitative limits impose a certain degree of diversification on pension funds, it has been suggested that the current approach of piecemeal limits may not be the best way to achieve this. For example, the "basket" clause, which provides the fund manager with some degree of flexibility to take advantage of obviously good investment opportunities that may not otherwise qualify, has acquired a connotation of non-prudence which discourages many pension fund managers from using it to the extent possible. A more general approach to diversification, which would incorporate some of the quantitative limits above, has been suggested as an alternative worth studying.

3. Self-Dealing Rules

Under the Pension Benefits Standards Act, self-dealing rules prohibit loans other than residential mortgages from a pension fund to plan participants, relatives, and others participating in or closely related to the operation of the pension fund. The obvious importance of self-dealing rules in a trustee relationship, to protect the interests of beneficiaries, suggests that any change should be in the direction of strengthening these rules.

As well, a fund may not hold more than 30 per cent of the common shares of a corporation, the objective being to prevent a corporation from being controlled by a pension fund. In the modern corporate environment, it is no longer clear that control cannot be exercised below the threshold of 30-per-cent ownership and the possibility of lowering the threshold to 10 per cent is therefore being proposed.

4. The Foreign Property Rule

Under the Income Tax Act, a pension fund is penalized for holding more than 10 per cent of its assets in foreign property. This penalty amounts to 1 per cent of the value of the foreign property in excess of the limit at the end of each month. The objective of this rule is to ensure that most pension assets are available for investment within Canada. There are some concerns that the 10-per-cent limit has prevented some plans from achieving adequate diversification and distorts the efficient operation of capital markets. It is proposed in the May 23 budget, however, that this limit be increased by three times the amount of a fund's average small business investments held in the previous year and made on or after January 1, 1986 in Canadian corporations having less than $35 million in assets.

A Prudent Portfolio Approach

In contrast to the present regulations, which are directed toward the selection of individual securities, an alternative "prudent portfolio" system would provide fund managers with guidelines which would permit them to manage the portfolio of assets for the fund in a prudent manner. This approach is outlined in the section of the paper on investment rules for financial institutions and pension funds.

One example of a prudence requirement that could be used in such an approach is a rule proposed by the Ontario Law Reform Commission for trusts. This rule is as follows:

"In exercising the powers of the investment, the trustees and the managers of the pension fund must adhere to the following guidelines:

(1) In the discharge of their duties and the exercise of their powers, whether the duty or power is created by law or the trust instrument, the trustees and managers shall exercise that degree of care, diligence and skill that a person of ordinary prudence would exercise in dealing with the property of another person.

(2) Without limiting the generality of subsection (1), trustees who in fact possess, or because of their profession, business or calling ought to possess, a particular level of knowledge or skill which in all the circumstances is relevant to the administration of the trust, shall employ that particular level of knowledge or skill in the administration of the trust."

The rule above, however, deals only with the issue of prudence. A separate rule would cover the portfolio aspect of the system and could be worded along the following lines:

- The trustees of the pension shall determine the suitability of any investment of the funds of the plan by considering the nature and terms of the investment in light of the rules and investment objectives of the plan and the nature and terms of the other investments of the plan.

Another example, which does deal with the portfolio concept, is the requirement contained in the Employee Retirement Income Security Act (1974) of the U.S. which states that a fiduciary shall discharge his duties with respect to a plan solely in the interest of the participants and beneficiaries and:

(A) for the exclusive purpose of: (i) providing benefits to participants and their beneficiaries; and (ii) defraying reasonable expenses of administering the plan;

(B) with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims;

(C) by diversifying the investments of the plan so as to minimize the risk of large losses, unless under the circumstances it is clearly prudent not to do so; and

(D) in accordance with the documents and instruments governing the plan insofar as such documents and instruments are consistent with the provisions of this title.