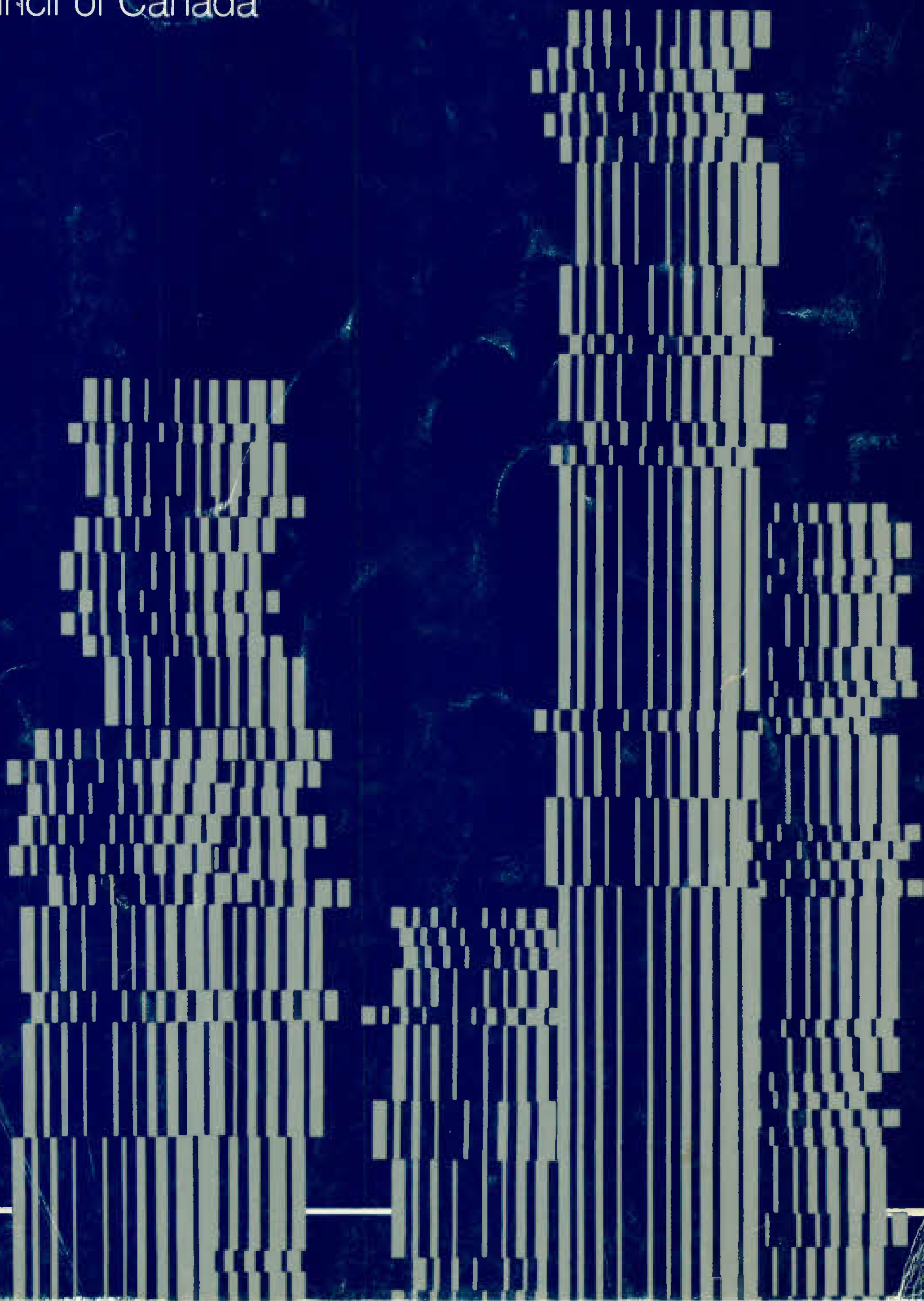
A Framework for Financial Regulation

A research report prepared for the
Economic Council of Canada
1987



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ERRATA

Page 7, second column, line 11, read: "financial future"

Page 50, second column, line 3, read: "The financial leverage of financial institutions"

In Table B-1 (pages 112, 113, and 114), the column heading on the right should read: "Selected liabilities as a proportion of total liabilities"

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Contents

Foreword

The Canadian financial system plays a vital role in the operation of the Canadian economy as a whole. Its sound and efficient functioning has long been of considerable concern to the Economic Council of Canada. The Council previously published three major reports dealing with particular financial issues. Its 1976 report on deposit institutions, *Efficiency and Regulation*, was released prior to the decennial review of the *Bank Act*. This was followed in 1979 by *One in Three*, an examination of the issues surrounding the operation of the Canadian pension system. In 1982, the Council published *Intervention and Efficiency*, a study of government credit and credit guarantees available to the private sector.

In March 1985, the Council was prompted by a number of factors to launch a study of the regulations affecting the activities of Canada's financial intermediaries and agents. Foremost among them was the fact that far-reaching changes were occurring in the operations and scope of activities of financial institutions. While many of these changes were welcome because they contributed to greater competition, improved efficiency, and the provision of new services designed to meet new consumer requirements, they also included developments that were cause for growing concern. For example, in some cases, financial institutions were able to escape federal and/or provincial regulatory controls; in other cases, the effectiveness of the existing regulatory mechanisms had been impaired. Also, a succession of failures in the financial industry inevitably raised pressing questions about the continuing soundness of the financial system as a whole. The Council concluded that an in-depth examination should be undertaken in order to arrive at proposals aimed at improving the effectiveness of regulatory control over the financial system; strengthening public confidence in its stability; strengthening its ability to adapt to the changing needs of the Canadian people; and enabling it to compete in rapidly changing international financial markets.

The Economic Council has three related objectives in any research project: to provide relevant policy advice to decision makers, to enhance public understanding of key economic issues, and to advance the boundaries of knowledge on those issues. The policy-advice and public-education goals are best met through shorter reports written for a lay audience, while the advancement of knowledge requires more in-depth analysis and explanation to meet the needs of expert analysts. Accordingly, the Council has prepared two volumes to summarize the results of this research project. A short statement containing 31 recommendations by the Council was published in November 1986. These recommendations are based on extensive factual study and analysis reported in this longer volume. They are reproduced in Chapter 7.

An Advisory Committee composed of four Council members and five outside experts who, together, represented the major financial institutions and consumer interests, has reviewed the text of this report. More generally, the Committee acted as a valuable sounding board, providing guidance to the research team and suggesting changes to this report. On behalf of Council, I would like to thank the Advisory Committee for its valuable and much appreciated contribution.

Judith Maxwell
Chairman

A Framework for Financial Regulation

READER'S NOTE

The reader should note that various conventional symbols similar to those used by Statistics Canada have been used in the tables:

--	amount too small to be expressed
-	nil or zero
. .	figures not available
. . .	figures not appropriate or not applicable
e	estimated figures
x	data confidential, to meet the secrecy requirements of the *Statistics Act.*

Details may not add up to totals because of rounding.

A glossary of the major technical expressions found in the text appears at the end of the report. These expressions are printed in boldface upon their first appearance in the text.

1 A Changing Financial Environment

As this report is being written, financial markets and financial institutions are at a crossroads. The evolution of the Canadian financial system will be shaped in large part by public decisions that will be made within the next few years. Indeed, pressures for change come from everywhere. The development of technology is already changing the configuration and operation of the financial system in Canada and throughout the world. Sophisticated communications systems have brought the various international financial centres closer together and have brought round-the-clock trading one step nearer to reality. Automated banking machines that can handle many financial transactions (the deposit or withdrawal of money, the payment of bills, the purchase of certificates of deposit, the opening of a registered retirement savings plan, foreign-exchange transactions, and so on) are seriously being tested today. The **securitization** process of assembling car loans, mortgage loans, and operating loans in pools that issue share units to individual and corporate investors has started, although it is more advanced in the United States than in Canada.[1] Financial centres offering a diversity of financial products are in the making: The Laurentian Group has already opened one in Montreal.

In such a fast-changing world, many institutions are unhappy with the existing legislative framework and lobby intensively for greater scope in their operations. Most vocal are the chartered banks, insurance companies, trust companies, and securities firms, the so-called four "pillars" of the Canadian financial system, which have been kept separate by existing legislation - the federal *Bank Act*, federal and provincial legislation governing trust and loan companies and insurance companies, and provincial regulation of investment dealers and securities trading. All operate on the basis of a separation between the major categories of institutions each of which is performing specific activities. (Financial cooperatives - credit unions and caisses populaires - are often viewed as constituting a fifth pillar.) But that separation is eroding, and the rationale behind it is often forgotten; thus the demands for change.

The fact that the Canadian financial system finds itself at a crossroads is underscored by the number of reports and studies undertaken on this subject and by the accompanying public debate. In the spring of 1985, the federal government released a Green Paper[2] on the regulation of financial institutions and the Wyman Report on deposit insurance.[3] These were followed by hearings in the House of Commons and the Senate, which produced the Blenkarn Report[4] and the Senate Committee Report on deposit insurance.[5] In December 1985, the Ontario government released the report of its task force on financial institutions,[6] and a second report was released by the Senate in May 1986.[7] In October 1986, the Honourable Mr. Justice Estey, Commissioner of the Inquiry into the collapse of the Canadian Commercial Bank and the Northland Bank, released his findings on the circumstances surrounding these bank failures.[8] All of these hearings and reports gave rise to many briefs and submissions by academics, industry representatives, consumer groups, and other interested parties. All have made an important contribution to the understanding of many of the issues at hand, and in particular of the source of concern that was their specific focus of investigation. But depending on the report and on the issue, one can derive different visions of the organization of the Canadian financial system in the coming decades (see Appendix A). Our own report attempts to take a broad view of all the various issues that have surfaced in recent debates and to place them in the context of a consistent framework that will lead to needed reforms to the existing regulation of financial institutions.

An adequate regulatory framework is needed because the financial system performs a key role in the economy. Traditionally, it has been seen as facilitating the transfer of funds from ultimate lenders to ultimate borrowers. In doing so, it is also involved in the transformation of assets and of risks.[9]

The financial system also performs an important safekeeping role. Individuals or businesses entrust the funds that they have put aside for future use to financial institutions through deposits or other instruments. The financial system also provides the **means of payment** used in the economy. Banks, credit unions, trust companies, and even brokers (through their **cash-management accounts**) perform such a function today. They offer chequing facilities to transfer the funds entrusted to them. Some institutions, such as banks, credit unions, and trust companies, create means of payment in the intermediation process.

Finally, financial institutions are deeply involved in the supply of financial information and advice. This has become increasingly important, particularly in view of the growing number of financial products and market participants, but also in view of the growing complexity of financial transactions and of the increased magnitude of the stakes involved.

Of course, in the financial system of today, the supply of information, the **intermediation of funds and risks**, safekeeping, and the maintenance of a payments system are roles that are performed simultaneously. The financial system thus contributes to economic growth and social development. No wonder that several provincial governments view the existence of a strong local financial sector as a key element in their strategy for growth and development.

Historical Overview

At the end of 1985, the 12 chartered banks operating under Schedule A of the *Bank Act*, with about 7,000 branches across Canada, held about 47 per cent of the total assets of all financial institutions in the country (Table 1-1).[10] Schedule B banks, 57 in number, held a further 3.5 per cent of assets at that time. Some 100 trust companies, with more than 1,100 branches, controlled 8 per cent of all assets, while about 180 life insurance companies accounted for 12 per cent of the total. The 13 groups of financial cooperatives, bringing together nearly 4,000 retail outlets, represented some 6 per cent of assets.

Table 1-1

Assets of Financial Institutions, by Category, Canada, 1985

	Value of assets
	($ millions)
Chartered banks (Schedule A)	372,627
Life insurance companies	94,270
Trust companies	64,569
Mortgage loan companies[1]	52,396
Trusteed pension plans	44,899
Credit unions (local)	44,045
Chartered banks (Schedule B)	27,540
Property and casualty insurance companies	18,278
Financial corporations	16,788
Investment companies[2]	13,384
Investment dealers	12,207
Segregated funds in life insurance	11,544
Credit unions (central)	10,842
Business financing companies	6,861
Financial leasing companies	3,423

1 Mortgage loan companies associated with Schedule A chartered banks (with assets totaling $42.2 billion) are included with mortgage companies and not with banks. Also included with mortgage loan companies are real estate investment trust companies and mortgage investment companies.
2 Investment companies include mutual and closed-end funds.
SOURCE Statistics Canada, *Financial Institutions*, Cat. 61-006, and *Trusteed Pension Plans*, Cat. 74-201, fourth quarter 1984; *Supplement* to the Canada Gazette, February 1986.

While deposit-taking institutions and life insurance companies dominate the financial scene in terms of assets controlled, the 104 investment dealers and brokers and the 325 property and casualty insurance companies, which accounted for 1.5 and over 2.0 per cent, respectively, of the total assets of the financial industry, bear an importance in the financial-intermediation process that is far in excess of that suggested by these numbers.

Table 1-2 lists the five largest institutions within each pillar, many of which became household names long ago. But the financial system does not limit itself to the four or five pillars; other institutions are active in many different markets. (Appendix B describes the range of institutions that comprise the Canadian financial system.)

The rich texture of the Canadian financial system – a combination of diversified and specialized intermediaries – has emerged over time in response to regulation and to the strategies of participants in financial markets. This evolution was dominated by a concern for solvency and competition. The issue of solvency was a legacy from the Great Depression, and it stood at the forefront of public concern until the mid-1960s. After that, to the end of the 1970s, it was overshadowed by the desire to open up the financial system to competitive forces in order to increase the quantity and diversity of the financial services offered to Canadians. But in the early 1980s, solvency issues resurfaced dramatically.

The 1950s and 1960s

The Canadian financial system emerged from the Great Depression with a configuration that was to remain for many years. Under various federal and provincial legislations, separation was established between the main financial **functions** and between financial and nonfinancial **activities**. This was aimed at re-establishing confidence in the financial system following the failure of many institutions in the 1930s. The strict separation between commercial lending and trust activities, and between banking and securities dealing, was also intended to minimize conflict-of-interest situations. Banks primarily collected short-term funds through demand deposits and provided loans to businesses for the financing of **inventories** and **accounts receivable**. Trust companies were mainly involved in the management of estate and trust funds, including pension funds. They supplemented this activity by offering term deposits and providing some mortgage financing. And investment dealers were involved in securities trading and **underwriting**.

Table 1-2

Largest Financial Institutions, by Major Category, Canada, 1985

	Value of assets[1] ($ millions)
Chartered banks:	
Royal Bank of Canada	96,017
Bank of Montreal	82,420
Canadian Imperial Bank of Commerce	75,834
Bank of Nova Scotia	61,069
Toronto Dominion Bank	50,218
Trust companies:	
Canada Trustco[2]	21,570
Royal Trustco	13,453
National Victoria and Grey Trustco	8,706
Guaranty Trustco	3,814
Montreal Trustco	3,101
Life insurance companies:	
Manufacturers Life Insurance[3]	16,426
Sun Life Assurance Co. of Canada	15,960
Great West Life Assurance	10,801
Mutual Life Assurance Co. of Canada	7,149
Canada Life Assurance	6,915
Property and casualty insurance companies:	
Co-operators General	741
Royal Insurance Co. of Canada	717
Allstate of Canada	479
Wawanesa Mutual	462
Lloyds Non-Marine	455
Investment dealers:	
Dominion Securities Pitfield Ltd.	130
Wood Gundy Inc.	116
Burns Fry Ltd.	79
McLeod, Young, Weir Ltd.	73
Richardson Greenshields of Canada Ltd.	61

1 For investment dealers, the figures refer to paid-up capital. Chartered banks, trust companies, and life insurance companies are ranked according to their worldwide assets. The estate, trust, and agency business of trust companies is not included with their total assets. Property and casualty insurance companies are ranked according to their 1984 domestic assets.

2 Consolidated figures for Canada Trustco and Canada Permanent, which merged 31 December 1985.

3 Includes the figure for Dominion Life Assurance Co., whose assets and liabilities were transferred to Manufacturers Life Insurance Co., 1 January 1986.

SOURCE *Canadian Business*, June 1986; *The Financial Post 500*, Summer 1986; and *Report of the Superintendent of Insurance for Canada*, abstract of statements of property and casualty insurance companies, for the year ended 31 December 1984.

But the regulatory framework, together with the natural cautiousness of the financial institutions following the Depression, left many gaps in the provision of financial services, both in terms of the clientele that the institutions were serving (individuals versus businesses, different size of businesses, location of customers) and in terms of the services or instruments that they offered (mortgages, term loans, and so on). Businesses, particularly small ones, had difficulty obtaining term financing; mortgages were in short supply, as were consumer loans; and farmers also had difficulty securing loans. Governments attempted to compensate for these deficiencies by entering directly into areas where financing gaps were to be found. At the federal level, the Industrial Development Bank provided term financing to smaller businesses; the Farm Credit Corporation supplied long-term financing to farmers; and the Central Housing and Mortgage Corporation was involved in the supply of residential mortgages.[11]

The 1970s

Although the 1954 revision to the *Bank Act* allowed the chartered banks to enter in a limited way into the mortgage- and consumer-loan markets, it was not until the late 1960s and early 1970s that the focus shifted towards the closing of gaps in the supply of financial services through changes in the regulatory approach and in the attitude of the participants in financial markets. Matters of solvency were not overlooked, though, as 1967 saw the introduction of formal deposit protection through the establishment of the Canada Deposit Insurance Corporation and the Régie de l'assurance-dépôts du Québec.

The 1967 revision to the *Bank Act* was the main catalyst in opening up the Canadian financial system to competitive forces. The removal of the interest-rate ceiling, together with the granting of powers to extend conventional mortgage loans, signaled the massive entry of the chartered banks into the mortgage-loan market. Their share of that market increased fourfold between 1967 and 1985.

The elimination of the statutory interest-rate ceilings also aided in improving the competitiveness of the chartered banks in the consumer-loan market. It was only after 1967 that this share of consumer loans rose significantly, mainly at the expense of loan and finance companies.

The more aggressive behaviour of the banks in the mortgage- and consumer-loan markets was translated into lower costs and a greater choice of instruments for the consumer. But these developments were just one aspect of the new, aggressive spirit of the chartered banks in the retail-banking business. Soon after the removal of the interest-rate ceilings and the reduction to 4 per cent of reserve requirements on notice deposits, the banks introduced true-savings accounts that paid higher rates than traditional accounts. These were quickly matched by the trust companies. In 1973, the banks started offering package accounts; they also increased their marketing efforts; and they became more aggressive in the business-finance area, particularly in term lending. Throughout the 1970s competition intensified in many markets, as other institutions responded.[12] Thus, as Canada entered the 1980s, hardly a week passed without a new financial service being offered, one institution acquiring another, or an institution entering a new field - quite a change from the tranquil days of the 1960s!

Into the 1980s: Domestic and International Developments

Competition has remained so fierce in the 1980s that it has modified the relative positions of the so-called pillars in various financial markets. At the same time, the Canadian financial system has been plagued by the largest number of failures since the Depression. In the process, there has been a trend towards greater diversification - towards the introduction of new instruments and new ways of doing business - that has not fallen neatly into the separation of functions demanded by the pillar system. The 1980s have also witnessed a greater mixing of financial and nonfinancial activities, as well as increased concentration of ownership. A number of factors have contributed to these developments.

Socio-Economic Developments

Many of the changes taking place in the financial sector have been influenced by the performance of the economy. Favourable real income growth, averaging about 5 per cent in the 1960s, and a decline in the tax imposed on increases in real income in the 1970s, coupled with a healthy savings rate, have contributed to increasing the pool of funds available to financial institutions and financial markets.[13] Solid growth, rising consumer spending and capital expenditures, the undertaking of large projects such as James Bay and Alsands, and increasing government cash requirements pushed up the demand for funds during that period. As a result, the total assets of financial institutions rose at a compound annual rate of 14 per cent between 1967 and 1985, compared with an annual increase in gross national product of 11.3 per cent. This encouraged institutions to compete for growing markets and to introduce new products and new practices to satisfy the needs of savers and borrowers.

Rising inflation and high and volatile interest rates in the 1970s were also the cause of many changes in the Canadian financial system. In particular, borrowers and lenders alike did not want to enter into long-term commitments. This dealt a serious blow to the bond market and to institutions that operated mainly at the long end of the market (e.g., life insurance companies). Double-digit inflation, and the expectation of its continuation, encouraged a large number of financial and nonfinancial firms to seek a highly levered position. The expectations of continued high inflation, however, were not realized, as the 1982 recession marked the beginning of a disinflationary process. The combined effect of the most severe slowdown in economic activity since the Great Depression, the start of a disinflationary process, and widespread overlevering caused serious financial difficulties for many nonfinancial firms and, by ricochet, for many financial institutions. Also, to insulate themselves from interest-rate swings, many institutions (chartered banks, in particular) attempted to substitute fee income - by offering services such as payroll systems, the arrangement of swaps, and so on - for "spread" income, which depends on the difference between the interest charged on loans and the interest paid on deposits.

Because of the large amounts of savings and borrowings at stake and because of the impact of high and volatile interest rates, savers have become very sensitive to the levels of interest rates and are prepared to shift to higher-yielding assets. Similarly, borrowers are taking advantage of the cheapest financing available. As a result, financial institutions have had to innovate to remain competitive.

Structural changes have also contributed to shaping consumer demand for financial services. The aging of the population and the gradual approach of the baby boomers towards middle age have slowed down the rate of increase in the demand for home mortgages but have pushed up the demand for pension and other retirement savings vehicles. This has forced a reorientation of the activities of several groups of financial institutions. The increase in the participation rate of women in the labour force has also had an important impact on financial markets. With both heads of families working and less time for leisure, convenience has become an important feature when shopping for financial products. **Networking, cross-referrals**, bundling of financial products, and financial supermarkets are attempts to meet this need.

New Technology

The availability of new technology has changed the production and delivery of financial services and has aided financial institutions in meeting the changing demands of the purchasers of these services. The **electronic transfer of funds** (ETF) has automated the overall delivery of financial services in **retail banking**. ETF permits on-line banking, which means that the transfer of funds between two parties can be performed electronically as opposed to the conventional method of writing a cheque. Moreover, the development of on-line banking has permitted the introduction of multiple-branch banking and automated teller machines, enabling customers to do their banking at institutions other than their home branches and outside normal banking hours. The development of technology and computers has also permitted institutions to offer attractive options on mortgage loans, consumer loans, and retail deposits, such as weekly payments or daily interest. In the securities industry, the introduction of new technologies, such as advanced computers and telecommunications equipment, has enhanced the transmission of information. In 1977, for example, the Toronto Stock Exchange introduced one of the first automated stock-trading systems, known as CATS (computer-assisted trading system). When timing is all-important, trading through the use of computers can mean that deals are completed within seconds. And the cost of trading by computer is considerably less than by the conventional method of trading on the floor.

New technology has also contributed to improvements in the decision-making process. For example, through the use of microcomputers and specialized software packages, portfolio managers today can provide quick technical analyses of the latest information in order to take full advantage of investment opportunities.

Internationalization of Financial Markets

Technological changes have facilitated the growing internationalization of financial markets by bringing the financial centres of the world closer together. Because of the smaller relative size of the Canadian economy, Canada's financial institutions have always looked beyond its national borders for their expansion. For example, the Bank of Montreal established foreign representation in London and New York in 1818, just one year after it began operating; Manufacturers Life opened an office in Shanghai in 1897; and Wood Gundy established its head office for international operations in London in 1910. Today, banks, investment dealers, life insurance companies, and, to a lesser degree, trust companies have branches, representative offices, and subsidiaries abroad. And foreign operations represent a sizable share of total operations and an important source of revenue for many institutions. In 1985, international assets represented from 30 to 47 per cent of the consolidated assets of the major Canadian chartered banks. Life insurance in force outside Canada constituted close to 68 per cent of the total life insurance outstanding (excluding reinsurance) of Canada's foremost insurance company and over 44 per cent of the total of its third largest insurance firm. Canadian banks are present in almost every country of the world, with commercial, wholesale, and retail operating units and a large number of correspondents.

Canadian financial institutions are increasing their presence in foreign markets. Money is flowing freely from one financial centre to another. Investors who take positions in many different financial centres play an important **arbitrage** role. And, as we have shown in a previous report, interest-rate changes in one market quickly spread to others.[14] Borrowers are also scouting various financial markets to search for cheaper sources of funds. Canadian corporations are increasingly looking to foreign markets to raise the funds they need. Many Canadian corporations have their stocks listed on the New York and London markets. Recently, Bell Canada Enterprises obtained a listing on the Tokyo Stock Exchange. Representatives of foreign institutions often come to Canada to seek business that would be entered into the books of their companies in New York or London. Canadians invest their surplus funds in U.S. markets and U.S. securities.

The growing internationalization of financial markets and, more importantly, the increasing international role of Canadian institutions have a direct impact on the Canadian financial system itself. First, institutions are involved in all kinds of operations that they do not perform at home, and they are thus able to gain expertise in new areas. Some Canadian, U.S., and European banks, whose credit ratings dipped below those of multinational nonfinancial companies because of the many problem loans on their books, have become a market intermediary, assisting these multinationals in raising funds on direct markets – a role performed by securities firms in Canada. Several Canadian banks, through subsidiaries with headquarters abroad, are involved in merchant banking – an activity from which they are barred in domestic markets. Furthermore, a number of financial innovations first appeared on international financial markets – the **note-issuance facilities**, for example. To remain competitive abroad, institutions have to be innovative, and again this has an impact on their domestic activities. Finally, because of its openness and of the important role played by Canadian institutions abroad, the Canadian financial system is sensitive to developments in other countries, particularly those south of the border.

Deregulation Abroad

The evolution of financial systems in the United States, Europe, and Japan has had an influence on

Canadian institutions. In particular, "deregulation" abroad has had an impact on the forces at play and on the pressures for change in Canada (see Appendix C for a description of deregulation abroad). Stories are told about deregulation in the United States, Japan, the United Kingdom, or West Germany. In all of these countries, and in Canada as well, deregulation has become a buzz word. It does not, however, mean the same thing in all countries. In Japan, it means removing controls on interest rates, as Canada did 20 years ago, and on international capital flows. In France, it means giving a greater role to market forces in the determination of interest rates and easing foreign-exchange controls. In the United States, it means, among other things, the removal of the prohibition against interstate branching - a prohibition that never existed in Canada. Indeed, for the most part, deregulation of the financial system in other countries means moving towards the Canadian system.

With respect to the regulation of the powers of financial institutions, however, Canada lags behind West Germany and France, and more recently the United Kingdom and the United States. Nevertheless, because many U.S. firms operate directly or through subsidiaries in Canada, financial innovations and changes in financial practices are spilling over into Canada. Many Canadian institutions are active in U.S. markets, and they have had to adapt to changes south of the border to remain competitive. As a result, money-market funds, certificates of deposits, NOW ("negotiable orders of withdrawal") accounts, and cash-management accounts, which originated in the United States, are now being introduced in Canada in one form or another. Canadian institutions have been carefully watching the acquisitions and mergers, and the strengthening of **financial holding companies**, that have been taking place south of the border.[15]

The New Inter-Pillar Competition

Canada's Schedule A banks have always had the largest share of the fast-growing deposit-taking market. Now, almost all financial institutions are fighting for a bigger share of that market. In the urban centres, banks, trust companies, and local credit unions and caisses populaires meet head on. In smaller urban and rural communities, the credit unions and caisses populaires are the major competitors of banks. Other institutions such as life insurance companies and securities dealers are developing new instruments to get around restrictive legislation so that they too can get their piece of the action.

The 1980 revision to the *Bank Act* provided access to the Canadian Payments Association for trust companies and credit unions without imposing reserve requirements, thus giving these institutions a cost advantage. And, indeed, the trust companies increased their share of the market of individual demand deposits from 6.5 per cent in 1979 to 16.5 per cent in 1985; their share of total demand deposits rose from 3.5 per cent to 10 per cent over the same period.

In the residential and commercial mortgage markets, as noted earlier, banks now offer stiff competition to the traditional lenders in this area - mainly the trust and life insurance companies. Indeed, banks now have the largest share of the market, while the share of life insurance companies (and, to a lesser extent, of trust companies) has declined. Competition also comes from credit unions and caisses populaires, as well as from some mortgage loan companies.

In the face of this competition, and as the mortgage business is becoming less lucrative with the aging population and the decline in home purchases, trust companies have responded by moving into the banking and personal- and commercial-lending market - traditional preserves of chartered banks. Other pressures on this market are coming from caisses populaires and Schedule B banks.

In personal lending, Schedule A banks have almost wiped small loan companies from the market and are now the main lenders, though they face increasing competition from financial cooperatives and trust companies (the latter, however, are still restricted, to some extent, in this line of activity). In the field of corporate finance - that is, the servicing of large companies - the competition is among banks, trust companies, and investment dealers. While foreign banks are also active in this area, Schedule A banks are still the main source of commercial loans for small and medium-sized firms.

In the corporate-trust and estate-management field, trust companies are quite well protected by regulation. In the estate-management area, they share business with lawyers only because demand exceeds their servicing capabilities.

Life insurance companies have little competition from other institutions in their traditional field of life insurance underwriting. But the products they offer have undergone some changes.[16] Life insurance companies have also attempted to diversify by investing in other companies and by associating with **financial holding groups**.

In the area of corporate underwriting and securities dealing - the traditional preserve of investment dealers - securities firms face competition domestically from Canadian foreign banks and dealers and internationally from Canadian and foreign banks and foreign dealers. Canadian securities firms appear undercapitalized, and their survival can, to a large extent, be attributed to protective regulation that gives them the exclusive right to corporate underwriting in Canada and makes it quite difficult for other institutions to enter directly into securities brokerage activities.

In summary, in this highly competitive era, financial institutions have been increasingly invading the traditional domains of other institutions. In the process, there have been gainers and losers. In general, all institutions have attempted to reposition themselves in their quest for growth - and, in some cases, for mere survival.

Diversification

As competition heated up, financial institutions embarked on an extensive diversification of their activities. The banks were the leaders in this process. At first, they diversified within their own sphere by increasing the variety of deposits and financing instruments available to individuals and businesses. But they also moved beyond the traditional business of banking to offer lease financing, factoring, and even venture-capital financing, either directly or through subsidiaries.[17] Trust companies diversified their operations by offering new kinds of deposits, mutual funds, and **registered retirement savings plans** (RRSPs), and by increasing their loans to businesses. Investment dealers diversified by entering into deposit-taking activities through cash-management accounts (Merrill Lynch) or access accounts (Midland Doherty).

Despite the growing number of diversified firms, some specialized institutions have been able to carve out a niche for themselves. Venture capitalists and merchant bankers still specialize in the supply of more-risky capital to businesses. Investment counsellors, which have multiplied since the late 1960s, offer specialized management services to pension funds and other holders of large pools of funds. Financial planners are taking advantage of the growing complexity of financial instruments and markets to offer advice to the smaller investor and saver. But this does not negate in any way the general trend towards diversification.

New Instruments and Practices

In many instances, diversification has been effected by the introduction of new *instruments*. It has been estimated that over 1,000 new financial instruments have been designed in the United States in recent years; many of these innovations have also been introduced into Canada. On the deposit side, there are daily-interest savings and chequing accounts, cash-management accounts, T-Bill passbook savings accounts, money-market accounts, and short term deferred annuities. On the mortgage side there are five-year mortgages as well as three-, two-, one-year, and six-month mortgages; mortgages with weekly, bi-weekly, or bi-monthly payments; multiple-term mortgages; gradual-payment mortgages; variable-rate mortgages; and even indexed mortgages. In the securities business, **floating-rate preferred shares**, income debentures, **stripped bonds**, deep-discount bonds, **financial future**, and other instruments have been developed. **Universal life policies** have been introduced in the life insurance business.

Innovations in the supply of financial *services* include automatic teller machines, some of which provide printouts on the status of various accounts; bought deals, where an underwriter assumes the full risk associated with a primary issue by purchasing the total issue for future resale; networking, where one institution agrees to sell the products of another institution; cross-referrals, where one institution refers potential customers to another institution for further servicing of their needs (i.e., London Life agents referring customers to Royal Trust); the bunching of financial products, where the various needs of customers are being addressed by one salesman licensed to sell mutual funds, life insurance policies, general insurance policies, retirement savings funds, certificates of deposit, and so on (this is the approach used by Eaton's in its department stores); and, finally, the supermarket approach, where different categories of institutions are grouped together under one roof to offer the customer a diversity of financial products - as in the Laurentian Group experience at its Montreal centre, which brings together La Laurentienne mutuelle d'Assurance, La Laurentienne Générale, Geoffrion Leclerc (a securities broker), and the Montreal District and Savings Bank.

The Financial and Nonfinancial Mix

Diversification has also resulted in a greater mixing of financial and nonfinancial activities. For example, merchandisers like the Eaton Company are now offering a diversified line of financial services. The EDPER Corporation has interests in Noranda Mines and John Labatt Company - and through Trilon, in London Life, Royal Trust, and Wellington Insurance. Power Corporation has large interests in financial and nonfinancial activities. Imasco Ltd., a diversified nonfinancial company with interests, among others, in tobacco and pharmaceutical products, acquired Canada Trust in 1986 through the takeover of Genstar Corporation. This has raised the issue of the wisdom of mixing financial and nonfinancial activities.

Concentration of Ownership and Holding Companies

Diversification is often effected through the acquisition route. Banks, trust companies, life insurance companies, and even investment dealers have acquired interests in other institutions in order to diversify their operations. Banks have mortgage-loan, real-estate, and data-processing subsidiaries, as do many life insurance and trust companies. Some life insurance companies have acquired interests in trust companies and vice versa. In the late 1970s, financial holding companies emerged, bringing together under one umbrella one or several trust companies, life insurance companies, mutual funds, investment counsellors, general insurance companies, and sometimes investment dealers and banks (Table 1-3). Quite often these financial holding companies are part of a larger group encompassing financial and nonfinancial firms, as in the case of Trilon and Power Financial. With the exception of the network that was built by Quebec's Desjardins Group over the decades, the emergence of financial holding groups, such as Power Financial, Trilon, CrownX, E-L Financial, and Traders, is a recent phenomenon. The corporate objective of some of these holding companies is to rationalize the production and delivery of financial products and to take advantage of the synergies and economies of scope that emerge from bringing together different types of financial institutions; other holding companies are just the result of investment decisions by their owners.[18] The concentration of ownership is apparent not only in the emergence of financial holding companies but also in a movement away from the diffused ownership of financial institutions: for example, the last large trust company to be widely held, Canada Trust, became a wholly owned subsidiary following a takeover in 1985.

Table 1-3

Assets of Large Financial Holding Groups,[1] Canada, 1985

	Value of assets
	($ millions)
Desjardins Group	26,368
Caisse centrale, regional federations, and local caisses populaires	22,532
La Confédération des caisses populaires	271
Groupe Desjardins (general insurance)	167
Assurance-vie Desjardins	944
La Sauvegarde (life insurance)	610
Fiducie du Québec	1,119
Société d'investissement Desjardins	262
Crédit industriel Desjardins	380
Corporation de fonds de sécurité de la Confédération	83

Table 1-3 (concl'd.)

	Value of assets
	($ millions)
Trilon Financial Corporation	20,830
Royal Trustco Ltd.	13,453
London Life Insurance Company	6,390
Wellington Insurance Company	349
Corporate assets of the holding company	638
Power Financial Corporation	15,948
Investors Group (corporate assets)	1,910
Montreal Trustco Inc.	3,101
Great-West Life (insurance company)	10,801
Corporate assets of the holding company	136
Crown Financial Group[2]	6,103
Crown Life	5,937
Coronet Trust	166
Laurentian Group[3]	5,167
Laurentian Mutual Insurance	707
Laurentian Group Corporation	4,460
Traders Group	4,460
Guaranty Trustco Ltd. (consolidated)[4]	3,814
Canadian General Insurance Group	260
Finance Group (Trans Canada Credit Corporation)	386
Eaton Financial Services[5]	1,061
Eaton Trust Company	730
Eaton Life Insurance Company (1984 data)	331
E-L Financial Corporation (consolidated)[6]	1,118
Empire Life Insurance Company	392
Dominion of Canada General Insurance (and subsidiaries)	708
E-L Investment Management Ltd.	. .
Groupe Prêt et Revenu (consolidated)	503
Fiducie Prêt et Revenu	386
Aeterna-Vie (life insurance)	103
St-Maurice (casualty and property insurance)	14

1 On a nonconsolidated basis unless otherwise stated; the estate, trust, and agency business is not included.
2 The Crown Financial Group also owns Private Ledger Financial Services Inc., which sells a broad range of investment-related products throughout the United States, and the investment counselling firm of Beutel, Goodman and Company Ltd. The corporate assets of those firms are not available. As of 30 June 1985, the pension-fund assets managed by Beutel, Goodman amounted to $2.8 billion.
3 In 1985, the Laurentian Group also owned 29.5 per cent of the shares of the Montreal City and District Savings Bank and its wholly owned subsidiary, the Credit Foncier. As of 31 October, the bank's consolidated assets amounted to $6.2 billion. The Laurentian Group Corporation includes: Fonds Laurentien Inc. and its subsidiary, Imperial Life Insurance Co.; Laurentian General Insurance and its subsidiaries; Yorkshire Trust Co.; Laurentian Financial Services Ltd.; and F-I-C Fund.
4 Includes the accounts of Guaranty Trustco Ltd. and its subsidiary companies, Guaranty Trust Company of Canada (and its wholly owned subsidiaries - Guaranty Properties Limited and Guaranty Realty Investments Limited), Guarantee Trust Company of Canada (U.K.) Ltd., Trans Canada Credit Financial Inc., and Trans Canada Realty Limited.
5 In 1985, Eaton Financial Services also managed mutual funds. The company was acquired by the Laurentian Group Corporation in 1986.
6 The assets of the subsidiaries are presented on a nonconsolidated basis.

Rising Insolvencies

One of the repercussions of growing competition and unpredictable fluctuations in the economic environment has been the increasing number of failures of financial institutions. The year 1985 was particularly difficult in this respect. It witnessed the collapse of two banks – the Canadian Commercial Bank (CCB) and the Northland Bank – the first such failures since 1923. Because of the regional nature of these two institutions, their failure again brought to the forefront the difficulty of maintaining an open and competitive system geared to improving access to financial services while ensuring solvency and preserving public confidence in financial institutions. In 1985, five trust and loan companies also went out of business, as did two general insurance companies. Two years earlier, the failures of three trust companies and two loan companies that were related to one another through ownership links had raised the question of how to protect the Canadian financial system from improper transactions. Altogether, there were 22 failures of financial institutions between 1980 and 1985 (see Figure 4-1).

Other financial institutions faced serious financial difficulties, and although these difficulties did not result in bankruptcies, they were often resolved through mergers with other institutions. In 1981, Quebec's Caisses d'entraide économique faced bankruptcy, and some of the locals were amalgamated with the Desjardins Group the following year. At the beginning of 1986, the Mercantile Bank of Canada merged with the National Bank of Canada. Also in 1986, the Morguard Bank was purchased by the Security Pacific Bank, a subsidiary of a foreign bank; and the Bank of British Columbia and the Continental Bank had to resort to borrowing from the Bank of Canada and to assistance packages put together by other banks. Later in the year, the Continental Bank announced plans to merge with Lloyds Bank of Canada, a subsidiary of Lloyds Bank of London; in November 1986 was announced the purchase of the Bank of British Columbia by the Hongkong Bank of Canada, a Schedule B bank. Although bank mergers did occur in the past,[19] the reorganization that took place in 1986 was the most significant to occur in a single year.

Within the trust industry, the District Trust, North West Trust, and Termguard Savings and Loan have faced financial difficulties. Although there have been no failures as such in the securities industries, there were 20 mergers and acquisitions between 1981 and 1985. For example, A. E. Ames merged with Dominion Securities in August 1981 to form Dominion Securities Ames, and the latter merged with Pitfield MacKay Ross in May 1984 to form Dominion Securities Pitfield. Mergers sometimes occur as the result of financial difficulties; they are also an avenue to augment the capital base and to rationalize operations so as to be better able to withstand competition and to survive leaner times.

Weakening of the Pillar System

Increased competition and the accompanying trend towards diversification have contributed to the slow erosion of the distinction between banking, trust, insurance, and securities dealing. With the new instruments it becomes more and more difficult to determine what is a mortgage, what is a commercial loan, what is a deposit, and what is an investment in a security. Distinctions based upon the composition of liabilities are becoming imprecise and ineffective. Trust companies have only limited powers to enter into commercial lending activities, but they can offer loans to businesses secured by real estate and call them mortgage loans. What is the difference between a cash-management account and a deposit in a bank? The holders of cash-management accounts enjoy chequing privileges, and in some instances their funds are covered by deposit insurance if the securities dealer deposits them overnight in a chartered bank. There is little difference between the **short-term deferred annuities** offered by life insurance companies and the term deposits offered by banks or trust companies. Thus life insurance companies and investment dealers have now joined banks, trust companies, and financial cooperatives in offering deposits or depositlike instruments. Furthermore, the beginning of the securitization process and the involvement of banks as an intermediary in note-issuance facilities or **interest-rate swaps** are bringing banking closer to securities trading. At the same time, trust companies and life insurance companies compete for business and personal loans, the traditional line of business of banks and financial cooperatives. All of these developments have raised concern over the prudence of mixing various financial functions such as banking and insurance, or banking and underwriting.

An Antiquated Regulatory Framework

The regulatory framework has not kept pace with these developments. Many institutions are constrained by existing regulation from meeting the competition head on. For example, banks have had some difficulty in reacting to competitive pressures because they are required to hold non-interest-bearing primary reserves against their deposits, while other institutions have no such statutory requirements, even when they have deposit or depositlike liabilities. While trust and life insurance companies have been able to diversify their activities significantly through financial holding companies or through eligible subsidiaries, the chartered banks have been prevented from doing so. Furthermore, the banks are not allowed to engage in trust activities, while trust companies are allowed to do banking. Mutual life insurance companies are severely restricted by existing regulations in their ability to secure new sources of funds (besides selling life insurance policies), in their ownership of other institutions, and in their participation in financial holding groups. Trust companies are constrained by regulation in their commercial and personal loan activities.

The introduction of new products and new practices since the mid-1970s reflects increasing attempts to circumvent constraining legislation.[20] New financial instruments, such as fixed-term annuities or cash-management accounts, have helped to blur the distinction between a loan and an investment or between a loan and a mortgage. Financial holding companies have emerged to bypass restrictive regulation on the investment powers of financial institutions. In December 1985, Manufacturers Life Insurance managed to raise funds indirectly through retractable preferred shares – an avenue not directly open to mutual companies by existing legislation.[21] It did so through the use of eligible subsidiaries. In Quebec, before the introduction of Bill 75, La Laurentienne mutuelle d'Assurance acquired a number of institutions through eligible subsidiaries. In both cases, this might have been contrary to the basic intent of the law, but the regulatory authorities did not object. Similarly, regulators did not object to the creation of financial holding companies bringing together various institutions under their supervision. This benign neglect is explained in part by the fact that Parliament and the provincial legislatures have been slow to react to changes in market conditions.

Moreover, the existing legislation and regulatory system have not been able, in recent years, to cope fully with insolvencies. The Estey Commission, for example, was scathing in its description of the inadequacies of the regulatory process in the case of the CCB and Northland Bank fiascos. Existing regulation was unable to prevent the **non-arm's-length transactions** and the overvaluation of real estate provided in collateral for mortgages that led to the failure in 1983 of five Ontario-based trust and loan companies.

As we move towards even greater diversification, the Canadian financial system appears to be governed by what might be called "regulation by looking the other way" rather than by legislative authority. Many of these problems can be attributed to lack of clarity in the sharing of responsibilities between federal and provincial governments and to lack of harmonization of the various regulatory regimes. Furthermore, with the exception of the revisions to the *Bank Act* and a few recent moves at the provincial level, there has been no major overhaul of most of the legislation governing financial institutions for many decades.

Towards a Reform of Financial Regulation

The regulatory framework must allow financial institutions and markets adequately to perform the intermediation of funds and risks, to participate in the maintenance of a payments system, to offer safekeeping, and to supply information.[22] For a financial system to operate efficiently, from private and public perspectives, markets must be competitive; financial institutions must benefit from the confidence of the public; and there must be broad access to the services offered by financial institutions and agents.[23] Other factors (such as diversification, separation between main financial functions and between financial and nonfinancial activities, ownership, solvency, the capital base, abuses of **conflict of interest**, and **self-dealing**) are also important, but they come into play through their impact on competition, confidence, and access.

In a dynamic market, all of these factors interact with one another, and each has a different impact on efficiency. While competition is healthy, it may lead to financial difficulties for a number of institutions, to a reduced capital base, or even to failure. In turn, the reduced number of participants in the market may limit competition; at the same time, the financial difficulties experienced by one institution may have a ripple effect and negatively affect public confidence in the operation of the entire system. Indeed, while the failure of a bank may, from a private point of view, be a sign of well-functioning markets that weed out the losers, it may also jeopardize not only the well-being of the bank's depositors and shareholders but also that of an entire local economy.

The challenge of regulatory reform is to produce a framework that will lead the financial system to the best attainable balance between competition, confidence, and access. Establishing the kind of regulation that will ensure solvency while encouraging competition and accessibility requires an analysis of the forces at play and an understanding of the trade-offs involved.

2 Financial Regulation in Canada

From the very early days, the Canadian financial sector has been regulated to ensure that the trust and contracts between individual financial institutions and their clients are maintained. Regulation has a double function: to establish rules of the game, by which the players in financial markets have to abide; and to ascertain that these rules are, indeed, followed. The latter is the supervisory aspect of regulation.

Forms of Regulation

In its dual function, regulation in Canada has traditionally been a blend of **self-regulation** by the industry, **corporate governance**, and **direct government regulation**.

Sources of Regulation

Self-regulation exists when the members of an industry establish, and agree to abide by, a set of rules that includes sanctions for those who break them. Self-regulation may be set up in conjunction with government authorities or independently of them. The Investment Dealers Association and the various stock exchanges are self-regulatory bodies that operate in conjunction with provincial regulatory authorities. The Canadian Bankers Association was established with the blessing of the federal government to act as a self-regulatory body and to complement the regulatory activities of the Inspector General of Banks and the Bank of Canada. It has lost most of its regulatory powers in recent years, particularly since the establishment of the Canadian Payments Association in 1980.

Corporate governance refers to a form of regulation put in place by an institution to regulate its own activities. The special committee of the board established by the Royal Trust to review non-arm's-length transactions is an example. This form of regulation is also intended to convey to the public that the corporation is guided by some strict rules of behaviour and thereby enhance customers' confidence in the institution.

Under *direct government regulation*, rules governing the behaviour of financial institutions are set down in law by legislative authorities, and government officials ensure compliance with those rules. Regulation of activities governs the collection of funds, as well as their uses, through restrictions on the composition of the liabilities and assets of financial institutions. An example is the restrictions on commercial lending by trust and life insurance companies; restrictions on networking or **cross-selling** are also a form of activity regulation. Regulation of ownership deals with the number and characteristics of the shareholders of a financial institution. An example is the 10-per-cent limit on the proportion of the shares of a Schedule A bank that any single shareholder is allowed to hold. Incorporation, licensing, and reporting requirements are means to implement regulation of activities and of ownership, but they are also important in ensuring the solvency of the institution.

In a broad sense, the insurance coverage of certain activities of financial institutions and the role of the Bank of Canada as **lender of last resort** are also part of the regulatory framework.[1] Insurance may cover deposits, as is the case with banks, trust and loan companies, and financial cooperatives; it may cover funds entrusted to some institutions, as in the case of the compensation funds set up by the Investment Dealers Association; or it may cover **contingent liabilities**, such as those of insurance companies.

Regulation by Institution vs. Regulation by Function

Regulation may apply to the institution as a whole so that all institutions incorporated under the same legislation have to abide by the same rules. This is commonly known as *regulation by institution*. By contrast, under a *regulation-by-function* approach, it is a function, such as banking or insurance, that is the subject of regulation rather than the institution performing that function. Such an approach promotes a "**level playing field**" – i.e., a situation where all institutions involved in the performance of the same function are subjected to the same rules. On the other hand, as solvency is a matter that relates to the institution as a whole, particularly because funds can easily be moved from one activity to another, regulation by institution provides for better control to minimize insolvencies and abuses.

Ex-Ante vs. Ex-Post Regulation

A distinction should also be made between ex-ante and ex-post regulation. Because of the fluidity of financial assets and their ease of transfer, it is difficult for the purchasers of financial services to obtain ex-post redress against wrongdoing, particularly after the failure of an institution. This is why regulation to ensure the solvency of the financial system, the fair treatment of its users, and the free operation of market forces is needed and must be of an ex-ante form. Ex-ante regulation specifies investment powers, permitted corporate activities, and prohibited transactions.

The Regulatory Framework

The regulatory framework of the Canadian financial system has two major characteristics. First, two different levels of government are involved. Second, regulation is uneven among various categories of financial institutions, some being the subject of quite detailed regulation, while others are virtually unregulated.

A Two-Level System

The authority to legislate and regulate the conduct of business and other aspects of financial institutions in Canada is divided between the federal and provincial governments. The Parliament of Canada has the power to incorporate banks and to regulate banking. Provincial legislatures have the power to regulate the securities industry.[2] The two levels of government share in the power to regulate trust, loan, and insurance companies. Other companies that do not operate under specific legislation, such as investment companies and venture-capital firms, fall under the authority of the jurisdiction where they are incorporated (Figure 2-1).

Figure 2-1

Legislation Regulating Selected Canadian Financial Institutions

Institutions	Acts
Chartered banks	Federal *Bank Act*
Life insurance companies, segregated funds property and casualty insurance companies	Federal *Canadian and British Insurance Companies Act*, the *Foreign Insurance Companies Act* or a corresponding provincial Act
Trust companies	Federal *Trust Companies Act* and corresponding provincial legislation
Mortgage loan companies	Federal *Loan Companies Act* and corresponding provincial legislation
Local and central credit unions, and caisses populaires	Incorporated or registered under a provincial credit union Act; federal *Cooperative Credit Associations Act*
Investment dealers	Regulated under provincial jurisdiction – e.g., in Ontario, the Ontario Securities Commission; also self-regulated under the Investment Dealers Association
Trusteed pensions	Federal *Pension Benefits Standards Act* and corresponding provincial legislation (e.g., Ontario *Pension Benefits Act*, pioneering provincial legislation)
Financial corporations	Federal *Small Loans Act* and the *Investment Companies Act*
Investment companies	Federal *Investment Companies Act*.

An analysis of the current regulatory framework should start with an examination of the division of powers between the two levels of government accorded by the *Constitution Act* of 1867 (formerly the *British North America Act*). Section 91 generally defines the authority of Parliament; section 92 details some of the matters that fall under the authority of provincial legislatures.

Section 91(15) gives the Parliament of Canada the authority to regulate the business of banking, but banking is not defined in either the *Constitution Act* or the *Bank Act*. Section 91 also gives Parliament the authority to incorporate banks. The power to incorporate and thus regulate other financial institutions is derived indirectly from section 92(11), which limits the provinces to the incorporation of companies "with provincial objects." Accordingly, the Parliament of Canada has the power to incorporate companies with objects that are interprovincial or national in scope. There is however, some limit to the use of federal incorporation powers for regulatory purposes. While Parliament can use these powers to confer on an institution its legal personality, to deal with its organization, and to impose limitations on its corporate capacity as conditions of its incorporation, only a provincial legislature has the authority, under section 92(13), to regulate certain aspects of the institution's activity – e.g., the terms and conditions of insurance contracts. This, of course, does not apply to chartered banks, as the regulation of banking falls under federal legislative power.

It is considered by some that Parliament would have authority to regulate certain aspects of the nonbanking activities of financial institutions under the authority of section 91(2) of the *Constitution Act* – "the Regulation of Trade and Commerce" – as well as pursuant to the opening words of section 91, which assign to Parliament the general power to legislate for "the Peace, Order, and good Government of Canada."[3] Some have interpreted this as jurisdiction over matters of national interest.

Finally, there exist other potential sources of federal authority in the *Constitution Act*. First, Parliament has exclusive jurisdiction under section 91(21) with respect to "Bankruptcy and Insolvency," which gives it the power to make laws in relation to the affairs of insolvent financial institutions, including those that are provincially incorporated; this authority comes into effect only when an institution is in a state of insolvency. Therefore, "it is an open question, and one of considerable doubt, whether section 91(21) would permit federal intrusion into otherwise exclusive provincial areas for the purpose of preventing the insolvency of financial institutions generally on a prospective basis."[4] Second, Parliament has exclusive jurisdiction, under section 91(27), with respect to legislating criminal law; thus Parliament may enact laws providing for the imposition of penalties in respect of financial transactions that are entered into for fraudulent purposes. Third, Parliament has exclusive jurisdiction, under sections 91 and 92(10), over interprovincial "Works and Undertakings" and intraprovincial works that it deems to be "for the general Advantage of Canada." It has been suggested that this could be used to implement a comprehensive regulatory scheme for the Canadian securities market.[5] Finally, the *Constitution Act* gives Parliament exclusive jurisdiction over "Currency and Coinage" [section 91(14)], "Savings Banks" [section 91(16)], "Bills of Exchange and Promissory Notes" [section 91(18)], "Interest" [section 91(19)], and "Legal Tender" [section 91(20)].

The source of provincial authority to legislate and regulate financial institutions falls under section 92(13) of the *Constitution Act*, which deals with "Property and Civil Rights" and which has been interpreted by the courts "to include contracts, dealings with property, and the regulation of businesses, trades and professions."[6] Financial activity, like any other business activity, is carried out by way of contract. Provincial authority under this section is considered wide in scope, since it encompasses all kinds of business transactions. Provincial legislatures also have authority over financial institutions under the clause giving them responsibility for "the Incorporation of Companies with Provincial Objects" [section 92(11)]. This enables provincial legislatures to make "laws pertaining to corporate powers, organization, internal management and financing."[7] Provincial authority to regulate financial institutions is thus quite far-reaching, but it is limited by the powers given to the Parliament of Canada.

Although the *Constitution Act* gives Parliament extensive powers in the area of banking, it has only exercised it sparingly. Only the institutions listed in the "schedules" of the *Bank Act* must abide by its provisions. Parliament has never attempted to apply any of its banking legislation to other institutions that carry on near-banking functions. It does, however, maintain a presence in the regulation of near-banking institutions such as trust, loan, and insurance companies incorporated under federal legislation.

The courts have, time and again, reaffirmed the authority of Parliament over banking. One can cite two decisions by the Privy Council of the House of Lords: one in 1938, pertaining to *Attorney General for Alberta v. Attorney General for Canada*, on appeal from the Supreme Court of Canada, which concerned a provincial *Act respecting the "Taxation of Banks"*; and one in 1947, pertaining to *Attorney General for Alberta v. Attorney General for Canada*, on appeal from the Supreme Court of Alberta, which concerned the introduction of the social credit doctrine through the *Alberta Bill of Rights Act*. Both Acts were held to be invalid because they were encroaching on Parliament's jurisdiction over banking. Similarly, a Quebec law aimed at confiscating deposits in credit institutions on which there had not been any activity for about 30 years was struck down by the Privy Council in 1947.[8] In all of these cases, the provincial law's primary impact was on the activities of chartered banks, and for that reason the provincial law was considered by the court as banking legislation. In a 1949 judgment in *Re Bergethaler Waisenamt*, a failed provincial trust company, the Manitoba Court of Appeal reaffirmed the jurisdiction of the Parliament of Canada over banking.[9] The same judgment upheld, however, the deposit-taking function of a provincially incorporated trust company, provided that such deposits are not transferable by cheque, so that the company cannot be construed as being involved in banking activities.

The *Canadian Pioneer Management v. Labour Relations Board of Saskatchewan* (1980) case affirmed, however, the power of a provincial legislature to authorize a provincially incorporated trust company or financial cooperative that has not been brought within the federal authority with respect to banking, to perform functions similar to those of the chartered banks. Some have, in fact, expressed the view that some of the near-banking activities of provincial institutions could possibly be regulated by Parliament if it chose to enact more comprehensive banking legislation.[10]

The jurisdiction of the Parliament of Canada over banking may even go so far as to encroach upon provincial authority. For example, in an 1894 decision of the Privy Council in *Tennant v. Union Bank of Canada*, Lord Watson noted that "notwithstanding that 'Property and civil rights' was a topic allocated to provincial legislatures under s. 92, 'banking' was one of the matter concerning which the exclusive legislative authority of the Parliament of Canada could not be operated without interfering with and modifying civil rights in the Province."[11]

While the federal government has been given clear jurisdiction over banking by the *Constitution Act* of 1867, the definition of banking remains an issue that has not been settled. The courts have not directly provided such a definition, which must then evolve out of a dynamic process. The principle of "progressive interpretation" put forward in the 1947 *Alberta Bill of Rights* case recognized that "the meaning of 'banking' was not confined to the kinds of transactions carried on by banks in 1867, but expanded along with subsequent expansions of the business of banking."[12] Distinctions were made by the courts between the function of banking and other activities carried out by banks. The former is generally related to the provision of the means of payment; the latter would include, among other things, the extension of credit. The 1949 decision in the *Re Bergethaler Waisenamt* case rested on the view that an essential characteristic of a bank is its obligation to honour its customers' cheques or drafts. Several previous cases were referred to in arguments supporting the 1949 decision; in *Foley v. Hill* (1848), Lord Brougham said, "I am now speaking of the common position of a banker, which consists of the common case of receiving money from his customer on condition of paying it back when asked for, or when drawn upon." In *Joachimson v. Swiss Bank Corp.* (1921), it was stated that the relationship between a bank and a customer includes a promise to repay any part of the amount due against the written order of the customer addressed to the bank at the branch. The banking function, defined as the provision of the means of payment, was also an important argument in the 1947 Privy Council hearing on the *Alberta Bill of Rights* case. In this context, a progressive interpretation of banking would suggest that what constitutes a means of payment should be adjusted to the realities of the time.

The cases referred to above expressed a functional approach to the definition of banking. In the *Canadian Pioneer Management* case, which involved a question of labour relations, the Supreme Court adopted an institutional definition of banking. Mr. Justice Beetz, writing for the majority acknowledged, however,

> that the institutional test might not be appropriate where the issue was the constitutionality of a particular law with some impact on functions performed by banks. In that context, the word banking in s. 91(15) might have a "wider" meaning than just those functions performed by banks. . . . In effect, Beetz J. deferred to the parliamentary definition of banks in order to define the scope of banking. He acknowledged that this institutional test granted to the federal Parliament the power to define its own power: the scope of banking would expand or contract according to the extent to which Parliament had chosen to legislate.[13]

Thus, on the basis of the *Constitution Act* of 1867, Parliament has jurisdiction over banks and banking. Parliament also has some jurisdiction over financial institutions (other than banks) that are incorporated under federal legislation, although some of their activities may still be regulated by a provincial authority. Because of the absence of a clear definition of banking and because Parliament has not made full use of its powers to regulate banking, certain near-banking activities are currently regulated at the provincial level. As a result, various institutions carrying on similar financial activities are regulated at the federal or provincial level, or both.

The Regulation of the Pillars

Among all groups of financial institutions, the so-called "pillars" operate under the most formal and extensive regulatory framework.

The Chartered Banks

The federal statute that governs banks and banking is the *Bank Act*. It is administered by the federal Inspector General of Banks, who in turn reports to the Minister of Finance. At the time of writing, there are 10 chartered banks operating under Schedule A of the *Bank Act*. The 1980 revision of the Act allowed foreign banks to establish subsidiaries in Canada, and in 1985 there were 57 such subsidiaries chartered under Schedule B.[14]

Figure 2-2 summarizes the many activities that banks may pursue under the *Bank Act*. It should further be noted that the Act specifically forbids banks to engage in any trade or business other than banking – such as fiduciary activities, portfolio management, investment counselling, or insurance. Even though other groups of financial institutions (such as trust and loan companies, financial cooperatives, and the agencies of some provincial governments) engage in a number of banking activities (especially those related to deposit-taking and lending), they are not subject to the *Bank Act*. But only those institutions operating under the Act can use the word "bank" in their corporate names.

Figure 2-2

The Regulatory Framework of the Pillars of the Canadian Financial System

Institutional group	Jurisdiction of incorporation	Regulatory structure	Investment powers	Regulation of liabilities	Ownership restrictions	Capital-base restrictions
Chartered banks						
Schedule A	Federal government	Office of the Inspector General of Banks (OIG-B); internal inspection system: - board of directors - audit committee - other board inspection unit	Power of a natural person but may not engage in such activities as: - fiduciary activities - portfolio management or investment counselling - insurance - dealing in goods, wares, and merchandise General investment powers include: - conventional mortgage lending - commercial lending - lending money without security - engaging in leasing and factoring operations - issuing payment, credit, or charge cards - lending money on the security of conditional sale agreements and other purchase-money security agreements	May accept deposits and raise funds through the issuance of debentures Reserve requirements on deposits: - must hold cash or deposits with Bank of Canada amounting to: • 10 per cent of demand deposits • 3 per cent of notice deposits • 3 per cent of foreign-currency deposits booked in Canada - secondary reserve is set between 0 and 12 per cent by Bank of Canada and must be held in the form of cash, treasury bills, or day loans to securities dealers.	10 per cent restriction on any individual or related person; 25 per cent restriction in total on non-residents	Authorized capital may not be less than $2 million
Schedule B	Federal government	OIGB	Same as Schedule A banks, except there are limits on the size of Schedule B banks' assets	Same as Schedule A banks	No restrictions	Authorized capital may not be less than $5 million
Trust companies	Federally or provincially incorporated	Federal Department of Insurance; each province also has its own department; registration is conducted at the provincial level	Company and guaranteed trust funds: may administer estates and trusts, and may store for safekeeping all kinds of securities, personal property, and rent spaces May act as transfer agents for stocks, bonds, or other obligations	May receive deposits in trust provided that they are repaid with interest May issue guaranteed investment certificates provided they are repaid with interest agreed upon over a fixed number of days	No domestic restrictions; no one nonresident may own more than 10 per cent of the shares, and a group of nonresidents may not hold more than 25 per cent	Companies cannot be registered to transact business in Ontario unless they have a capital paid-in and unimpaired of at least $1 million

Figure 2-2 (concl'd.)

Institutional group	Jurisdiction of incorporation	Regulatory structure	Investment powers	Regulation of liabilities	Ownership restrictions	Capital-base restrictions
Trust companies			May purchase or invest in mortgages but can only invest or lend up to 75 per cent of the value on any one parcel of real estate May purchase, or invest in, government bonds May purchase, or invest in, company bonds, debentures, preferred shares, or common shares, provided the company meets some quality tests Investments are subject to a 7 per cent basket clause May not engage in insurance business or act as insurance agent or broker	Liabilities may not exceed 20 times the total amount of the company's capital reserve and surplus		
Life insurance companies	Federally or provincially incorporated	A superintendent of insurance has been established at the federal level and in each of the provinces Registration can be at the federal level or with a province Each province (but not the federal government) has licensing and distribution restrictions	Company funds: no more than 25 per cent of total assets may be held in common stocks Holdings of any one company are limited to 30 per cent of that company's stock 10 per cent of assets may be invested in directly owned real estate Investments are subject to a 7 per cent basket clause Unless insured, investments in mortgages may not exceed 75 per cent of the value of any one parcel of property	May not accept deposits or underwrite securities May issue short-term annuities May underwrite various kinds of life insurance policies	No domestic restrictions	In Ontario, the company must have paid-up capital and surplus of not less than $2 million

Securities firms	Provincial jurisdiction	Each province has enacted securities legislation and created securities commissions for the purpose of supervising securities firms located, and conducting business, within its provincial boundaries Self-regulation done by stock exchanges and investment dealers association	May underwrite, and deal in, securities and engage in brokerage activities		No nonindustry participant may own more than 10 per cent of the voting shares; a group of nonresidents may not own more than 25 per cent	Along with a number of other restrictions, every dealer must maintain a minimum free capital of $25,000
Financial cooperatives (credit unions and caisses populaires)	Provincial jurisdiction	Each province has enacted legislation and has established a regulatory structure to deal with financial cooperatives incorporated and operating within its jurisdiction	Have the powers or capacity to achieve their objects of purposes; only in British Columbia, Manitoba, New Brunswick, and Saskatchewan are credit unions given all the powers of a natural person; in Quebec, the caisses populaires have all the rights and powers of a corporation within the meaning of the civil code Financial cooperatives have general powers to: – make loans to members – deposit money in credit union league of federation, or in some cases in other institutions – invest in securities of institutions and government bodies, and in some cases of corporations – draw, make, accept, endorse, execute, discount, and issue promissory notes, bills of exchange, or bills of lading	May receive money on deposit from members and as payment for shares May receive deposits from institutional and government bodies In most provinces (except Quebec), borrowing powers generally follow a rule of 25/50 per cent of combined capital, surplus, and deposits	No ownership requirements Depending on province, applications for incorporation must be endorsed by a minimum number of persons (between 10 and 25)	Unlimited shares

SOURCE Economic Council of Canada.

A sunset clause is attached to the *Bank Act*, requiring that a decennial review be carried out. This has allowed the regulation of banks to adjust to developments taking place in the financial sector. Surprisingly, this feature of the *Bank Act* has not been applied to other existing legislation in the financial sector. (Some proposed legislation, including Ontario's Bill 116, contain some sort of sunset clause or provision for automatic review.)

As noted earlier, the Inspector General of Banks is the administrator of the *Bank Act* and is responsible for examining all aspects of chartered banks and the conduct of their business activities to ensure compliance with the Act. The Inspector General also advises the Minister on policy matters regarding banks and banking. The Office of the Inspector General of Banks (OIGB) was created in response to a crisis in the Canadian banking system in the wake of the 1923 failure of the Home Bank of Canada. The *Bank Act* provides for the recovery of the costs of the OIGB by directly billing each bank.

Since the *Bank Act* revision of 1980, banks have been chartered by the issuance of letters patent by the Minister of Finance rather than by a special Act of Parliament, as previously required. The conditions for forming a bank entail submitting a detailed business plan to the Inspector General of Banks. This plan must include an account of how the new bank will contribute to increasing competition within the banking system, as well as a detailed summary of the strategies that it will use. Once a bank receives a charter, it has one year in which to meet a number of conditions before banking operations can begin. These requirements pertain to the raising of capital and the appointment of directors and management, as provided for in the *Bank Act*.

Several other aspects of banking, such as ownership, self-dealing, nonfinancial subsidiaries, and disclosure, are regulated. No individual or corporation may own more than 10 per cent of the voting stock of a Schedule A bank, but Schedule B banks may be closely held. The total assets of Canadian subsidiaries of foreign banks may not exceed a given percentage of the assets of the Canadian banking system. With respect to self-dealing, strict rules establish limits on bank loans to employees. There is also a restriction on the mixing of banking and other financial and nonfinancial interests, whereby chartered banks are forbidden to engage in any business other than banking. Accordingly, banks may not purchase more than 10 per cent of the voting shares of a company unrelated to a banking business. According to the OIGB's submission to the Estey Commission,

> the Bank Act imposes a duty on the directors to manage the bank honestly and in good faith with a view to the best interest of the institution. . . . [It] also requires each bank to have an Audit committee composed of not less than three directors of the bank, none of whom is an officer or employee of the bank or any of its affiliates. . . . While not required by legislation, Canadian banks have traditionally had strong internal inspection groups who report directly to the most senior members of management.[15]

The OIGB usually begins its supervisory process by reviewing the minutes of the board of directors, the audit committee, and any other significant committees of the board.

The shareholders' auditors also play a key role in the supervision of banking in Canada. In fact, seven sections of the *Bank Act* are devoted to dealing with the appointment, qualification, rights, duties, and reporting responsibilities of the auditors.[16] The OIGB depends on the inspection and reports of the shareholders' auditors as part of the overall supervisory process of banks. The rationale for this has been "that the Inspector General could rely on such a system and confine his own activities to a more general overview of banks and the banking system without the need to make detailed examinations of each individual bank."[17] Finally, the compliance division enforces the standards imposed by the *Bank Act*, participates in legislative reform, drafts various forms of legal documents, and grants approval for various bank activities.

Loan and Trust Companies

Trust companies can be incorporated by either Parliament or a provincial legislature. Among the provinces, Quebec and Ontario have the largest number of incorporated trust companies – 18 and 16, respectively (Table 2-1). Newfoundland and New Brunswick have none, and the other provinces have only a few. Thirty-six trust companies have been incorporated at the federal level. As mentioned earlier, provincial governments retain the authority to regulate the activities of federally incorporated companies. Accordingly, if one such company wishes to conduct business in a particular province, it must register initially with the regulators of that province. Registration is also required for companies that are incorporated in one province but want to conduct business in another.

The federal statute that governs the activities of federally incorporated trust companies is the *Trust Companies Act*. There is corresponding legislation in most provinces (the Ontario *Loan and Trust Corporations Act*, for example). Although differences do exist, the main powers accorded trust companies are similar under both federal and provincial legislation.

Table 2-1

Number of Federally and Provincially Incorporated Chartered Banks, Trust Companies, and Life Insurance Companies, Canada, by Province, 1967, 1979, and 1984

	Federally incorporated		Provincially incorporated companies											
	Domestic companies	Foreign-owned companies	Newfound-land	Prince Edward Island	New Brunswick	Nova Scotia	Quebec	Ontario	Manitoba	Saskat-chewan	Alberta	British Columbia	All provinces	Total
1967														
Chartered banks	8	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	8
Trust companies	9	. . .	–	–	1	3	18	17	5	3	4	2	53	62
Life insurance companies	41	81	–	–	–	–	22	6	–	–	–	3	31	153
Total	58	81	–	–	1	3	40	23	5	3	4	5	84	223
1979														
Chartered banks	11	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	11
Trust companies	25	. . .	–	11	–	2	20	20	6	3	5	3	70	95
Life insurance companies	58	95	–	–	3	–	20	4	–	–	2	1	30	183
Total	94	95	–	11	3	2	40	24	6	3	7	4	100	289
1984														
Chartered banks														
Schedule A	14	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	14
Schedule B	1	57	. . .	. . .*	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	58
Trust companies	36	. . .	–	14	–	1	18	16	3	4	5	3	64	100
Life insurance companies	62	93	–	–	2	–	16	4	–	–	1	2	25	180
Total	170	93	–	14	2	1	34	20	3	4	6	5	89	352

*Trust companies in Prince Edward Island are currently inactive.

SOURCE *Supplements* to the *Canada Gazette*; Department of Insurance Canada, *Report of the Superintendent of Insurance for Canada*; and the superintendent of insurance for each province.

Figure 2-2 details the activities in which trust companies may engage. In particular, their investment in the bonds, debentures, preferred shares, or common shares of a company is ruled by some quality tests, such as the payment of dividends by the company in each of the five years preceding the date of investment. (In recently proposed legislation, the quality tests are replaced by quantitative restrictions.) Trust companies are not directly allowed in the commercial-lending field, but under the legislation governing their activities they may extend loans if the latter are secured by 75 per cent of the appraised value of real estate (or the equivalent) belonging to the borrower, or by the borrower's assets if the borrower is a company with an earnings record, over the previous five-year period, sufficient to pay dividends of a specified amount. In cases where this condition is not met, the trust company may provide loans under a basket clause that allows it to invest or lend funds up to a given percentage of its total assets in activities not otherwise permitted under the governing legislation. The basket clause is often used for investments that are expected to become eligible in the not-too-distant future. A trust company may also enter the commercial-lending field indirectly by acquiring interest in a company that provides commercial loans to business.

With respect to the supervision of trust companies and the responsibilities of various authorities, a distinction has to be made between registration and incorporation. The registering authority is responsible for the regulation of trust companies in matters related to contract law and consumer protection. By contrast, the incorporating authority is responsible for regulating, supervising, and inspecting these companies for solvency.

Because all provinces have the authority to incorporate trust companies, they are responsible for establishing a regulatory system that will monitor and supervise the business activities of trust companies operating within their jurisdiction. Ontario and Quebec are the only two provinces that have established a comprehensive regulatory system. The chief regulator in Ontario is the Superintendent of Deposit Institutions, who in turn reports to the Department of Financial Institutions. In Quebec it is the Inspecteur général des institutions financières.

The federal regulator is the Department of Insurance. It supervises and examines those trust companies incorporated at the federal level. Moreover, through special agreements with a number of provinces it is authorized to supervise and examine trust companies that have been incorporated within their jurisdiction. For example, the federal Department of Insurance supervises and examines trust companies incorporated in Manitoba, Nova Scotia, and Prince Edward Island, since no regulatory system currently exists in those provinces.

There are no legislated ownership restrictions for Canadian residents, but foreigners cannot individually own more than 10 per cent or, as a group, more than 25 per cent of a trust company (the "10/25" rule). A recently introduced federal bill (Bill C-9) would submit for prior ministerial approval the acquisition of more than 10-per-cent ownership of a federal trust company.

The federal and provincial trust legislation has not been revised for over 60 years; however, a number of amendments to the federal *Trust Companies Act* (and to corresponding provincial Acts) were made between 1954 and 1980, permitting trust companies to expand their investment powers. New trust legislation is currently being debated in the Ontario legislature. While maintaining the pillar system, it would increase the lending powers of Ontario trust companies. The newly proposed *Loan and Trust Corporations Act* (Bill 116) would allow trust companies in that province to invest 20 per cent of their assets in consumer loans, 10 per cent in commercial loans, and 10 per cent in commercial leases. Taking into account the 5-per-cent basket clause, it would allow trust companies to devote up to 45 per cent of their assets to activities currently performed by banks; as it happens, no more than 45 per cent of bank assets are in business and personal loans combined.

Life Insurance Companies

As in the case of the trust industry, insurance companies can be federally or provincially incorporated. Unlike the trust industry, however, the majority of companies in the life insurance industry are incorporated at the federal level. In 1984, for example, there were 62 federal companies and only 25 provincial ones; in addition, 93 foreign companies operated in Canada under federal jurisdiction. Provincial legislatures have constitutional authority over the operation of all companies within their territory.

The federal statute that governs the activities of federally incorporated life insurance companies, as well as some provincially incorporated ones, is the *Canadian and British Insurance Companies Act*. Corresponding provincial Acts also exist, such as the Ontario *Insurance Act*, which governs the activities of provincially incorporated insurance companies in Ontario, as well as those of registered insurance companies incorporated in other jurisdictions but operating in that province.

Life insurance companies may invest in common stock to a maximum of 25 per cent of their assets, with the holdings of any one company being limited to 30 per cent of the capital stock of the firm it invests in; they may invest up to a maximum of 10 per cent of their own assets in directly owned real estate, and up to 75 per cent of the value of the property (unless insured) in mortgages. Investments in corporate bonds and stocks are subject to performance rules with respect to the history of profits or the payment of dividends. Life insurance companies are allowed to underwrite various kinds of life insurance policies and annuities, but they may not accept deposits nor underwrite securities. Recently, Bill 75 in Quebec changed that province's approach to the regulation of investment powers. It allowed life insurance companies incorporated in the province to extend their activities, either directly or through subsidiaries. Furthermore, qualitative restrictions on investment were removed and replaced by quantitative ones. The main change in this respect was that managers were required to behave as prudent and expert persons, acting in the best interest of the policyholders and shareholders, rather than as "good family men." The simple "good family man" administration of assets is one that requires that the manager maintain the value of the asset entrusted to him. Full and expert administration requires the manager not only to maintain the value of the assets but also to obtain an adequate rate of return.[18]

A superintendent of insurance at the federal level and in each province is responsible for inspecting and supervising for solvency, and for ensuring that companies comply with the Act under which they operate. The provinces also regulate the licensing of insurance agents. Only Quebec, Ontario, Alberta, and British Columbia have a comprehensive regulatory system; in the other provinces, the regulatory and inspection duties have, to a large extent, been delegated to the federal Department of Insurance. Although an office of the superintendent of insurance does exist in these provinces, it has only limited scope.

With the exception of Quebec's Bill 75, federal and provincial life-insurance legislation has not been revised in over 50 years, although between 1954 and 1980 a number of amendments were made to the *Canadian and British Insurance Companies Act*.

Securities Dealers

Each province has enacted securities legislation and created a securities commission for the purpose of supervising securities firms located, or conducting business, within its boundaries.[19] A key feature of the regulatory framework of the securities industry is the large portion left to self-regulation. The five major self-regulatory organizations in Canada are the Alberta, Montreal, Toronto, and Vancouver stock exchanges, and the Investment Dealers Association of Canada (IDA). While each stock exchange operates according to provincial securities legislation, the IDA is a national organization, incorporated federally, that operates in all provinces through "provincial district councils." The IDA's primary responsibilities are to deal with all provincial securities commissions on behalf of its member firms and also to coordinate policy between provincial jurisdictions. Moreover, as part of its supervisory function, the IDA collects financial information from member firms, performs audits, and reports its findings (especially with respect to capital deficiencies) to the stock exchanges and to the provincial securities commissions.

The scope of the self-regulatory process is determined within the context of provincial legislation and regulation. With respect to ownership, for example, the self-regulatory organizations have established specific rules to carry out the full intent of ownership provisions as stated in provincial securities legislation - provisions intended to ensure that securities firms are controlled by domestic full-time members. Currently, foreign ownership of the stock of a securities firm registered in Ontario is limited to a maximum of 25 per cent of its equity, and no more than 10 per cent may be owned by any single foreign investor. In addition, a nonindustry participant - including an institution from another sector of the financial system - is allowed to own no more than 10 per cent of the stock of a securities firm registered in Ontario. In Quebec, however, financial institutions are permitted "to hold any number of shares in a securities firm subject to [the Commission's] consent."[20]

In June 1986, the Ontario Minister of Financial Institutions announced changes to the rules governing the securities industry, partially opening up the securities industry to nonindustry participants. Following six months of intensive discussions, more sweeping changes were announced by the Minister in December 1986. As of June 30, 1987, Canadian financial institutions - banks, insurance and trust companies - will be allowed to own up to 100 per cent of a securities dealer. Federal financial institutions will only be allowed to enter the securities business if this business is carried through a subsidiary. A corresponding amendment to the *Bank Act* will be needed to allow banks to purchase or set up securities subsidiaries. On June 30, 1987 nonresidents will be limited to a 50 per cent interest in a Canadian securities dealer and will be able to increase their stake to 100 per cent on June 30, 1988. From that date on, foreign dealers registrants will also be able to engage in a full range of activities.

Another function of the self-regulatory organizations is to assist securities administrators in ensuring that dealers comply with a number of requirements when registering with provincial securities commissions. These requirements include capital-adequacy rules to ensure solvency; education requirements to ensure that the firm's representatives are equipped to perform their duties and responsibilities; and "know your client" and "know your investment suitability" rules. Securities firms are not required to register if they operate within specified exemptions. For example, in Ontario and in most other provinces a securities firm that engages in transactions on government securities or in deals with a value in excess of $97,000 is not required to operate under registration. This is deemed to be a highly specialized market catering to sophisticated investors (mainly institutions that do not need to be protected by regulation). In his recent announcement, however, the Ontario Minister of Financial Institutions noted that the province intends to regulate this so-called "exempt market."

More generally, regulation of the securities market has to deal with three major issues - namely, disclosure requirements, to enable rational decisions with respect to trading and securities underwriting; the licensing of securities personnel, to ensure integrity and competence; and legal remedies against wrongdoing. Registration may also provide a basis for controlling aspects of the business and structure of registrants for purposes other than investor protection.

Although a large part of the system is based on self-regulation, the provincial securities commissions continue to play a direct and active role in regulating certain areas of the securities field. For example, the securities commissions of each province have prospectus requirements.[21] In practice, however, when Ontario and Quebec give their acceptance to a prospectus, it is usually approved in the other provinces as well. The securities commissions also take an active role in licensing individual investment brokers.

The securities commissions have to ensure that the self-regulated organizations will not pursue the interests of their members to the detriment of others. They have been empowered, in several cases, to review and reverse any rule or other action by the stock exchange in their province.

Financial Cooperatives

Credit unions and caisses populaires are incorporated and regulated at the provincial level, but the federal *Co-operative Credit Associations' Act* was introduced in 1953 to facilitate the pulling together of credit unions' assets at the national level. To accomplish this objective, the Canadian Co-operative Credit Society (CCCS) was formed to serve as a national financial agent for credit unions in Canada, except in Quebec where the provincially incorporated Caisse Centrale Desjardins plays this role. The influence of federal legislation on central and local credit unions is relatively small when compared with legislation at the provincial level, but there exist no constitutional barriers that prevent the federal government from implementing more significant legislation. As early as 1907, Alphonse Desjardins, the founder of Quebec's caisses-populaires movement, sought federal legislation. A bill that passed the House of Commons in 1907 was defeated by one vote in the Senate on the grounds that caisses populaires were institutions serving local interests. During the 1909-10 and 1910-11 sessions, similar bills were introduced but without success. Bills to regulate financial cooperatives, introduced by the Solicitor General in 1913 and 1914, only received first reading.[22] As a result, financial cooperatives were content to operate under provincial legislation.

The powers of credit unions and caisses populaires are specified in their Acts. Broadly speaking, they are authorized to receive money on deposit or as payment for shares, and to make loans to members. They can make loans to, or buy the securities of, the central or regional federation, the Government of Canada, a provincial government, chartered banks, or trust companies. In some provinces, credit unions may invest in the securities of corporations that are registered to conduct business in the province; they may open branch offices and purchase life and casualty insurance for their members.

The regulatory framework of credit unions and caisses populaires operates on two or three levels, depending on the province. First, the local credit unions are regulated and function as independent entities. In some provinces they join together for common purposes to form regional federations. Finally, the locals or federations belong to a financial-cooperative central that operates provincewide, six of which are federally regulated.

Each provincial regulatory agency has its own method of supervising the financial cooperatives that fall within its jurisdiction. Depending on the province, such methods include discretionary inspection, remedial powers, and so on. The regulatory authority in nine provinces is charged with supervising the liquidity of assets. Prince Edward Island is the only province in which there is no mandatory reserve requirement. In most provinces, credit unions must undergo an annual audit, and in all provinces failure to file an annual return is an offence. Seven provinces have specific conflict-of-interest provisions in their legislation.

The Regulation of Other Institutions

Other groups of financial institutions fall under various jurisdictions and have to abide by various sets of rules. For example, mortgage loan companies can be federally or provincially incorporated, and they generally operate under the *Loan Companies Act* at the federal level and under similar legislation at the provincial level (the *Loan and Trust Corporations Act* in Ontario, for example). The regulatory requirements and powers of loan companies are similar to those of the trust companies.

Consumer loan companies can be incorporated at either the federal or the provincial level; regardless of their incorporation, they are supervised by the federal Superintendent of Insurance under the *Small Loans Act*. This Act refers to these companies as money lenders when provincially incorporated and as small-loans companies when federally incorporated. Small-loans companies are authorized to lend money on promissory notes or personal security and on chattel mortgages. The Act covers loans under $1,500, on which only a prescribed maximum rate of interest may be charged. A small-loans company may not accept funds on deposit. The Superintendent has the authority to inspect the chief place of business of every company at least once a year and to make a careful examination of its conduct of business. Any provincially incorporated money lender also has to be licensed under the federal *Small Loans Act*.

The *Investment Companies Act* regulates federally incorporated sales-finance companies. The Act applies to federally incorporated companies that are not governed by any other type of legislation and that borrow funds from the public on the security of their bonds, debentures, notes, and other forms of debt instruments. The proceeds from such borrowing are used for investment purposes. The administration of the Act falls under the responsibility of the Superintendent of Insurance, and the Canada Deposit Insurance Corporation is authorized to be a lender of last resort.

Pension funds are regulated according to the place of incorporation of the sponsoring body. The pension funds of federally incorporated private corporations and of federal Crown corporations with trusteed plans are regulated under the federal *Pension Benefits Standards Act*. Examples of such corporations include Canadian Pacific, Air Canada, and Canadian National. The trusteed pension plans of provincially incorporated corporations, provincial Crown corporations, and some municipalities are governed by similar legislation in the various provinces. For example, the Ontario Hydro pension plan is regulated by that province's *Pension Benefits Act*. Nontrusteed public-sector plans, such as the Public Service Superannuation Fund, whose surplus funds are absorbed into the general revenue fund, are regulated by their own Act - either federal or provincial, as the case may be.

The model for all other Acts relating to trusteed pension plans is that of Ontario. This legislation covers such provisions as vesting, locking-in, and so on, as well as investment powers. Generally, pension plans can invest in the same types of assets that are allowed under the *Canadian and British Insurance Companies Act*, with two exceptions: first, there is no restriction on the amount of common stock, real estate, or leaseholds that pension plans can hold; second, under the federal *Income Tax Act* they are restricted in their holding of foreign assets. The income of trusteed pension plans is exempt from income tax, except when more than 10 per cent of assets is invested in foreign securities. In that event, funds are taxed at a penalty rate of 1 per cent per month on any excess over the 10-per-cent limit.

Lawyers who have control of trust funds have to abide by provincial trustee legislation - the Ontario *Trustee Act*, for example. According to the Act, trustees may invest any trust money in their hands in the bonds or debentures of federal or provincial governments, in the first mortgages and bonds and debentures of a corporation guaranteed by governments, in the bonds or debentures of a corporation that has paid dividends in each of the past five years, and in the preferred and fully paid common shares of corporations that have also had a history of dividend payments. These investments should be made only if they are proper and reasonable in every other respect. In fact, the regulations pertaining to the investment powers of trustees are quite similar to those applying to the investments of trust and loan companies, life insurance companies, and pension funds. These regulations may, however, be overridden by the terms of the instrument creating the trust.[23]

Lawyers also have to abide by provincial *Law Society Acts*. Of particular interest are the "Rules of professional conduct" that set out standards of behaviour. For example, according to Rule 5 of the Ontario "Rules," a solicitor must not be placed in a position where there is a potential conflict of interest. Finally, it should be noted that a lawyer need not have expertise or meet specific standards of qualification in order to be a trustee.

Jurisdictional Problems

Clearly, financial institutions fall under different jurisdictions and have to abide by varying sets of rules. Institutions performing exactly the same functions may be regulated at either the provincial or the federal level, and sometimes differently according to the regulatory body. Moreover, institutions involved in similar functions may be regulated at the same level under different Acts. For example, banks and federally incorporated trust companies are involved in similar operations, such as deposit-taking, but fall under different pieces of legislation. This leads to duplication, confusion and even conflicts, as recognized by the Dupré Task Force:

> The importance of federal-provincial harmony in the area of financial services regulation cannot be overstated. The current jurisdictional maze . . . has led to enormous duplication, confusion and, often, conflict between both levels of government. Such . . . dual regulation can seriously undermine the efficiency of our Canadian capital markets, by generating additional and often disparate obligations which the industry must fulfil. . . . Despite the panoply of formal meetings which currently take place (of provincial securities regulators, of federal-provincial Superintendents of Insurance, of federal-provincial Deputy Ministers of Consumer and Commercial Relations and of Ministers of Consumer and Commercial Relations, of federal-provincial Deputy Ministers of Finance in the Continuing Committee of Officials and of Ministers of Finance) there is no single forum in which all of the relevant factors responsible for the regulation of and development of policy for the financial services industry can meet and resolve issues of mutual concern.[24]

Serious problems with harmonization do not arise with either Schedule A or Schedule B chartered banks, which operate almost exclusively under the *Bank Act*. Nonetheless, some jurisdictional overlap in the regulation of related banking activities has developed over the years, mainly as a result of the lack of a concise definition of banking. The *Bank Act* grants banks certain powers that may not fall exclusively under banking activities and that are subject to provincial regulation. For example, in the securities area, the Act authorizes chartered banks to engage in the distribution of bank-issued securities to the public and in the purchasing and selling of securities for their own account or as agents for their clients. But each province regulates securities markets within its own boundaries. Thus there is a jurisdictional overlap.

In another example, even though chartered banks and their affiliates are incorporated federally, their mortgage-loan subsidiaries are subject to registration in some provinces (Alberta, Saskatchewan, Manitoba, and Ontario). These provinces monitor and regulate the activities of mortgage-loan subsidiaries regardless of how the parent company is supervised. In practice, however, they request only that certain information be filed with the provincial authority, with no further compliance necessary.

It is quite a different story in the trust industry, where different standards result from different regulatory regimes. For example, in Ontario and Quebec, where comprehensive regulatory systems for trust companies are in place, there is overlap and duplication of supervision between provincial and federal authorities.

Lack of harmonization between regulatory authorities is apparent in the registration process. The Ontario statute is the most stringent. Besides meeting solvency and capital requirements, a trust company incorporated in another province (but not a federally incorporated company) must demonstrate to the Ontario Registrar that there is a public need for its services – either as a first instance or in addition to existing services – in the locality where it wants to carry on business. In British Columbia and most other provinces, only pre-notification and financial disclosure are required for registration.

The standards that trust companies must meet differ between jurisdictions. For example, while federal and Ontario legislation limits the basket clause of companies incorporated within their jurisdiction to only 7 per cent of total assets, a 10-per-cent basket clause is currently in effect in Alberta.[25] Like other provinces, Ontario has no jurisdictional authority to regulate the activities of trust companies outside its territory, although it could attempt to do so through the "treatment of equals" clause in its proposed trust and loan legislation, whereby institutions operating in Ontario but incorporated in another province must meet some Ontario rules in all jurisdictions where they also operate. The current *Loan and Trust Corporations Act* only gives the Ontario regulators the right to visit the head office of an out-of-province company for the purpose of inspecting for solvency. The regulators, however, currently have no right to regulate transactions taking place outside Ontario.

Part of the problem in the trust industry may be the absence of a central regulatory office or a formal agreement among jurisdictions. Currently, regulators in one jurisdiction must rely on regulators in the others to ensure that standards are equal across provincial boundaries.

In contrast to the trust industry, provincially incorporated life insurance companies may register at the federal level under the *Canadian and British Insurance Companies Act*, which allows them to carry on business across Canada. But even though the major part of insurance business in Canada is conducted by federally incorporated companies, and provincially incorporated companies can register at the federal level, such activity does not completely avoid provincial regulatory requirements, particularly with respect to the licensing of agents and the distribution of life-insurance products.

The laws governing the distribution of life insurance vary from province to province. For example, provincial regulation requirements differ in relation to part-time and full-time agents, multicompany representation, and the multiple licensing of various financial services, such as the selling of mutual funds, real estate securities, and various insurance contracts.

Until recently, though, the life insurance industry had a long history of cooperation and coordination between federal and provincial regulators. The impetus for such harmonization came from a strong federal presence, coupled with the early establishment (in 1917) of the Association of Provincial Superintendents of Insurance (APSI). The presence of a dominant federal regulatory system has undoubtedly helped to harmonize the provincial systems. But the formation of the APSI contributed to the achievement of a certain degree of uniformity of legislation. Initially, the association was strictly confined to provincial superintendents, but soon the federal superintendent was invited to attend its meetings. In 1984, the association was reorganized, and the federal Department of Insurance formally became part of a new group, called the Council of Canadian Superintendents. But Quebec's Bill 75, voted in 1984, which put in place less-onerous conditions of registration for life insurance companies operating in the province and increased their scope for diversification through the establishment of subsidiaries, was a departure from the existing regulatory approach, and the other provinces have not followed suit. Ontario's proposed legislation with respect to trust and loan companies can be seen as maintaining the status quo with respect to the regulation of financial institutions across Canada, although its latest move in the securities industry may give a different signal.

In the securities industry, there have been, time and again, conflicts between provinces with respect to prospectuses, disclosures, registration, takeover bids, and so on. There has even been some attempt at restricting the free flow of trade in securities across the country - e.g., when Quebec's Commission des valeurs mobilières in the 1970s required that orders originating from Quebec residents be placed first on the Montreal Stock Exchange. Nonetheless, there have been efforts to harmonize regulation through various policy statements and directives. With respect to consumer protection, for example, provincial securities commissions have exchanged information with one another and have coordinated the exercise of the power to freeze the assets of a person or the cancellation of registration of an investment dealer. According to a study prepared for the Macdonald Commission,

> although the provincial legislatures and their delegates have for over half a century attempted to ensure the effectiveness of their securities laws and to enhance the efficient functioning of the securities market through legislative and administrative coordination, the overall scheme of securities regulation in Canada remains less than harmonious. Indeed, the history of Canadian securities regulation during the past two decades is marked by differential obligations on issuers, different levels and types of protection for investors and frequently ineffective or overreaching enforcement. Even today, despite continuous efforts by the Canadian Securities Administrators to achieve a uniform or compatible national system of regulation, with the motivational assistance of potential federal "intrusion" into their domain, the provincial laws and administrative policies differ in substance and in detail and there is no prospect of a diminution in regulatory diversity or its consequences. If anything, the present pace of securities law reform suggests the introduction of further disparities between the provincial statutes and ensuing alterations of policy and practice.[26]

There is still a long way to go. And that is true not only of the securities industry but of other financial areas as well.

It is important to avoid the balkanization of markets. Most financial markets, regardless of how they are regulated, are national in scope. That is true of banking activities, insurance activities, securities trading, and even - to some extent - trust activities. (It may be less so with the activities of credit unions.) Furthermore, financial markets transcend national boundaries. This calls for cooperation and harmonization, not only between various provincial jurisdictions but also between countries. International harmonization cannot be achieved unless there is some form of harmonization within the country itself. Cooperative efforts, nationally and internationally, are needed because financial transactions are not respectful of barriers between provinces or nations.

There is a trade-off, however, between uniformity and the principles of federalism. On the one hand,

> If the laws of one province impose greater burdens than those of others, persons engaging in the regulated activity may be able to avoid them by conducting their business elsewhere or by excluding residents of that province from participation in a particular transaction. The resultant differential treatment of similarly situated investors may undermine their apprehension of the market's integrity and frustrate the provincial administrator as well as the broader goals of the legislation. . . . An uncompromising commitment to uniformity, however, may be contrary to one of the fundamental premises of federalism, namely, the ability of individual provinces to develop their own policies to address local needs and goals.[27]

There may also be some benefits from competition in regulation, whereby different authorities strive towards the most efficient regulatory framework. A diversity of regulatory authorities contributes to such competition but also leads to the balkanization of the regulatory system.

The Need for Reform

There is a definite need for an overhaul of the legislation governing financial institutions. First, with the exception of the *Bank Act*, the existing sectoral legislation has not been the subject of a global review in many years. The limited attempts at reviewing legislation may have, in fact, caused more harm than good, as they applied to some specific institutions but had an impact on all the players in financial markets. Two major difficulties with the existing regulatory framework that have been brought to light in this chapter increase the urgency of reform: the absence of a clear definition of the sharing of responsibilities; and a lack of harmonization between the various regulatory authorities, resulting in the unequal treatment of similar functions performed by groups of institutions falling under different sets of regulation. Furthermore, as will become evident in subsequent chapters, current legislation is, in many instances, a stumbling block to the efficient operation of Canadian financial institutions and markets.

3 Competition in the Financial System

Competition is a necessary condition for the achievement of public and private efficiency in any market. The question that must be addressed in this report is: Can competition really exist in markets that appear to be so dominated by huge financial **conglomerates**?[1]

The issue of market concentration has surfaced several times in recent years. The attempt by Power Corporation to gain control over Argus Corporation in 1975 was the catalyst for the establishment of the Royal Commission on Corporate Concentration. More recently, in a brief submitted to the House of Commons Standing Committee on Finance, Trade and Economic Affairs in August 1985, the Cadillac Fairview Corporation argued that "there is a moderate to high degree of concentration in individual financial markets in Canada. . . . The concern is that these large groups will have the ability to earn an acceptable level of profit (e.g., sufficient to prevent a takeover) and be able to use their powers to achieve objectives other than increasing the shareholders' wealth."[2] In spring 1986, the takeover of Genstar by Imasco, giving it control over Canada Trust, prompted public discussion on the issue of concentration and its potential impact on competition in the financial sector.

The Empirical Evidence on Concentration

While it is market concentration that should be the object of concern in this respect, it has often been confused in recent debate with concentration of ownership and concentration of power. Concentration of ownership refers to the distribution of the shares of an institution and to the exercise of control over the institution by a single shareholder or group of associated shareholders. Concentration of power refers to the ability of an institution or a group of interconnected institutions to influence regulators, legislators, or other institutions by virtue of the size of its assets. A corporation exercises economic power when it can influence economic activity because of its sheer size, and not because of its share of a market. Political power is the ability to influence government policy. Because of its size, a large corporation is involved in many activities, and its fortunes affects many people. Both economic and political power derive from the size of the firm, which in turn can be measured by the concentration of assets. Market concentration refers to the share of an industry's total output that is accounted for by a small number of firms.

Concentration of Ownership

It has often been argued that the concentration of ownership in the financial sector has increased over the past five years. Reference is made to the emergence of financial holding groups that bring together life insurance companies and some of the largest trust companies in the country, to the merger between Canada Trust and Canada Permanent Trust, and to many other acquisitions within the financial industry.

The recent emergence of the financial holding structure has led to an increase in the number of **closely held** financial institutions. For example, Trilon owns 50 per cent of the shares of Royal Trustco; Canada Trust became a wholly owned subsidiary of Imasco in 1986, and there are no longer any large, widely held trust companies in Canada. Unquestionably, it can be said that, as measured by the degree of dispersion of the voting stock of individual institutions, concentration of ownership has increased in recent years.

In fact, there are today three different models of ownership. Schedule A chartered banks are **widely held**, with no individual shareholder owning more than 10 per cent of outstanding shares. Credit unions and mutual insurance companies are also widely held institutions. Second, several trust and loan companies are closely held by individuals or firms. Finally, several trust companies and insurance companies have a majority shareholder, but a large portion of their shares is also held by the public at large.

Concentrated ownership of financial institutions has been the object of negative comments lately, but it is not necessarily all bad. As their interests are directly at stake in any major management decision, the owners of a closely held institution may legitimately wish to keep tighter control on the quality of management. The Dupré Task Force recognized "that a closely-held financial institution can be managed efficiently and successfully. There are certainly examples where controlling shareholders have been a beneficent force requiring excellent management and a high standard of conduct."[3] A study done for the Economic Council of Canada notes that "ownership control is an important mechanism by which weak management teams are replaced by stronger ones."[4]

On the other hand, institutions closely held by individuals may have more difficulty in raising funds. For example, small, closely held trust companies have been limited in their ability to raise additional equity and thus to expand their deposit-taking operations. At the same time, concentration of ownership may be the proximate cause of some conflict-of-interest situations; it may also facilitate self-dealing and even make it more attractive. Abuses of conflict of interest and self-dealing, discussed more fully in Chapter 5, distort the process of resource allocation through their negative impact on competition and on the availability of information, besides weakening confidence in the financial system.

Concentration of Assets

In the Canadian financial sector there appears to be a large concentration of assets held by a few corporations. Among banks, trust and loan companies, and life insurance companies, the four largest institutions accounted for 52 per cent of total assets in 1984 (Table 3-1); only 17 institutions were needed to account for 80 per cent of total assets – a "relatively high" degree of concentration.[5] These measures were obtained by taking into account only the most obvious ownership links.[6] When more elaborate ownership links are considered and holding groups are added, the proportion of assets controlled by the four largest institutions does not change, but the number of firms needed to account for 80 per cent of assets is slightly lower.

By comparison, in the manufacturing sector the four largest firms accounted for 11.1 per cent of total assets in 1983. The corresponding figures for four component industries of that sector were as follows: food industry, 15.6 per cent; wood industry, 28.9 per cent; paper and allied products industry, 33.6 per cent; and transportation equipment industry, 75.2 per cent. Against these figures, concentration in the financial sector appears somewhat above average.

The growth of financial holding groups does not appear to have, as yet, significantly increased the concentration of assets. While nine holding groups accounted globally for about 10 per cent of all institutions' assets in 1985, individually each group had a very small share of the total (Table 3-2). The recent mergers and takeovers in the financial industry did not affect the measures of concentration of assets, mainly because of the size of the banks – the dominant firms. Adding the **estate, trust, and agency business** (ETA) of trust companies to their other assets lowers the percentage of assets controlled by the four largest companies, as ETA business significantly increases the relative size of trust companies (Table 3-3).[7] It does not, however, change the fact that the four largest financial intermediaries are the Royal Bank, the Bank of Montreal, the Canadian Imperial Bank of Commerce, and the Bank of Nova Scotia. In fact, it only slightly modifies the number of companies needed to account for 80 per cent of the assets of the group. More importantly, while concentration of total assets increased between 1967 and 1979, it declined somewhat thereafter.[8] The entrance of Schedule B banks after the 1980 revision to the *Bank Act* decreased concentration within the banking industry. And because of the important relative size of this industry, overall concentration of assets in the finan-

Table 3-1

Concentration of Assets among Major Groups of Financial Institutions,[1] Canada, 1967, 1979, and 1984

	Percentage of total assets represented by the four largest companies		Number of companies needed to account for 80 per cent of total assets[2]	
	Obvious ownership links	More complete ownership links, including holding groups[3]	Obvious ownership links	More complete ownership links, including holding groups[3]
1967	46.4	. .	17	. .
1979	54.8	54.8	13	12
1984	52.2	52.2	17	16

1 Banks, trust companies, loan companies, and life insurance companies.
2 In a study by the Department of Consumer and Corporate Affairs, the degree of concentration is determined by the number of companies that account for 80 per cent of the output or employment of an industry. The degree of concentration is "very high" when that number is four or fewer; "high" with five to eight; "relatively high", with nine to 20 companies; "relative low," with 21 to 50 companies; and "low," with more than 50 companies.
3 See footnote 6 of Chapter 3 for a full explanation.
SOURCE Mayrand, "Diversification, concentration et concurrence."

cial sector was reduced. The decline could be short-lived, however, should the current merger and acquisition activity continue and involve large corporations.

When only domestic assets are considered, the proportion of assets controlled by the four largest firms is reduced, but the same banks remain at the top. When the ETA business of trust companies is added to their other domestic assets, the four largest enterprises account for only 36 per cent of all assets, and Trilon Financial replaces one of the banks among the four largest companies.

Regardless of the measure considered, concentration of assets in the financial industry is higher than in most other sectors of economic activity. However, the level of concentration decreased between 1979 and 1984, the latest year for which a complete series of statistics is available. Although the different measures lead to similar conclusions, the most appropriate one to assess concentration of assets is that based on worldwide assets, excluding the ETA business of trust companies, while domestic assets without the ETA business are the most appropriate measure for market concentration. Indeed, the ETA business of trust companies is a quite separate activity, over which they do not have the same level of control as with company or guarantee funds. Although the trust manager may have discretionary powers over some ETA business, the capital gains realized on these transactions are not added to company funds, and losses

Table 3-2

Share of Nine Financial Holding Groups in Total Assets, Lending, and Deposits of All Financial Institutions,[1] Canada, 1979 and 1985

	Total assets		Mortgage loans		Other loans		Deposits	
	1979	1985	1979	1985	1979	1985	1979	1985
	(Per cent)							
Desjardins Group	2.94	3.33	6.15	6.63	2.90	5.94	5.14	6.56
Trilon Financial Corporation	. . .	2.63	. . .	5.84	. . .	1.76	. . .	3.63
Power Financial Corporation	1.65	2.01	3.53	4.36	0.31	0.46	0.61	0.82
Crown Financial Group	0.50	0.77	0.83	1.45	0.18	0.25	–	0.02
Laurentian Group	0.37	0.65	0.49	0.63	0.07	0.12	–	0.14
Traders Group	0.76	0.56	1.49	0.93	1.01	1.08	0.98	0.94
Eaton Financial Services	0.15	0.13	0.48	0.44	--	--	0.26	0.21
E-L Financial Corporation	0.12	0.14	0.12	0.09	0.02	0.02	–	–
Groupe Prêt et Revenu	0.04	0.06	0.11	0.15	--	0.02	0.06	0.11
Nine holding groups	6.54	10.29	13.20	20.51	4.49	9.66	7.06	12.44

1 Excluding trusteed pension plans.
SOURCE Mayrand, "Diversification, concentration et concurrence."

Table 3-3

Concentration of Assets among Major Groups of Financial Institutions,[1] Canada, 1979 and 1984

	Percentage of total assets represented by the four largest companies				Number of companies needed to account for 80 per cent of assets[2]			
	Total assets		Domestic assets		Total assets		Domestic assets	
	Without ETA	With ETA	Without ETA	With ETA	Without ETA	With ETA	Without ETA	With ETA
1979	53.1	45.0	47.7	39.4	13	14	16	17
1984	50.4	41.0	42.2	35.7	16	15	21	19

1 Full ownership links and holding groups are taken into account. See footnote 7 of Chapter 3 for a full explanation.
2 See footnote 2 of Table 3-1.
SOURCE Mayrand, "Diversification, concentration and concurrence."

do not come out of the company's capital base. To do otherwise would be a breach of trust. When analysing the concentration of assets, the concern is generally with economic and political power. Because the degree of that power is related to the total size of the corporation, worldwide assets are the most appropriate measure. When market concentration is the concern, however, domestic assets and domestic activities are a more appropriate measure.

Market Concentration

At the "**production level**," market concentration can be measured by the share of mortgages, business and personal loans, or deposits on the books of an institution. At the **delivery level**, concentration has to do with the availability of points of sale. Market share at the production level may be quite dependent on delivery arrangements, on the presence of a branch system, or on the degree of concentration in delivery. If, for instance, the branches of a bank are the only points of sale in a region, that bank will have an advantage in issuing mortgages in that region. Naturally, that could change if shared distribution systems were put in place as a result of new technological advances. But, for the present, concentration in the delivery system will have an impact on concentration at the production level.

The Production Level

A firm-by-firm analysis shows that the *mortgage market* has a relatively low degree of concentration compared with other financial markets: in 1984, the four largest companies accounted for 32.6 per cent of total mortgages outstanding, and 20 companies were needed to account for 80 per cent of mortgage loans (Table 3-4). These numbers reflect full ownership links and holding groups – the most complete ownership structure considered in the analysis to which we shall continue to refer. Concentration in the mortgage market has, however, increased over the years, particularly when financial holding groups are explicitly taken into consideration. Trust companies, Schedule A banks, and holding groups were the most important players in the mortgage market in 1984.[9]

The recent merger of Canada Trust and Canada Permanent has contributed to increasing further the degree of concentration in that market. On the basis of 1984 data, the new Canada Trust would be the second largest mortgage lender. If 1984 figures for Canada Trust and Canada Permanent were combined, the four largest companies would account for 34 per cent of the market.

The level of concentration in the *domestic deposit market* is relatively high, as the four largest companies accounted for 47.7 per cent of deposits in 1984, and 12 firms were needed to account for 80 per cent of the market. The level of concentration decreased between 1979 and 1984, however. The deposit market was dominated by the Schedule A banks. The merger of Canada Trust and Canada Permanent in 1985 would have reduced to 11 the number of companies that accounted for 80 per cent of the deposit market.

Concentration in the *personal-* and *commercial-loan market* is the highest of the markets considered. The four largest companies accounted for about 63 per cent of this market in 1984, and seven companies accounted for 80 per cent of loans. Again, the degree of concentration decreased between 1979 and 1984. Recent mergers and acquisitions have not had a large impact on concentration in this market, which is dominated by the Schedule A banks.

Concentration in the *life insurance market* is low compared with that in other financial markets. In 1984, the four largest firms in the ordinary life market accounted for about 28 per cent of directly written insurance in

Table 3-4

Concentration in Selected Markets among Major Groups of Financial Institutions,[1] Canada, 1979 and 1984

	Percentage of activities represented by the four largest companies			Number of companies needed to account for 80 per cent of the market[2]		
	Mortgages	Domestic deposits	Domestic personal and commercial loans	Mortgages	Domestic deposits	Domestic personal and commercial loans
1979	29.9	53.8	70.0	23	9	5
1984	32.6	47.7	62.7	20	12	7

1 Full ownership links and holding groups are taken into account. See footnote 6 of Chapter 3 for a full explanation.
2 See footnote 2 of Table 3-1.
SOURCE Mayrand, "Diversification, concentration et concurrence."

force, while it took 30 firms to account for 80 per cent of the market. In group life insurance, the four largest firms accounted for about 40 per cent of directly written insurance in force, and 20 firms accounted for 80 per cent of the market.

In the *general insurance market*, according to a study prepared for the Insurance Bureau of Canada, the four largest firms accounted, in 1979, for 24.4 per cent of net premiums on policies written for total insurance.[10] For automobile insurance, the percentage was 29.6; for property insurance, it was 23.2; and for liability insurance, it was 30.9.

Securities markets are quite highly concentrated when new issues of Canadian enterprises and governments (excluding private placements) are considered. In 1985, four securities firms accounted for almost 65 per cent of the value of common stock issues, while eight firms were needed to account for 80 per cent of that market. The four largest firms accounted for some 67 per cent of preferred stock issues, while six firms accounted for 80 per cent. In debt financing (bonds, debentures, and so on), 67 per cent of new issues were done by the four largest firms, while 10 firms accounted for 80 per cent of the market.

In conclusion, concentration at the production level varies among markets, from "high" in the personal- and commercial-loan market, the deposit market, and the primary securities market to "relatively low" in the mortgage and insurance markets. Quite independently of the particular measure chosen, however, the degree of concentration has generally declined over time, as a result of the efforts made by many institutions to improve their competitive position. Nevertheless, concentration in several markets remains high.

The Delivery Level

The number of branches of financial institutions serving various localities is a measure of concentration in the delivery of financial services. Not surprisingly, there is a higher level of concentration in rural than in urban areas. In larger centres, various institutions compete with one another in the delivery of financial services: Metropolitan Toronto, for example, had 1,075 bank branches, 284 credit unions, and 225 trust company branches in 1984 (Table 3-5). In small urban and in rural areas, customers have much less choice. At the beginning of 1985, there were 2,616 cities and towns in the country with at least one branch or office of a Schedule A or Schedule B bank, a trust company, a credit union, or an investment dealer, but - excluding the insurance business - close to 1,600 of them were served by only one retail outlet. The local bank branch, credit union, or caisse populaire is the only immediately available point of service for a great number of Canadians who live outside the larger urban centres. Including automatic teller machines (ATM) does not really alter the picture. The 4,000 machines installed by banks, financial cooperatives, and trust companies are mostly located in larger centres. It is true that the Bank of Alberta has retained the services of 58 individuals and small businesses to sell its registered retirement savings plans and term deposits, but these represent only a small part of banking services. In fact, some other institutions also have a network of agents to collect term deposits and sell funds. In the latter activity, they compete with life insurance agents and financial planners, who are also present in smaller communities. Concentration in the delivery of financial services is, however, expected to weaker in the future with the development of new technology.

Concentration and Competition

While our analysis reveals some concentration in financial markets at both the production and distribution

Table 3-5

Retail Banking Institutions in Selected Urban Centres,[1] Canada, 1984

	Number of branches			
	Banks	Credit unions and caisses populaires	Trust companies	Total
St. John's	42	2	11	55
Fredericton	20	6	4	30
Moncton	26	13	7	46
Saint John	28	9	7	44
Halifax	77	25	31	133
Montréal	718	281	79	1,078
Québec	106	74	14	194
Hamilton	132	83	46	261
Ottawa	127	39	32	198
Toronto	1,075	284	225	1,584
Winnipeg	180	47	29	256
Regina	58	31	16	105
Calgary	233	64	45	342
Edmonton	202	65	50	317
Vancouver	394	115	84	593
Victoria	60	32	19	111
Total	3,478	1,170	699	5,347
	(Per cent)			
As a proportion of all branches in Canada	48	31	62	44

1 Including metropolitan areas.

SOURCE Based on Canadian Payments Association, *Directory*, 1985; Trust Companies Association, *Directory of Members and Certain Non-Members*, February 1985; and Investment Dealers Association of Canada, *Membership Directory*, 1985.

levels, this does not preclude the existence of competitive behaviour.

Turnover in Concentrated Markets

If, over time, different institutions are found among the top four or if their relative sizes change, then a case can be made for the existence of some competition, provided that such turnover is not the direct result of a merger or acquisition.

In the deposit market, the same four banks were the largest institutions in 1979 and 1984. Only their rank changed - albeit slightly - between the two dates. Similarly, in the loan market there was little turnover among the four largest institutions, although one bank replaced another between 1979 and 1984. Turnover was greater in the mortgage market. The four largest companies in 1979 were the Desjardins Group, the Royal Bank, the Royal Trust, and Canada Trust; in 1984, they were the Desjardins Group, the Royal Bank, the Canadian Imperial Bank of Commerce, and Trilon Financial Corporation.[11]

Furthermore, as indicated in Table 2-1, the number of players has risen over time. The total number of banks and life insurance and trust companies rose from 223 in 1967 to 352 in 1984 - another sign of increased competitive pressures.

Barriers to Entry and Exit

Even though a market may be concentrated, firms would behave in a competitive fashion if there were freedom of entry and exit. Should noncompetitive profits arise, freedom of entry will ensure that new players will emerge. Competitive behaviour does not require a large number of participants but, rather, the potential entry of new participants to the market. Participants behave in a competitive fashion if markets are "**contestable**."[12]

Barriers to entry and exit do exist. There are quite a large number of legislative barriers to entry in many markets, such as the various incorporation and licensing requirements at the federal and provincial levels, capitalization requirements, and the restrictions preventing specific institutions from operating in specific markets. For example, banks may not enter directly into the securities-underwriting and -dealing markets or into the trust and life insurance markets; trust companies face restrictions with respect to commercial lending; and life insurance companies may not accept deposits.

In fact, rather than strive to provide a level playing field, the regulatory system imposes different costs and constraints on a number of particular activities - the difference depending on the type of institution involved (Figure 3-1). Quite apart from its lack of fairness, it constitutes a barrier to entry. In a level-playing-field environment, all the institutions involved in the acceptance of deposits, for example, would be required to meet the same requirements with respect to the holding of reserves. As explained in Chapter 2, institutions in a number of different pillars accept deposits (however described), but only the chartered banks are required by statute to hold noninterest-bearing reserves against those deposits. On the other hand, while trust companies are not obliged to hold noninterest-bearing reserves, they face limits on the amounts of personal and commercial lending that they can undertake; and unless they qualify as a direct clearer with the Canadian Payments Association, they cannot turn to the Bank of Canada as a lender of last resort for help in surmounting short-term liquidity problems.

The requirement of "widespread ownership" for certain categories of financial institutions and of minimum capitalization may also, in some circumstances, constitute a barrier to entry. Although these rules are aimed at minimizing insolvency and unfair treatment of users of financial services, they make it more difficult for new firms, particularly small ones, to enter financial markets. Legal barriers to exit are to be found in the need to receive approval to wind down operations and to surrender a charter, and in the rescue operations often put in train by governments to prevent the failure of a financial institution.

Even with the removal of these legislative impediments, it is unclear whether the retail market would attract substantial additional players. The sunk costs involved in the building of a branch network in order to be competitive on the retail side of banking, may not be compensated by expected revenues. As long as the delivery of retail banking services will require a "shop on Main Street," costs of entry in this market may prove high, particularly in relation to alternative business opportunities. That may change with the development of technology and automatic banking machines, however.

The 1980 revision to the *Bank Act* was aimed at increasing competition within the banking industry by opening up the doors to subsidiaries of foreign institutions and by speeding up the process of incorporation of a chartered bank. But the cost of setting up an extensive branch system is one of the reasons why foreign banks are mostly involved in wholesale transactions and cater to larger businesses - although this does not thwart their success. None of the foreign banks have so far attempted to establish a branch network that would come even remotely close to that put in place by the five large Canadian banks. Fifty foreign banks had four branches or fewer at the end of 1985, and 24 had only one branch. Most of the branches were located in larger cities, such as Toronto, Montreal, Vancouver, Calgary, and Edmonton.[13] Recently, Citibank expressed its intention to enter the retail banking business by opening some branches, but these will also be located in large centres.

The smaller Schedule A banks that were established in the second half of the 1970s have been at a competitive disadvantage because they have not been able to develop a strong branch system and have had to rely on wholesale funding rather than on a more stable retail-deposit base. Among institutions other than banks, the network of local credit unions and caisses populaires comes closest to a branch system.

Cross-Market Competition

Concentration figures tend to underestimate the nature of competition, as they do not take into account the competitive pressures coming from instruments that are substitutes for those traded in the markets under consideration. While Canadian banks dominate the commercial-loan market, trust and life insurance companies offer financing instruments that are close substitutes for commercial loans but that are not captured by an analysis of the commercial-loan market. Chapter 1 showed how competition increased in the 1970s, as trust and life insurance companies indirectly engaged in activities similar to commercial lending and as life insurance companies and securities firms offered depositlike instruments. Although these developments help to increase global competition within financial markets, the efforts of various groups of financial institutions are often thwarted by legal barriers to entry.

Foreign Competition

Foreign institutions have not, as yet, significantly affected the measures of concentration, but their presence has enhanced competition. This is particularly true in the banking industry.

To some extent, the 1980 revision to the *Bank Act* merely formalized the presence in Canada of several of these institutions and obliged them to abide by the *Bank Act*. Before 1980, many so-called "suitcase banks" were involved in banking or banking-related activities without calling themselves a bank. Today, 55 foreign banks are in more open (albeit still limited), competition with Canadian banks, seeking business from large companies, mostly in large urban centres. Approximately half of Canadian life insurance companies are foreign, and they contribute to maintaining a certain level of competition in this sector. In other areas, foreign competition is not as open because of regulatory constraints. Foreign securities firms are present in the **exempt-securities market**; they are also called upon to assist in takeovers and in raising funds for governments in Canada. At present, they do not directly participate in the corporate underwriting business or in securities trading because of regulatory restrictions presently in place in some provinces. Nevertheless, they constitute a strong competitive force for domestic firms in the unregulated segment of the securities market. Nomura International and Bank of Tokyo International are leading underwriters on Canadian bond markets. Proposed changes to the regulation of the securities industry in Ontario would open to foreign dealers, within certain limits, the domestic nonexempt markets.

Several foreign firms - such as merchant bankers - come to Canada to seek business from Canadian corporations that will be booked in their country of origin. Although it is difficult to gauge the importance of such activity, it must be recognized as a competitive pressure on domestic firms. More generally, the recent movement towards the internationalization and globalization of financial markets has opened up alternatives for large Canadian firms and large investors, adding competitive pressures on domestic Canadian financial institutions. At the present time, such developments do not directly affect the retail side of financial intermediation. Some had predicted that the opening-up of the Canadian financial system to foreign firms could intensify competition at the retail level as domestic firms by multiplying their efforts on domestic markets; this has not occurred, however, as many Canadian firms have fought back by entering the foreign institutions' territory in their search for the most profitable business.

Competition and Diversification

Concurrently with the increased competition in many financial markets, there has been a trend towards greater diversification. The largest financial institutions are the banks and the trust companies, which are actively competing on many markets. These institutions, together with the financial cooperatives, exhibit the most diversified balance sheets. Investment dealers and life insurers are less diversified. While fast-growing groups of institutions include both diversified and more specialized firms, the slow growers are the less diversified firms. The rapid growth of financial holding groups in recent years - their assets grew at an annual rate of 20.6 per cent between 1979 and 1985, compared with 11.9 per cent for all financial intermediaries - strengthens this observation. This raises the question of the relationship between competition and diversification.

Figure 3-1

Major Regulatory Differences Affecting Different Categories of Financial Institutions in Canada

	Banks	Credit unions and caisses populaires	Trust companies	Loan companies	Life insurance companies	General insurance companies	Securities dealers
Deposits	Allowed	Allowed	Allowed	Allowed	Can provide only depositlike short-term deferred annuities	Not allowed	Deposit accepted in form of cash-management accounts
Statutory reserves							
Primary (non-interest-bearing)	10 per cent on demand deposits 2 per cent on notice deposits up to $500 million 3 per cent on notice deposits over $500 million 3 per cent on foreign-currency deposits of Canadian residents	Not required	Not required	Not required	Not required	Not applicable	Not required
Secondary	Required, as set by Bank of Canada	Not required	Not required	Not required	Not required	Not applicable	Not required
Deposit insurance	CDIC coverage	Covered by RADQ in Quebec; OSDIC in Ontario; protected by stabilization funds in other provinces	CDIC coverage, except RADQ for provincial companies in Quebec; some companies not covered	CDIC coverage, except RADQ for provincial companies in Quebec; some companies not covered	None	Not applicable	Industry contingency fund
Mortgage lending	Allowed	Allowed	Allowed	Allowed	Allowed	Allowed	Allowed
Commercial lending	Allowed	Allowed	Restricted to inclusion in basket (varies, depending on incorporation)	Restricted to inclusion in basket (varies, depending on incorporation)	Not allowed	Not allowed	Not allowed
Personal lending	Allowed	Allowed	Restricted to inclusion in basket (varies, depending on incorporation)	Restricted to inclusion in basket (varies, depending on incorporation)	Can only offer policy loans	Not allowed	Can extend credit on margin accounts

Corporate securities underwriting	Not allowed	Not allowed	Not allowed	Not allowed	Not allowed	Not allowed	Allowed
Securities distribution	Allowed, but cannot advertise outside branch or solicit business	Allowed	Allowed	Not allowed	Not allowed	Not allowed	Allowed
Investment counselling	Not allowed	Not allowed	Allowed	Not allowed	Allowed	Allowed	Allowed
Portfolio management	Restricted to non-discretionary funds	Not allowed	Allowed	Restricted to acting as agency	Allowed	Allowed	Allowed
Trustee services	Not allowed	Not allowed	Allowed	Not allowed	Not allowed, except for provincial incorporated companies in Quebec	Not allowed except for provincial incorporated companies in Quebec	Not allowed

Diversification of a financial institution refers to the extent to which its revenues come from a number of unrelated sources: from lending activities,[14] deposit-taking activities, underwriting, buying or selling securities, managing mutual funds, and so on. An institution can diversify in essentially three, not necessarily mutually exclusive, ways - namely, by seeking new kinds of clients, such as new corporations or individuals, businesses of different sizes or businesses that operate in different sectors, and so on; by offering new products; and by providing services to clients in different regions of the country. In this sense, all domestic financial institutions are, to some extent, diversified; some, however, are more diversified than others. A fully diversified institution would offer all financial services and would serve all classes of customers in all regions of the country. At the other extreme, a completely specialized institution would offer only one service to one customer. Canadian financial institutions operate somewhere between these two extremes.

Product diversification can be measured by the relationship between the services offered. Figure 3-2 lists the various groups of financial products and services that are generally offered by financial firms. As one moves from one column to the next, the closeness of the relationship between products decreases. A diversified firm offers several products and services within one column. A conglomerate offers products and services from at least two columns. According to such a definition, life insurance companies or investment dealers (which do not offer cash management accounts) are diversified firms. Schedule A banks, trust companies, and financial cooperatives are conglomerates. Figure 3-3 presents a summary description of the degree of diversification of several groups of institutions in the supply of various products and services.

Factors of Diversification

By diversifying, a firm can achieve a better combination of risks and returns and thereby reach its ultimate objective of increasing profits, growth opportunities, and the chances for long-term survival in a rapidly changing economic environment. For example, a mortgage loan company operating in one region might move into a new region, thereby diversifying and reducing overall risk relative to earnings. Alternatively, the company might move into the higher-risk/higher-return personal lending area and might, in fact, increase the overall risk of its portfolio. But as long as the increase in earnings more than compensated for the increase in risk, the shareholders would prefer the higher-risk/higher-profit combination. The improvement in the risk/return combination would enable the firm to raise equity capital more easily and thus broaden its operations. Indeed, diversification is generally linked to a corporate investment decision in a growth context. There are technical and market reasons for diversification.[15]

The *technical factors* are linked to the supply of financial services. For example, the development of new technology facilitates the introduction of new instruments, which in turn enables firms to diversify. Excess capacity may also lead to the entry of a financial institution into new areas - the credit-card business, for example.

Diversification may also involve economies of scope, which arise from joint production or distribution. In the financial sector, two types of economies of scope can be identified: the use of a single distribution network for several products, and the synergies that may develop in the gathering and analysing of information as part of the corporate planning process. The massive entry of the chartered banks into the mortgage market after the 1967 revision to the *Bank Act* provides an example of the first type of economies of scope. The banks were able to use their extensive branch network to deliver mortgage-lending services. An example of the second kind of economies of scope would be the pooling of managers with different expertise from the member companies of a financial holding group, to examine how the quality of existing products could be improved. Both kinds of economies of scope reduce the costs of producing and delivering financial services: they make the firm more competitive.

Just how important economies of scope are for financial institutions is difficult to determine. The few studies on this subject indicate that such economies are difficult to identify. The economies of scope may, however, turn out to be significant with the increased use of new computer technology.

As an example of the influence of *market factors* in corporate decisions, a firm whose product market has reached maturity may choose to diversify into other areas. This was clearly the case when Sears Roebuck in the United States decided to offer a full range of financial services in its stores. A firm may also diversify in order to cope with changes in demand. A well-diversified firm, such as a French or West German "universal bank," could retain the business of customers regardless of whether they were seeking financing through a **nonmarketable** loan or through a bond or equity issue. Diversification in response to these factors contributes to increasing the competitiveness of a firm.

Financial Holding Groups: A Special Form of Diversification

A financial holding group is a special kind of financial conglomerate composed of two or more financial companies operating in different areas of the financial system and closely held by a holding company.[16] Financial holding groups are not homogeneous. They differ with respect to their size, their organizational structure, the services they offer, their philosophy, and their *modus operandi*. Some, like the Desjardins Group, Trilon, and Power Financial, are large conglomerates offering their customers a variety of services that span several pillars. Others, such as E-L Financial and Groupe Prêt et Revenu, are of more modest size and offer more limited products. Some - such as Eaton Financial Services[17] and, to a lesser extent, Power Financial - have been established to compete for business in the context of a **one-stop financial centre**. Others are simply the outcome of an attempt by their owners to diversify their assets. Some financial holding groups try to bring together as many of the operations of their subsidiaries as possible through cross-selling or cross-referrals, and by having member companies service their affiliates. Others, like Traders, take a more passive role. The closest to a full-service financial holding group is the Laurentian Group, followed by Trilon and the Caisses populaires Desjardins. Some financial holding groups, such as Trilon and Power Financial, have close ties with the real sector of the economy; others do not. This heterogeneity should be kept in mind in the drafting of any legislation pertaining to the operations of such groups.

Many factors that explain the trend towards diversification and the development of conglomerates can also explain the emergence of financial holding companies in Canada. The Canadian regulatory system, the quest for flexibility, and the desire to maintain a corporate culture and the loyalty of customers are factors more specific to financial holding groups.

As the laws and regulations governing the Canadian financial system have historically been designed around the pillars, institutions have been prevented legally from directly diversifying into areas outside their core functions. Such restrictions have been overcome by resorting to a holding-group approach.

But the advantages of the holding-group structure go beyond the ability to circumvent existing regulation. It provides flexibility in management and is also intended to facilitate the blending of various corporate cultures. In particular, the members of a financial holding group are often encouraged to participate in cross-selling, networking, and cross-referring. This, again, will enhance the benefits of diversification and should provide some competitive advantages. But networking arrangements are often more easily planned than put into effect. First, networking is often prohibited across pillars, and in many cases one institution cannot receive a commission for selling the products of another institution. Second, it may be difficult to foster an environment of cooperation between institutions that have historically operated as separate entities. This is even more difficult when an institution does not feel that it would directly benefit from cross-selling.

The members of a financial holding group retain their corporate identity and are therefore able to raise funds on their own. On the other hand, a holding group, because of its size and its stronger balance sheet, particularly if the parent is inactive, may be in a better position to raise new capital than some of its subsidiaries. The group may find it easier to tap capital markets than if it had been organized as a conglomerate, with all its subsidiaries merged into one corporate entity. Furthermore, it may be easier within a holding-group structure to reallocate funds between activities and core functions and to obtain a better match of assets and liabilities. While the legislation governing trust and insurance companies prohibits lending to, or purchasing the shares of, companies associated through ownership links (i.e., "**cross-lending**"), affiliated institutions can buy and sell each other's assets, thus obtaining a better match with their liabilities. Funds can also be reallocated through the interplay of direct investment from, and dividend payments to, the parent company. The ability to move funds between affiliated companies belonging to the same holding group contributes to the internal process of resource allocation, to increased profitability in relation to risk, and to enhanced competitiveness of member institutions.

The emergence of diversified firms, and more particularly of financial holding groups, could be viewed as an innovative way of responding to the needs of the users of the financial system, which may or may not be clearly reflected in market demand. It has been asserted that some diversification is aimed at the creation of a one-stop financial-service organization, which would in turn provide attractive options to users of the system. These options would include a wider range of new and innovative products, increased shopping convenience, and improvement in the delivery of products at reasonable cost. At present, however, there is little evidence to suggest that a strong demand for one-stop financial shopping exists, though it may be too early to tell.

Impact of Diversification on Competition

While diversification enables financial institutions to be more competitive, its overall impact on the competitiveness and contestability of markets could be both positive and negative, depending on the environment and business practices.

Figure 3-2

Classification of Main Services Offered by Canadian Financial Institutions

Lending	Deposit taking and currency exchange	Life insurance and other services related to life contingencies	Property and casualty insurance	Trustee services	Market intermediaries	Specialized business finance	Information and advisory services	Fund management
Mortgage loans Loans to individuals Personal loans Personal lines of credit Credit cards Overdraft protection Business loans and financing Lines of credit Term loans Commercial mortgages Bridging loans Syndicated loans Letters of credit Bills of exchange Retail and inventory financing Gold-lending arrangements Bankers' acceptances Loans to provinces and municipalities or school corporations	Households deposits Chequable deposits - true chequing accounts - daily-interest accounts - chequable savings accounts Nonchequable deposits - true savings accounts - daily-interest savings accounts - daily-interest RRSPs - RRIFs Term deposits - short-term deposits - long-term deposits - GICs - retirement term deposits (RRSPs) - self-directed RRSPs - retirement investment certificates - RRIF investment certificates - self-directed RRIFs - fixed-term annuities Commercial deposits Chequable deposits - current accounts (business cheques) - chequable savings accounts	Services to individuals Life insurance - term insurance - whole-life insurance - universal life insurance Annuities - life annuities - deferred annuities Sickness and disability insurance Services to enterprises and groups Group life insurance plans Employee pension plans Surgical/medical insurance plans	Individual insurance Automobile insurance Home insurance Others Corporate insurance Liability insurance Fire and theft insurance	Services to individuals Estate executor Will executor Trustee for lifetime, trusts, and donations Trustee for self-directed RRSPs Trustee for self-directed RRIFs Administrator for Quebec stock saving plans Investment management services Services to corporations Transfer agent and registrar for shares and bonds Disbursing agent for dividends and interest Investment management services	Services to individuals Full brokerage Discount brokerage services Services to enterprises Full brokerage services Discount brokerage services Underwriting of new issues of shares and bonds	Venture capital financing Merchant banking Financial leasing Lease financing Factoring Export and import financing	Information on the economic situation (data analysis and forecasts) Cash management consulting for enterprises Investment counselling Financial planning Estate and will planning Security advice and investment advice	Fund mutualization Securitization Mortgage-backed securities Car-loan pool

- contract investment accounts
Term deposits
- short-term deposits
- long-term deposits
- GICs
- money-market investment certificates
- bearer deposit notes
- certificates of deposit
- swap deposits
Cash-management accounts
Currency exchange
Safety-deposit boxes
Automatic teller
Traveller's cheques

NOTE GICs = guaranteed investment certificates; RRSPs: registered retirement savings plans; RRIFs: registered retirement income funds.

Figure 3-3

Services Offered by Selected Canadian Financial Institutions

	Chartered banks	Trust companies	Financial cooperatives	Life insurance companies	Property and casualty insurance companies	Investment dealers
Lending						
Mortgage loans	x	x	x	x	x	–
Other loans to individuals	x	x	x	x[1]	–	–
Business loans and financing	x	x	x	–	–	–
Loans to provinces and municipal or school corporations	x	–	x	–	–	–
Deposit taking and currency exchange						
Households' deposits	x	x	x	–[2]	–	–
Commercial deposits	x	x	x	–	–	–
Cash management accounts	–	–	–	–	–	x
Currency exchange	x	x	x	–	–	–
Safekeeping facilities	x	x	x	–	–	x
Automatic teller machines	x	x	x	–	–	–
Traveller's cheques	x	x	x	–	–	–
Life insurance and other services related to life contingencies						
Services to individuals						
- Life insurance	–	–	–	x	–	–
- Annuities	–	–	–	x	–	–
Services to enterprises and groups						
- Group life insurance plans	–	–	–	x	–	–
- Employee pension plans	–	x	–	x	–	–
- Surgical/medical insurance plans	–	x	–	x	–	–
Property and casualty insurance						
Individual insurance	–	–	–	–	x	–
Corporate insurance	–	–	–	–	x	–
Trustee services (other than trusteed pension plans)						
Trustee services for individuals	–	x	–	–	–	x[3]
Corporate trust services	–	x	–	–	–	–
Market intermediation						
Full brokerage	–	–	–	–	–	x
Discount brokerage	x	–	–	–	–	x
Underwriting of new issues	–[4]	–	–	–	–	x
Specialized business financing						
Venture-capital financing	x	–	x	–	–	–
Merchant banking	x	–	x	–	–	–
Financial leasing	x[5]	x	x	–	–	–
Lease financing	x	x	x	–	–	–
Factoring	x[6]	–	x	–	–	–
Export and import financing	x	x	x	–	–	–

Figure 3-3 (concl'd.)

	Chartered banks	Trust companies	Financial cooperatives	Life insurance companies	Property and casualty insurance companies	Investment dealers
Information and advisory services						
Information on the economic situation	x	x	x	x	x	x
Cash-management consulting for enterprises	x	–	x	–	–	–
Investment counselling	–	x	–	–	–	x
Financial planning	–	x	x	–	–	x
Other services						
Fund mutualization	x	x	–	x	–	x
Securitization	–	x	–	–	–	x

1 Loan to policyholders: loan against a policy's cash value.
2 Life insurers offer short-term deferred annuities that are close substitutes for deposits.
3 Investment dealers can act as trustees for self-directed RRSPs and self-directed RRIFs.
4 Chartered banks are not allowed to underwrite new issues in Canada but can do so abroad.
5 Chartered banks can do financial leasing through a subsidiary only.
6 Chartered banks can do factoring through a subsidiary only.
SOURCE Mayrand, "Diversification, concentration et concurence."

On the negative side, there are fears that diversification may lead to greater concentration, particularly if it comes by means of mergers – although such an impact is not yet supported by evidence. The West German experience indicates that diversification, and even conglomeration, need not be associated with market concentration. While there were 11 chartered banks in Canada in 1981, there were close to 900 private commercial and public-sector banks with so-called "universal powers" in West Germany. This number does not include the almost 4,000 cooperative banks with similar powers. Of the 900 "universal banks," the big three accounted for only 16.8 per cent of total bank assets.

The capacity of a financial holding group or a conglomerate to satisfy all of its customers' needs could be seen as detrimental to competition if it prevents consumers from seeking alternatives. Quebec legislation requires any institution to notify consumers that they are not obliged to purchase a full package of services and that they can seek, for instance, the life insurance policies that will accompany their bank loans from other suppliers. Such arrangements help to keep competitive forces at play.

A diversified firm might be able to use **predatory pricing** in one market and subsidize its unfair competitive practices from the profits of its operations in other areas. The fear is that this kind of pricing behaviour could end in a price war that would ultimately squeeze out a number of independent firms. Predatory pricing is not viable in the long run, however, unless the firm already benefits from an oligopolistic position in that market.

Tied selling, where the customer is required to purchase a second service as a condition of purchasing the first, is another undesirable practice that may be used by a conglomerate. For tied selling to be effective, however, either the diversified firm must be in a monopolistic situation in the market for the first service or there must be insufficient information on the alternatives available to the customer. Furthermore, tied selling can be disallowed by the new Competition Tribunal if, in its opinion, it is likely to reduce competition. There are, however, some practices that strongly invite the customer to purchase other products manufactured and delivered by the same institution. For example, in the United States, Sears Roebuck offers discounts on purchases in its retail stores to customers who have acquired a house through the services of its real-estate subsidiary, Coldwell Banker, and to those who carry its Discovery credit card. In Quebec, Les Coopérants – a mutual life insurance company that owns, among others, a property and casualty insurance company, a real estate company, and more than 92 per cent of the shares of Guardian Trustco – offers to purchasers of its new life insurance contract, "Vie-sans-pareille," a discount of 5 per cent on their car or home insurance premiums for a period of five years if their life insurance policies remain in force.

In many instances, the quest for increased competitiveness through diversification has led to the mixing of financial and nonfinancial activities. This is thought to have a negative impact on competition. It is conceivable, although there is no hard evidence to that effect, that a financial institution may provide favourable financing to the nonfinancial corporations with which it is associated through ownership links. Or a financial institution may refuse funding to the competitors of its affiliated nonfinancial corporations. As long as markets are competitive, this may not have too much of a negative impact. But as soon as there are barriers to entry in one form or another, this may indeed distort the process of financial- and real-resource allocation. The Gessler Commission, studying the "universal" banking system in West Germany, noted the possibility of problems when banks own shares in nonfinancial companies and proposed to impose a limit on such holdings.[18] This is currently not a problem in Canada, as financial institutions are restricted in their investments in the stocks of nonfinancial firms. Nonfinancial institutions may own financial companies, however, and this could lead to favourable treatment toward the parent company.

On the positive side, as they benefit from synergies, from economies of scope, from cross-selling and networking arrangements, and from an increased flow of information, diversified firms can offer a more varied line of products and can therefore provide more competition in the production and delivery of services. Overall, as diversification strengthens the players in financial markets and enables them to meet many challenges, it has probably had a positive impact on the competitive nature of financial markets, despite fears to the contrary.

Specialized Institutions

While many financial institutions are diversifying as a means of reducing costs and improving opportunities for growth, others are finding that specialization can also be a successful strategy. This is true for firms whose main "product" is expertise and that do not need either a large distribution network or elaborate technology to manufacture and distribute their products. Diversified institutions often do not have sufficient specialized knowledge in all areas. Venture-capital firms attract customers through their specialized knowledge of business financing. Many financial planners trained on the job by the Investors Group prefer to operate their own financial planning firm, where they can direct customers to any mutual fund, not just those managed by the Investors Syndicate. Many pension-fund managers have left large institutions, particularly trust companies, to set up – with very little capital – investment counselling firms, where they put to good use their many years of experience and their newly acquired flexibility.

The rapid growth of assets managed by investment counsellors is a testimony to the success of these specialized financial agents. The 10 years between 1975 and 1985 witnessed a dramatic shift in the management of funds from institutions to independent counsellors. In 1975, a total amount of about $1 billion was under management by independent investment counsellors; this figure had climbed to $15.4 billion by 1985. This represents an annual growth rate of about 32 per cent over that period, leaving assets managed by trust and insurance companies behind, with growth rates of 12.4 and 17.9 per cent, respectively. By 1985, investment counsellors were the most important group managing pension funds. To some extent, this is attributable to their relatively better performance. For example, over the 1981-85 period independent investment counsellors realized a 14.2-per-cent rate of return annually on their investment in Canadian equities – a performance better than that of other managers.[19] But part of the success of this group of financial intermediaries is also attributable to their proximity to their customers and to greater flexibility.

Specialization may also at times be a winning strategy because the success of diversification depends on the closeness of the relationship between the various products and services offered. According to the Bryce Report,

> a growing body of evidence, however, throws into doubt the theory that a strategy of conglomerate diversification is either a profitable one for investors or a good use of the firm's assets. . . . Firms that followed a strategy of unrelated diversification were less profitable in sales, grew less quickly and returned less to their stockholders in dividends and stock appreciation than did the portfolio of stocks that duplicated the acquiring firm's diversification pattern. As well, of the 100 largest publicly held firms in Canada, those that followed a strategy of unrelated diversification had a significantly lower return on equity and return to their investors over the same period.[20]

There are thus some competitive advantages to specialization and there will always be a niche for specialized institutions.

Competition and Regulation

There exists a body of legislation that is more directly geared at ensuring competition. This is the *Act to establish the Competition Tribunal and to amend the Bank Act and other acts in consequence thereof*, better known as the *Competition Act*, which replaced the *Combines Investigation Act* in 1986.

According to subsection 19(1), the purpose of the *Competition Act* is

> to maintain and encourage competition in Canada in order to promote the efficiency and the adaptability of the Canadian economy, in order to expand opportunities for Canadian participation in world markets while at the same time recognizing the role of foreign competition in Canada, in order to ensure that small and medium-sized enterprises have an equitable opportunity to participate in the Canadian economy and in order to provide consumers with competitive prices and product choices.

To this end, conspiracy to limit competition and predatory prices are criminal offences, while abuses of dominant position, mergers, and certain commercial practices such as exclusive dealing, market restrictions, and tied selling are matters subject to review by the new Competition Tribunal, which may issue an order prohibiting these activities.

Until 1 January 1976, the *Combines Investigation Act* generally applied to the production and trading of goods, and only to some services and insurance. From then on, the Act has applied to all economic activities except those which were explicitly excluded in total or in part, such as collective bargaining, amateur sports, or securities underwriting, and those which specifically fell under another Act, such as the *Bank Act*. The new *Competition Act* abrogates subsection 255(5) of the *Bank Act* and transfers into the *Competition Act* the provisions of section 309 of the *Bank Act*. Bank mergers now fall under the *Competition Act*, although the Minister of Finance will retain the power to approve mergers and acquisitions. Under the new Act, certain interbank agreements will remain illegal, such as agreements with respect to interest rates on deposits or loans, or with respect to fees. With the inclusion of banks, the *Competition Act* now applies to most financial institutions, although securities underwriting still does not fall under its purview.

The *Competition Act* only addresses some of the issues related to competition, however; for example, it does not deal with many of the barriers to entry in financial markets. In fact, as already mentioned, some barriers are the result of existing regulation. Legal barriers to entry exist in the form of licensing, registration, and incorporation requirements, ownership restrictions, and regulation of the composition of assets and liabilities. In particular, the regulatory framework that perpetuates the pillar system inhibits trust companies, life insurance companies, banks, and investment dealers from fully diversifying the scope of their operations.

On the other hand, certain categories of institutions operate in an environment that is almost free of any regulation. Financial holding companies and merchant bankers are examples. These institutions have grown rapidly over recent years and may pose a threat to competition.

The dilemma, of course, is to modify existing regulation so as to encourage greater competition. As mentioned, the raison d'être of a holding group and one of its main competitive advantages is the ability to move funds from one subsidiary to another, thus taking advantage of profit and growth opportunities. Introducing legislation that would prevent such movement of funds would affect its competitive position. On the other hand, the movement of funds between member companies of the same group could be a manifestation of self-dealing or abuses of conflict of interest, which themselves may contribute to reducing competition. A *juste milieu* has to be found.

While ownership restrictions often constitute in many cases a legal barrier to entry (in the banking and securities industries, for example), in relaxing those restrictions the regulator will not want to encourage the concentration of assets in the hands of a few companies, as that would, in turn, lead to market concentration and loss of competition.

Similarly, while diversification may lead to increased competition, there is room for specialized institutions. Today, we see the growth of financial planners, investment counsellors, merchant bankers, and so on; tomorrow, we may witness the development of other specialized institutions. Thus, while encouraging diversification, the presence or absence of regulation should not prevent the development of specialized firms wherever they may have a competitive advantage.

To promote competition, it is quite important that institutions performing the same function be regulated in the same way. In other words, no institution performing a specific function such as deposit taking, commercial lending, mortgage lending, or personal lending should have an advantage by regulation over another institution performing the same function but belonging to a different group. The need to maintain a level playing field calls for regulation by function, as was recommended in a previous Economic Council report.[21]

It is, indeed, a difficult task to carve out a regulatory framework that would strike the proper balance between diversification and specialization, between regulating by function and ensuring that no multifunction institution comes to dominate different markets. While competition has increased in recent years, many markets remain concentrated, and barriers that hinder competitive efforts continue to exist. Changes in the existing regulatory framework must therefore move in the direction of removing impediments to competition.

4 The Soundness of Financial Institutions

The recent failures of the Canadian Commercial Bank and the Northland Bank, and of several trust and general insurance companies, have caused regulators, legislators, industry officials, and the general public to take a closer look at the soundness of financial institutions and at public confidence in the Canadian financial system. Confidence takes on a special dimension in the financial industry because of the very role played by financial institutions.

Indeed, deposit-taking institutions take part in the provision of the means of payment. The very existence of the payments system rests on the widespread acceptability of currency and deposits for the purchase of goods and services, for the acquisition of income, and for the discharge of debt.[1]

Financial institutions are also special, not only because they issue transaction accounts or maintain a payments system in the economy but also because they are a backup source of liquidity for business, governments, and individuals. For the financial sector to perform that role and contribute to the efficient allocation of financial resources, there must be trust and confidence in its operations. Confidence is built on trust: a sense that managers of financial institutions will not compromise safety to obtain higher returns and that all customers will be treated fairly. The latter is particularly important with respect to the efficiency of the allocation of financial resources.

More generally, the whole intermediation process is based on confidence - in the soundness of the system, in the solvency of individual institutions, and in the even-handed treatment of both savers and borrowers. Without this, the payments system cannot be maintained; the intermediation process cannot function; and the financial system breaks down.

This chapter deals with those factors and regulations which bear on the solvency of financial institutions. The following chapter deals with matters bearing on the issue of even-handed treatment.

The Importance of Solvency

The relationship between the solvency of particular financial institutions and public confidence in the soundness of the financial system is not a simple one; nor is it predictable. Loss of confidence may be complete, as happened during the Great Depression in the United States. In that case, the increasing number of failures between 1929 and early 1933 resulted in some states declaring bank holidays. About half the states had done so by the time President Roosevelt took office in March 1933, and the new President immediately declared a nationwide, week-long bank holiday, during which time an Emergency Banking Bill was passed in an attempt to restore public confidence in the banking system. But the loss of public confidence may be partial, as well. While there were over 100 commercial-bank failures in the United States in 1985, this had no apparent impact on confidence in the soundness of the U.S. financial system. The previous year, however, to avoid a confidence crisis of major proportions, U.S. authorities rescued the Continental Illinois Bank, which had assets and deposits many times larger than those of the commercial banks that failed in 1985.

In Canada, deposit flights occur from time to time, as in the case of a branch of the Montreal City and District Savings Bank in 1965. In 1985, confidence was lost in the Canadian Commercial Bank and the Northland Bank. A more limited crisis of confidence affected the Bank of British Columbia and the Continental Bank in 1985, and again in 1986. But in all of those cases, the loss of confidence and fears of insolvency were directed solely at an individual institution and not at the system as a whole.

Solvency and Liquidity

According to the *Bank Act*, any bank that cannot meet its liabilities as they accrue is insolvent after a period of 90 days. This legal definition appears to overlook the distinction between illiquidity and insolvency. That distinction is nonetheless important, particularly with respect to remedial measures. In financial terms, an institution is insolvent when the market value of its assets is less than that of its liabilities. If it is simply unable to meet its liabilities as they come due because of insufficient liquid assets, that situation is generally referred to as illiquidity. Thus a financial institution may be illiquid if it cannot temporarily meet its immediate obligations but will remain solvent if the value of its liabilities does not exceed the value of its assets.

Temporary liquidity problems may occur because of the process of financial intermediation itself. As part of their day-to-day operations, deposit-taking institutions have large amounts of liabilities payable on demand or on very short notice. These funds are typically invested in commercial loans or personal loans that are less easily called on demand. A sudden withdrawal by depositors of a large amount of funds could cause a temporary liquidity problem. This may resolve itself over the longer run, provided that the institution has a loan and asset portfolio in good standing. Insurance companies may also experience temporary problems because of an improper assessment of claims, poor-quality reinsurance arrangements, or policies issued at too low a premium.

But a situation of illiquidity could lead to insolvency if an institution were forced to sell off its assets at prices below their book value. It may indeed be hard to dispose of commercial and personal loans at book value, since it would be more difficult for another institution to evaluate those loans over the short period of time available before the liquidity crisis turns into insolvency.

At the time of its failure, the Canadian Commercial Bank was clearly insolvent. There were so many bad loans on its books that the market value of its assets was far below that of its liabilities. At the end of 1985, the Mercantile Bank suffered liquidity problems but was not insolvent, since its portfolio of loans and other assets appeared to be in good standing.

Factors Contributing to Financial Difficulties

The ups and downs of the global economy, the oil price shocks and the swings of other commodity prices, foreign wars, and other developments inevitably have an impact on the assets and liabilities of financial institutions. So, too, do the domestic and regional swings in economic activity, terms of trade, and prices. A massive repudiation of a country's debt obligations can also throw international banking circles into disarray and threaten the solvency of some of the major lenders. But these developments, by themselves, rarely cause an institution to fail if it has been managed soundly. External factors may contribute to an already difficult situation, but usually financial failure derives from imprudent internal practices (Figure 4-1).

External Factors

Looking back on the 1960s and 1970s, it is clear that the management of many financial institutions made errors of judgment; however, these institutions were able to emerge either unscathed or facing only temporary liquidity problems because of favourable economic conditions. In those cases where difficulties persisted, mergers or takeovers were arranged without any loss to the public. For example, prior to the 1980s the Bank Canadian National merged with the Provincial Bank of Canada to form the National Bank of Canada; losses from the failure of the Caisses d'entraide économique in Quebec were minimized by the absorption of a few locals by the Desjardins Group.

But in 1981-82, after a decade of mostly double-digit inflation, the combination of severe monetary restraint and the worst recession since the 1930s exacerbated a number of internal difficulties that had been latent for many years. Many highly levered businesses failed, as interest rates skyrocketed and sales collapsed. As a result, some financial institutions registered a sizable increase in loan losses. Rising interest rates placed the institutions in a doubly awkward position: they had to pay more to retain deposits, and they also suffered large loan losses because the higher rates forced many borrowing customers to default.

The worsening of the international debt situation in 1982-83 had a negative impact on institutions that had loaned large amounts to some developing countries. The subsequent fall in oil prices and the poor performance of the real estate market in the western provinces compounded the internal problems of financial institutions. Most Canadian institutions were able to weather these financial difficulties. But a few that had high exposure to certain kinds of risks, lacked diversification, had inadequately matched assets and liabilities, and had a weak capital base ran into more serious trouble. Imprudent management, in the final analysis, is almost always the dominant cause of financial failure.

Internal Factors

While financial institutions have always been exposed to the risk that a borrower might default on the payment of principal and interest - the so-called credit risk - *loan losses* started rising significantly in the late 1970s. For all Canadian-owned chartered banks, actual loan losses as a proportion of equity rose from 6.4 per cent in 1979 to 21.8 per cent in 1983 and declined to 14.5 per cent in 1985 (Table 4-1). This rapid increase in loan losses was not limited to a few institutions but was experienced by all banks, partly as a consequence of the more risky ventures in which many institutions had engaged in the 1970s. The increasing importance of project loans is a case in point. With this type of financing, the debt is serviced from the expected cash flow of the project itself; security is limited to the assets of the project, and the lender has recourse only against the

Figure 4-1

Factors that Contributed to the Failure of Various Financial Institutions, Canada, 1980–85

		Internal factors						
		Management errors						
	Year of failure	Inadequate management of assets	Inadequate management of liabilities	Insufficient diversification	Mismatching of assets and liabilities	Erosion of the capital base	Questionable practices	External factors: economic environment
Chartered banks								
Canadian Commercial Bank	1985	x	x	x		x		x
Northland Bank	1985	x	x	x		x		x
Federally chartered trust and loan companies								
Astra Trust Co.	1980	x		x			x	
Dial Mortgage Loan Co.	1981	x						
Fidelity Trust Co.	1983		x	x	x			x
AMIC Mortgage Investment Corp.	1983	x		x		x	x	x
Greymac Mortgage Corp.	1983	x	x	x			x	x
Seaway Mortgage Corp.	1983	x	x	x			x	
Northguard Mortgage Corp.	1985	x		x		x		x
Pioneer Trust Co.	1985	x	x	x		x		x
Western Capital Trust Co.	1985	x		x	x			x
Continental Trust Co.	1985	x					x	x
Provincially chartered trust and loan companies								
Greymac Trust Co.	1983	x	x	x			x	
Seaway Trust Co.	1983	x	x	x			x	
Crown Trust Co.	1983	x	x	x			x	
London Loan Co.	1985	x					x	
General insurance companies								
Pitts General Insurance Co.	1981				x	x		x
Strathcona General Insurance Co.	1981	x				x		
Cardinal Insurance Co.	1982	x	x			x		
Ideal Mutual Insurance Co.	1985	x						
Northumberland General Insurance Co.	1985	x	x					
Other institutions								
Argosy Financial Group of Canada	1980	x					x	

project, not the sponsoring company. Large energy and real estate projects, whose success depended on higher prices, were financed with bank loans under the assumption that the inflation rate would continue to rise in the future. With the radically altered economic environment of the 1980s, the anticipated cash flow to be generated by many of these projects did not materialize, and the bank loans either went into default or had to be restructured.

Financial institutions, particularly banks, normally have significant amounts of *contingent liabilities*. These include, among others, commitments to extend credit, loan guarantees, letters of credit, forward exchange contracts, and financial futures and **option contracts**. They are credit risks that could have an impact on the financial position of the institution.

For example, bank guarantees on corporate preferred-share issues, whereby a bank guarantees any unpaid dividends or redemption amounts, became a concern of the Inspector General of Banks in 1984. Because some of these contingent liabilities are "off-balance-sheet items," they do not increase an institution's reported assets or liabilities. Consequently, depositors or shareholders in institutions with large contingent liabilities that are not included in the calculation of their **leverage ratios** face greater risk than is indicated by balance-sheet information.

Most of the liabilities of insurance companies are of a contingent nature. Companies must maintain adequate reserves in relation to expected claims. An insufficient level of reserves was a major factor in the bankruptcy of two of the five general insurance companies that have failed since 1980.[2]

The *size of individual loans* is another factor in solvency problems. In the 1970s, many institutions granted individual loans that were very large. The Inspector General of Banks, in a 1982 testimony to the House of Commons Standing Committee on Finance, Trade and Economic Affairs, revealed that there were four loans outstanding to a single borrower that exceeded $500 million and 15 other loans also in excess of $500 million to connected companies with closely related risks. He observed that such large loans created "fragility within the banking system," adding that he was "concerned that the system was running ahead of what [he] considered to be prudential limits."[3] He also indicated that he had informed the banks that total loans to any borrower should not exceed 50 per cent of a bank's shareholders' equity and preferred shares. In some cases, the amount of the loans had been equivalent to 75 to 100 per cent of the lending bank's capital. (The major banks subsequently announced that they were restricting loans to a single borrower to 15 per cent, and those to associated borrowers to 25 per cent, of the bank's total capital.)

The *quality and pricing of loans and other products* contribute to the financial performance of an institution. Canada's financial institutions have, time and again, been criticized for their high degree of conservatism. Greater aggressivity means addressing the needs of a greater number of Canadians and financing more projects. Driven by competitive forces, many institutions, especially the smaller ones, took on lower-quality loans and investments. It is always a matter of judgment, *ex ante*, whether an investment is more or less risky. As long as lower-quality investments are charged a premium commensurate with their risk and are added to a conservative portfolio, little harm is done. When

Table 4-1

Loan Losses of Canadian-Owned Chartered Banks, 1979–85[1]

	Loan-loss provision	Actual loan-loss experience	Shareholders' equity	Actual loan loss as a proportion of equity	Net income before taxes	Loan loss as a proportion of net income
		($ millions)		(Per cent)	($ millions)	(Per cent)
1979	486.3	437.0	6,848.1	6.4	1,443.0	30.3
1980	624.7	787.2	8,039.6	9.8	1,561.1	50.4
1981	864.6	934.8	10,105.9	9.3	2,229.4	41.9
1982	1,430.8	2,470.0	12,315.4	20.1	1,630.1	151.5
1983	1,757.4	3,006.6	13,819.7	21.8	2,722.5	110.4
1984	2,042.6	2,522.6	16,376.4	15.4	2,423.2	104.1
1985	2,390.1	2,658.7	18,387.4	14.5	2,970.2	89.5

1 Years ending 31 October.
SOURCE *Bank of Canada Review*, February 1986.

they constitute most of a financial institution's portfolio, trouble may be imminent. This was a key aspect of the problems undermining the solvency of the Canadian Commercial Bank (CCB) and the Northland Bank. Recent failures, in Canada and the United States, were often caused by too-rapid growth rates, fueled by soft investments.[4] As noted in the Estey Report, "the overall strategy in retrospect was to grow as quickly as possible."[5]

A similar strategy was also at the root of the failures of several general insurance companies. In order to capture a larger market share, the management of four of the five companies that failed between 1980 and 1985 had adopted a growth strategy that involved the underwriting of insurance policies at reduced rates. As the premium received did not reflect a correct assessment of potential claims, these companies found themselves in difficult financial situations when they had to honour those claims. This was particularly the case of the Pitts Insurance Company and Strathcona General Insurance Company in 1981 and the Northumberland General Insurance Company in 1985.[6]

The *lack of diversification* of risks, particularly for regionally based institutions, was another internal factor contributing to financial difficulties. The large banks and trust companies that had booked loans across the country and across industrial sectors were able to withstand the losses related to the collapse of the energy sector and the real estate market in the West. This was not so in the case of the Northland Bank, which in 1984 had close to 60 per cent of its loans in Alberta. In the same year, the CCB had about 45 per cent of its loans in Alberta and British Columbia. While there have been pressures for the development of "regional" financial institutions to serve the specific needs of the different regions in Canada, such institutions are subject to a greater risk of insolvency as a result of their lack of diversification than are those with a nationwide reach.

Diversification does not always reduce risks. If an institution extends new loans whose risks are well above those of loans already on its books, it may well become more risky even though it has increased the diversification of its portfolio. Greater participation by trust companies in commercial lending would contribute to the diversification of their activities but could, at the same time, increase their risk of insolvency. Studies of the impact of diversification on risk indicate that while regional diversification tends to lower risk, product diversification may not achieve the same result.[7]

Financial difficulties may also result from a *mismatch between assets and liabilities* with respect to terms to maturity and to interest charged and paid. This takes on particular significance during periods of volatile interest rates. But fully matching assets with liabilities would also limit an institution's earning potential, as well as its ability to supply the kinds of products demanded by customers. Institutions are thus caught in the middle. An excessive mismatching of assets and liabilities was an important factor in the failures of Fidelity Trust, Seaway Trust, and Western Capital Trust.[8] Because of the short-term nature of their contingent liabilities (generally one year) and because of the volatility of risks, general insurance companies must keep assets in short-term liquid instruments. The failure to do so was a major factor in the bankruptcy of Pitts Insurance Company.[9]

Modern portfolio theory has provided managers with a new set of tools to deal with this kind of risk - duration and gap measures, as well as financial futures, are examples of such tools. "Duration" takes into account the timing of the expected flow of interest and principal payments; "gap" takes into account the interest-rate sensitivity of assets and liabilities; and "financial futures" are instruments that enable institutions to protect themselves against interest-rate fluctuations.[10]

Because of their very nature as intermediaries, financial institutions not only face risks on the monies they lend (credit risk) but are also subject to risks with respect to their ability to borrow the funds they need (*funding risk*). Often, the first public sign that something has gone wrong with a financial institution is a flight of deposits or difficulty in securing financing on debt markets. Indeed, in the event that the institution suffers excessive loan losses and that, for this or other reasons, it is perceived to be too risky, depositors may withdraw their deposits, and investors may be reticent to provide more funds.

Historically, Canada's chartered banks have benefited from a stable base of domestic retail deposits, collected through their extensive nationwide branch networks from a wide cross-section of individuals, corporations, and institutions. Moreover, as a cushion to cover not only expected withdrawals and adverse clearings but also unexpected deposit drains, they have maintained a relatively high ratio of liquid to total assets. The larger banks still enjoy a stable deposit base but have allowed their liquid/total asset ratios to decline. The liquid/total asset ratio of all Canadian banks, which averaged above 21 per cent during the 1970s, fell to a low of 9.3 per cent in 1982, averaging about 11 per cent in the 1980s.

At the same time, **wholesale deposits** increased from some 20 to 30 per cent of the banks' total Canadian deposits. These are deposits from large firms or institutions that seek the highest rate of return and are often provided to banks and other financial institutions by deposit brokers. Such deposits may come from another financial institution that needs to invest excess funds for a few days or weeks or from firms that have accumulated funds to pay tax liabilities when they come due. These deposits are rather footloose, as their owners are constantly in search of the highest return for a given level of risk.

Retail deposits - the savings and chequing deposits of ordinary consumers - are usually for smaller amounts and are much more stable. These deposits are insured by the Canada Deposit Insurance Corporation up to an amount of $60,000. While consumers are fairly rate-sensitive, switching a deposit from one bank to another in order to gain a fraction of a percentage point is usually not worth the effort for the smaller depositor. Deposit-taking institutions that fund their activities through these kinds of deposits therefore tend to have much lower funding risk than others. Many small, regional commercial banks in the United States owe their survival to the stability of their deposit base. The credit unions and caisses populaires, the large chartered banks, and the larger trust companies have a more stable deposit base than do many of the smaller banks and trust companies. The six largest chartered banks have 74 per cent of their Canadian-dollar deposits insured (Table 4-2); by contrast, wholesale deposits amounted to 77 per cent of total deposits for the Northland Bank in 1984. As the Estey Report noted, the Northland's "wholesale funding plan was a hazardous base on which to build a small regional bank."[11]

Whatever the nature of its difficulties, an institution will remain solvent as long as it has a sufficient *capital base* to absorb losses.[12] Excessive loan losses weaken the capital base and additional capital must be raised. The leverage ratio of financial institutions - i.e., the ratio of total assets to permanent capital - is normally much greater than that of nonfinancial institutions, being around 20 for deposit-taking institutions and rarely exceeding 3 for healthy nonfinancial firms. Failure to maintain their capital base or to increase their surplus was an important factor in the bankruptcy of several insurance companies.[13]

Table 4-2

Total Canadian-Dollar Deposits and Insured Deposits of the Chartered Banks, Canada, 1984

	Canadian dollar deposits		Insured deposits as a proportion of total deposits
	Total	Insured	
	($ millions)		(Per cent)
Royal Bank of Canada	38,835	28,663	73.8
Canadian Imperial Bank of Commerce	36,020	27,103	75.2
Bank of Montreal	28,756	21,994	76.5
Bank of Nova Scotia	19,142	13,327	69.6
Toronto-Dominion Bank	20,382	14,664	71.9
National Bank of Canada	10,297	7,947	77.2
Other banks	16,994	5,289	31.1

SOURCE *The Canada Gazette*, Part I, 118, No. 24, (June 16, 1984); and "Final Report of the Working Committee on the Canada Deposit Insurance Corporation (CDIC)," 24 April 1985, p. 52.

Cases of insolvency sometimes go beyond management weakness and can be related to *questionable practices by management*, such as attempts by the owners of financial institutions to enrich themselves at the expense of the depositors or of the other shareholders.

Self-dealing, more fully discussed in the next chapter, has been a factor in some insolvency cases. Prior to the collapse of the Crown, Greymac, and Seaway Trust companies, the owners and their associates were alleged to have withdrawn $152 million, primarily for their own purposes. The routine was to lend money to an associate or to customers, who then paid considerable fees back to the owners.[14]

Although self-dealing and fraud appear to be the immediate cause of a number of failures, they may themselves be the outcome of more fundamental financial difficulties. As they sense that their institution faces insolvency in the not-too-distant future, some owners of firms in difficulty attempt to cut their own losses through self-dealing. According to the author of a paper prepared for the Economic Council, "self-dealing is common in poorly managed institutions, and failure is correlated with poor management."[15]

Although not motivated by personal profit directly, management, in its quest for survival, may engage in creative accounting and other practices to hide the true financial situation of its company. This was so in the case of the management of the Canadian Commercial Bank and the Northland Bank, as evidenced by the Estey Report. The questionable practices in those two cases included the movement of loans to a new corporate name, the rewriting of loans, the overvaluation of the underlying security, and the capitalization of unpaid interest on loans that could not be nursed back to good standing. Not only were profits overstated because insufficient provision for losses had been made, but the fees for rewriting loans were also added to profits, further inflating them. As the Estey Report noted, "the unwillingness of the management of the bank to see their bank die was natural, and their zeal and efforts to the very last to keep it going cannot, by themselves, be criticized. . . . Where those efforts and that zeal carried the bank beyond the rim of accounting and banking prudence and propriety, different issues arise."[16]

Solvency: A Problem of the Institution

Whatever the proximate cause of financial difficulty - credit risk, the mismatching of assets and liabilities, funding costs, or self-dealing and fraud - solvency is a problem that affects the whole organization and not just some specific operation of that organization. If problems with one activity are limited in scope - e.g., bad loans in Alberta only represented a small portion of the portfolio of the larger Canadian banks - operating income generated in other areas can compensate for those losses. But if the matter is more serious, as was the case when real estate and energy loans turned sour at the CCB and the Northland Bank, all the operations of the institution will be affected. While real estate deals triggered the events that led to the downfall of the Crown, Greymac, and Seaway Trusts, again, all their operations were subsequently affected.

Mechanisms in Place to Help Offset Problems

The failures that occurred in Canada and the United States have not, so far, had a significant impact on confidence in the financial system, nor have the incidents of self-dealing and fraud.[17] This may be attributable to the various mechanisms presently in place that directly and indirectly enhance confidence.

Deposit Insurance and Compensation Funds

Deposit insurance, more fully discussed in Chapter 6, enhances confidence in deposit-taking institutions. First, it allays the fears of depositors that they might lose their money in case of insolvency. It thus prevents a "flight to quality" at the first sign of financial difficulty. Second, deposit insurance may lower the risk of a contagion effect, whereby the financial difficulties experienced by one deposit institution would induce a loss of confidence in other institutions and a massive withdrawal of retail deposits. The liquidity problems resulting from such a withdrawal, if it is serious enough, could bring down institutions that are basically sound and solvent in the long run. A number of failures of financial institutions between 1929 and 1933 in the United States were indeed the result of such contagion effects. The subsequent introduction there of deposit insurance helped to prevent the recurrence of such events.[18]

In the recent insolvencies in Canada, deposit insurance has limited the loss of confidence. But it has been unable to prevent it completely, as witnessed by the shift in deposits from smaller, regional institutions to larger, national firms.

One reason why deposit insurance cannot fully prevent a loss of confidence is that depositors have historically had to bear some costs in the case of failures, even with deposit insurance. As evidenced by the handling of the failures of the Canadian Commercial Bank and the Northland Bank, depositors suffered losses of liquidity and interest income when their deposits were frozen for a period of several months. To avoid such losses, insurance agencies or regulatory authorities sometimes attempt to wind down the operation of an insolvent institution through a takeover by another institution that is solvent. In the United States these are often called "assisted takeovers," where the authorities compensate the acquiring institution for the difference between book and market value of low-quality assets.[19] This may not always be possible, however.

Furthermore, deposits of over $60,000 or with an initial term of more than five years are not covered by deposit insurance in Canada. Large deposits, particularly those obtained through wholesale deposit brokers, are footloose because they are not protected. It was the loss of wholesale deposits that precipitated the downfall of the CCB and the Northland Bank, although these institutions had been teetering on the brink of insolvency for a few years. The inability to secure needed funding on the wholesale market forced the merger of the Mercantile Bank (otherwise solvent) with the National Bank of Canada. A flight of wholesale deposits has been creating funding difficulties for the Continental Bank and the Bank of British Columbia and has forced them to rely on assistance from the Bank of Canada, although these banks have been declared solvent by the regulatory authorities. The movement of large uninsured deposits created serious liquidity problems for the Continental Illinois Bank in 1984, which resulted in the largest U.S. government-initiated rescue operation ever.

Not all deposit-taking institutions are covered by deposit insurance. Some provincially incorporated trust and loan companies may have no coverage for their deposits. Moreover, it is quite possible that the public will not view the protection afforded by credit-union **stabilization funds** as comparable to coverage provided by the Canada Deposit Insurance Corporation (CDIC). In the United States, there have been several runs on state-insured institutions, while there has been no significant loss of deposits at federally insured deposit-taking institutions. To some extent, this can be explained by the limited resources of the state insurance and by the lower credibility it commands among the American public.

The present design of deposit insurance cannot adequately protect depositors from potential loss caused by the failures of large institutions or by a large number of failures. The main objective of the CDIC is to protect depositors and to contribute to the continued stability of the Canadian financial system in the case of "accidents" in an otherwise well-oiled and well-operating financial system. The CDIC (as is the case with the Federal Deposit Insurance Corporation south of the border) is not designed to handle major or prolonged difficulties; nor does it have the funds to do so. Indeed, the immensity of the task can be seen by the fact that just the reimbursing of depositors of several trust companies and small chartered banks, in fiscal year 1985 alone, increased the CDIC's deficit to $1.2 billion.

The customers of securities firms are covered by a small national contingency fund, to which all dealers who are members of a Canadian stock exchange must subscribe. Insurance companies do not currently have any mechanisms in place to compensate consumers in case of failure; however, some discussions between industry representatives and supervisory authorities concerning the possibility of establishing compensation funds are now under way.

Lender of Last Resort

The Bank of Canada plays the role of "lender of last resort" for chartered banks and for nonbank deposit-taking institutions that are direct clearers with the Canadian Payments Association, while stabilization funds and provincial centrals play this role for the credit unions.[20] The CDIC is also empowered to play such a role, but it has never done so. (It has, however, advanced funds to smooth out the process of liquidation of insolvent institutions.) The existence of a lender of last resort is critical when an otherwise sound institution is facing a temporary liquidity problem. The lender of last resort can provide assistance to a solvent institution that cannot sell off its assets quickly enough to stave off a run, but it cannot prevent fundamentally insolvent institutions from folding.

Rescue Packages

Rescue packages, bringing together the lender of last resort, private financial institutions, and the government itself, have sometimes been put together when it was believed that a failure would seriously undermine confidence in the financial system. This was the explanation given for rescuing the Continental Illinois Bank in 1984 and the rationalization given for assisting the Canadian Commercial Bank. These two experiments had, however, different endings. In the United States, the government bailed out all the depositors, large and small, and virtually took over the bank. The bank was put back afloat, and consideration is now being given to returning it to private interests. In Canada, as the costs of rescuing the CCB continued to mount, the government made the decision to close the bank in order to cut its losses.

It may be argued that once a rescue has been started, it should be brought to a successful completion. Indeed, rescues are undertaken to enhance confidence in the financial system. It is important that the participants in financial markets - investors, savers, or borrowers - be convinced that the rescuers mean business when they come to the assistance of an ailing institution.

Preventive Mechanisms

Preventive mechanisms that guard against insolvencies are the fourth, and probably the most effective, avenue to boost confidence. They include the initial incorporation and licensing conditions; the setting of a minimum capital base and of borrowing multiples in relation to that capital base; the specification of investment powers and rules of conduct; and the establishment of disclosure requirements, including an enhanced role for auditors, minimum quality standards for directors and managers, as well as regular inspections, and the operation of an **early-warning system**.

Portfolio regulation is one of the mechanisms used to forestall the risk of insolvency. Activity restrictions prevent certain institutions from performing certain functions - e.g., banks from undertaking insurance, trustee, or underwriting business - and balance-sheet constraints specify the kind of assets in which financial institutions can invest. Investment rules can take two forms: qualitative rules that specify the "quality" of individual assets in which the financial institution may invest, and quantitative rules that limit the amount of any specific kind of asset held. Qualitative rules usually require that assets be either issued by government or backed by government guarantees, or that assets issued by private firms be backed by a history of company profitability or dividend payments. In particular, trust companies, life insurance companies, and pension funds have been restricted in their acquisition of securities of companies guaranteed by their name only. Quantitative rules, on the other hand, attempt to force financial institutions to diversify, thereby reducing the risk of the overall portfolio.

Some experts and regulators are now advocating that the qualitative rules be replaced by quantitative ones. Others call for the implementation of the so-called "prudent-man rule." While the existing qualitative rules are indeed restrictive, particularly from a resource-allocation point of view, they cannot be fully replaced by quantitative rules or by the prudent-man rule. Quantitative rules contribute to the diversification of a portfolio but not to the maintenance of a standard of quality in the individual investments within a diversified portfolio.

The *inspection system*, described in Chapter 2, increases confidence by reducing the risk that irregularities, management weakness, or fraudulent behaviour will lead to insolvencies. For the inspection system to be effective, the inspectors should have an early-warning system at their disposal and should have access to as much information concerning the activities of financial institutions as possible.

An *early-warning system* is intended to warn regulators that a financial institution is beginning to have problems. It focuses on a number of critical variables such as capital adequacy, asset quality, management ability, earnings, and liquidity. In the United States, the three federal bank regulatory agencies (the Comptroller of the Currency, the Federal Reserve System, and the Federal Deposit Insurance Corporation) have developed an early-warning system (known by the acronym CAMEL) that focuses on the five above-mentioned variables. Banks are given a rating, based on specific financial variables, ranging from 1 to 5. A rating of 1 or 2 indicates a sound institution, while a rating of 3 or 4 is considered weak. A rating of 5 requires that the bank be constantly monitored.

The Canadian system in place since 1984 at the Office of the Inspector General of Banks (OIGB) focuses on the same five features and also rates banks on a scale from 1 to 5 (Figure 4-2). Ontario has an early-warning system for trust companies. Early-warning systems are in place in some other provinces as well. An early-warning system of some sort, although limited to a single variable, has been included in the minimum standards of the securities industry's national contingency fund.[21]

An early-warning system is based on the assumption that solvency and liquidity problems develop over time and that by monitoring a number of variables provides an indication of the likely future course of events. Of course, if situations of insolvency and illiquidity happened very suddenly, an early-warning system would be of no use. A review of a number of insolvency cases, however, leads to the conclusion that problems grow gradually over time and therefore can be predicted at an early stage.

Information is the critical input into any early-warning system. There will always be disagreement over the extent to which information can be made available and to what extent it will be treated confidentially by the regulators. This poses a major dilemma for regulators. Most financial institutions argue that releasing too much information restricts their competitive ability and may conflict with their confidentiality obligations to their clients. On the other hand, for the system to be effective, adequate information will have to be made available by the institutions themselves. An early-warning system would be quite useless if the regulators did not have the power to require financial institutions to take remedial action at a sufficiently early stage.

Figure 4-2

Components of an Early-Warning System

Capital adequacy:
- Base capital equivalent as a percentage of maximum permitted leverage;
- Reinvestment rate; this is the percentage rate of asset growth that a bank can sustain without resorting to external financing, based on current profit levels.

Liquidity:
- Liquid assets as a percentage of all assets;
- Core deposits (retail) as a percentage of all deposits.

Asset quality:
- Actual loan losses as a percentage of average loans outstanding;
- Net nonperforming loans as a percentage of all loans.

Profitability (or earnings):
- Percentage change in marginal earning asset spreads;
- Return on assets net of preferred dividends.

Management performance:
- Percentage change in general loans (banks sustaining high asset growth are considered to be more risk-prone);
- Share divident covrage (as earnings recede, the dividend coverage ratio will do likewise; hence close monitoring of the dividend coverage ratio can provide particular insight into the general control and efficiency of management).

SOURCE Binhammer, "Depository institutions"; OIGB, "Submission."

The *auditors* of financial institutions have an important role to play in the availability of information on the institutions they audit and, in particular, in verifying the quality of the information received from the institutions themselves. The auditors' primary responsibility is to the shareholders and to the boards of directors. Since they are hired and paid by the institutions, they are in a conflict-of-interest situation when required to disclose information that could be potentially harmful to their employers. Auditors must make judgments about what is material to the public interest and what is not; because of their particular situation, there is a definite incentive to favour the financial institution.

Under the present system, the reporting requirements of auditors are set out in the various Acts. Subsection 242(3) of the *Bank Act* requires auditors to report "transactions or conditions affecting the well-being of the bank that in their opinion are not satisfactory and require rectification." In particular, auditors are required to report transactions that are not within the powers of the bank, as well as losses in excess of one-half of 1 per cent of equity. In the federal legislation governing trust and insurance companies, the reporting requirements are limited to the financial statements. Despite these provisions, the reporting requirements of auditors remain vague, as many factors not covered by the provisions have an impact on the well-being of a financial institution. According to the Canadian Institute of Chartered Accountants handbook, shareholders can sue their auditors if, in their opinion, the latter failed to report any fraud or error discovered in their investigation or to indicate the nature of problems detected during their audit when management refused to change financial statements. But facts of importance go beyond financial statements and clear instances of fraud. They may involve abuses of conflict of interest, inappropriate transactions, or transactions that could endanger the future solvency of the institution. In the various Acts, the auditors' obligations remain vague and incomplete in that respect.

Moreover, some auditors believe that, unless required to do so by law, they must have authorization from management to reveal any information to the regulator and that to do so without authority would be unethical. For example, letters from the CCB's auditors to the bank's management concerning the 1984 audit were not made public nor sent to the OIGB until the bank's management did so in March 1985, when the rescue package was being put together. By then, it was too late for remedial action. Before that, reports sent by the bank's auditors to the Inspector General's office gave no indication of how serious the problems were. The OIGB was left with the impression that the bank's position was reflected fairly in its financial statements.[22] These statements, in fact, did not reveal the extent to which the CCB's loan portfolio was impaired or how the configuration of bad loans was changed to make them appear to be in good standing. Although the auditors had commented to CCB officials on the questionable accounting practices of the bank's management, they still accepted the bank's financial statements. As reported in the Estey Report,

> The auditors' position in final form was simply that they had but one drastic remedy at hand, namely the withholding of approval of the proposed financial statements. This, of course, would be tantamount to a closing of the bank by the auditors. They professed no such power, and indeed, claimed that they were not in possession of evidence or information sufficiently drastic in nature to warrant such a drastic remedy.[23]

In the case of financial institutions, particularly deposit-taking institutions where shareholders' equity accounts for only about 5 per cent of assets, auditors should also be responsible to the depositors and to the general public as well. The Inspector General of Banks takes the view that under the *Bank Act* the auditors of a bank "have a duty not only to the shareholders of the bank, but also to the public at large."[24]

Corporate governance is another safeguard against insolvency. Internal audit committees that assist the auditors in their task indirectly play such a role. Audit committees exist in many institutions but often have only limited powers. While the establishment of an audit committee of the board of directors is mandatory under the *Bank Act*, the role and procedures of such committees vary among banks. In general, their role is to ensure the production of accurate and reliable data. In many cases, audit committees do not review provisions for losses, although in some banks they may play a wider role in assessing credit outstanding.

Audit committees cannot perform their task unless the information on which the audit is based is accurate and complete. This information, along with an accurate assessment of asset risk - particularly that of nonmarketable assets, such as personal and commercial loans and some mortgage loans - can only be provided by the financial institution's management and internal auditing staff. Currently, under subsection 246(5) of the *Bank Act*, management must supply all information required by the auditors. Subsection 314(2) establishes penalties for any offence against the Act, and most legislation governing other financial institutions does likewise. Subsection 85(2) of the federal *Trust Companies Act* establishes liability for any director, officer, or employee who refuses or neglects to make any proper entry in the books of a company. Although these requirements appear to be quite comprehensive, there is a need for extending them to ensure that management is responsible for the quality and completeness of the information given.

Regulatory Supervision and Public Confidence

In any event, supervision and inspection, and other preventive measures, were unable to anticipate, or prevent, the 22 failures that occurred in the first half of the 1980s, affecting mainly deposit-taking institutions; nor have they been adequate in helping some other institutions to avoid serious financial difficulties. Events have shown that the supervisory authorities lacked adequate staff to monitor the performance of the growing numbers of financial institutions, whose operations were becoming more diversified and more complex. The supervisory authorities also lacked the teeth to enforce the changes required when the performance of a financial institution was found to be wanting. In too many instances, they relied on the institution's auditors for an evaluation of its performance, although the auditors themselves may have been in a conflict-of-interest situation. Many practices of the institutions were accepted by their auditors on the basis that the audited institutions were going concerns. In hindsight, this was an unrealistic assumption for several institutions. The absence of a well-established early-warning system, at least until 1984, also made it difficult to identify firms likely to face serious financial difficulties.

In the case of the collapse of the CCB and the Northland Bank, there were failures at all levels of the regulatory process, as demonstrated in the Estey Report. Corporate governance at those two banks was weak, and the boards of directors did not place adequate checks on the overly aggressive lending behaviour of management, which led to booking too many problem loans. The boards of directors also accepted too readily the managements' procedures and expectations of future values of assets. For example, in the case of the Northland Bank, and contrary to procedures in major Canadian banks, the bank's chief inspector was instructed not to include an assessment of its loan portfolio in his reports. Setting aside provisions for loan losses was to be the exclusive preserve of management. This state of affairs was accepted by the audit committee of the bank's board of directors.

The external auditors of the banks also all too easily accepted the procedures of management. The auditors of the CCB, for example, took the view that decisions by management with respect to **workout procedures** for bad loans, such as taking accrued interest into income and not setting aside any loan-loss provisions, could not be reversed and that they were powerless to take a view opposite to management and insist upon its implementation. Similarly, at the Northland Bank, the auditors did not insist on adequate loan-loss provisions being set aside.

Finally, as pointed out in the Estey Report, there was ample evidence that the OIGB was aware of the questionable practices of management but relied on the acceptance of financial statements by the auditors.

The fact that deposit-taking institutions may be regulated at the federal or provincial level, or by different authorities, and that they operate under different legislation has rendered their supervision more difficult. Furthermore, solvency is an issue that relates to all aspects of an institution's operations.

Present regulations, by imposing a separation of functions and limiting, in certain cases, the ownership of financial institutions, restrict the ability of most institutions to diversify fully. To some extent, as discussed in Chapter 3, financial holding groups have been created to bypass these regulatory restrictions. It is unclear, however, whether the emergence of these new structures enhances confidence in the financial system as a whole. On the one hand, because of the large amount of financial resources it commands, a financial holding group may be able to come to the rescue of one of its affiliates facing financial difficulties. On the other hand, should financial difficulties affect one member of a holding group, there may be a loss of public confidence in other member companies.

The regulatory structure that is designed to prevent insolvency – in particular, the inspection system, the specification of investment powers, the rules of conduct, the disclosure requirements, and the minimum quality standards for directors – has an important role to play in securing public confidence in the system. So, too, do those measures that enhance consumer protection. But the interplay between the securing of confidence, consumer protection, and disclosure of information may pose a dilemma for the regulating agencies. When should information concerning the fragility of an institution be withheld in order to maintain confidence? As with so many things, there is no clear-cut answer to that question. The regulatory structure has to be such that failures can happen without a loss of confidence spreading to other institutions. This reinforces the important role of disclosure of information, the enhanced role of auditors, and the need for an early-warning system that will enable regulators to minimize damage from an institution in trouble, either by shutting it down before losses are too great or by forcing a merger with another institution.

While deposit insurance and the role played by the lender of last resort are important mechanisms in preventing a liquidity problem from turning into a solvency problem and in slowing down the contagion effect, more-effective regulation and supervision would help to bolster public confidence in the operations of the financial system.

5 Abuses within Financial Institutions

The even-handed treatment of customers and shareholders by financial institutions is an important aspect of confidence. It involves a number of elements. First, the managers of financial institutions must not take excessive risks with the funds entrusted to them and, in particular, must not pass on risks to others who are not rewarded for bearing those risks. Second, conflicts of interest, when they arise, must not be abused. Third, where non-arm's-length transactions occur, they must be executed at market conditions, so that no costs are passed on to either customers or minority shareholders. Finally, consideration must be given to the wisdom of mixing financial and nonfinancial activities within the same organization, where such mixing could create the potential for abuse and for the misallocation of financial resources.

Excessive Risk-Taking

Opportunities exist for the management of all financial institutions to take excessive risks, either through lack of diversification or through investing too large a proportion of assets in high-risk ventures. Many of the problems of the Canadian Commercial Bank and the Northland Bank were the result of having too much high-risk investment concentrated in the petroleum and real estate sectors of western Canada. The fact that financial intermediaries are normally highly levered provides an incentive to take excessive risks: the benefits fall to the owners, while much of the risk falls on the depositors or other customers.

Some risk-taking, of course, is normal in any financial institution. In particular, the raison d'être of a deposit-taking institution is to offer a fixed-value liability, thereby shifting the risk associated with the investment of funds onto the less risk-averse shareholders. In exchange, the expected rate of return to the shareholders is higher than that paid to the depositors.

In order to be able to provide a safe haven for deposits and to guarantee other commitments, the management of financial institutions must prudently invest the funds entrusted to them. In particular, this means that they must not take excessive risks. Also, legislation should be designed so as to reduce, as much as possible, the incentive to take excessive risks.

Several studies and reports have pointed out that the existence of deposit insurance funded by a flat-rate premium is an important source of excessive risk-taking by managers – a phenomenon otherwise known in economists' parlance as "moral hazard." In the absence of deposit insurance, the possibility of failure of the institution itself is the only risk borne by the depositors. Should such a possibility loom on the horizon, depositors will withdraw their funds. In making decisions concerning the asset mix, liquidity, and quality of its loan portfolio, management must therefore take into account the effect of those decisions on the risks associated with the loss of deposits.

Deposit insurance reduces the risk that depositors will withdraw their deposits and retards the loss of confidence in the institution when management embarks on more-risky ventures. If deposit insurance is funded by a flat-rate premium on deposits – the Canada Deposit Insurance Corporation (CDIC) currently charges a premium equal to one-tenth of 1 per cent of deposits insured – then a financial institution can make more-risky loans in its search for a higher rate of return without having to assume the full increase in risk, particularly the funding risk (discussed in Chapter 4), that it would otherwise have to bear. Thus it matters little to management and shareholders that the higher earnings do not in fact compensate for the higher risks. Risk is *de facto* shifted from the shareholders of the institution to the insurer. This could result in too many financial resources being allocated to risky ventures in relation to their expected private return (and to their social return as well, if no added social benefits are generated). In such circumstances, financial resources are not allocated efficiently. It is also a misuse of the confidence placed in these institutions. There is evidence that some deposit-taking institutions do indeed take more risks in their investment policy because they have access to deposit insurance.[1] Suggestions for reducing such moral-hazard problems are discussed in the next chapter, where they are assessed in the context of their impact on consumer protection – the main objective of deposit insurance.

Conflicts of Interest

A conflict of interest exists when the interest of one person and the interest of someone else acting on behalf of that person are at variance. This would occur if, for example, a company managing a trust fund has the opportunity to use money from that trust fund to purchase the securities of a commercial customer borrowing from the company, thereby increasing the security of the company's loan. A conflict also exists when someone, acting on behalf of several customers whose interests are at variance, must choose (or at least has the opportunity to choose) to serve the interest of one over the interest of the other. In 1983, the Ontario Court of Appeal ruled that the Canadian Imperial Bank of Commerce breached the trust it held with two customers when it favoured two others in a fight for the control of Crown Trust. A conflict of interest also occurs when the interests of managers or shareholders controlling a firm are at variance with those of the other shareholders.

While the separation of the main functions of the financial industry was viewed, in part, as a means of avoiding several of the more important conflict-of-interest situations, it has not eliminated all such conflicts in financial markets. Conflicts of interest are a common occurrence in all markets - indeed, they are a daily occurrence in everybody's life - and financial institutions are in no sense unique in having them. It should be noted that harm is caused not by the conflict of interest itself but, rather, by its abuse.

Conflict-of-interest situations could arise when banking and securities dealing are combined within the same institution. A conflict may exist between the institution's deposit business and its stock exchange transactions. The institution might not sufficiently uphold its customers' interests in investing in stocks and bonds, since the funds to pay for those investments would most likely come from the customers' deposits in the institution.

There may be a conflict of interest between the underwriting and lending business. For example, it might be more advantageous for a financial institution to lend to a firm than to assist it in the acquisition of new equity by underwriting an issue. This has been a concern with respect to banks with "universal powers" in West Germany. Critics of that system point out that share issues by new companies are smaller there than in other countries, partly because the underwriting business is not as vital to the universal banks as to securities firms.[2]

There is also a potential conflict of interest between a financial institution's stock exchange transactions and its lending business. The institution might withhold information obtained in its credit business from customers in its securities business. Or the institution could use information from its commercial activities to have an advantage over other stock market participants. The West German commission of enquiry into the banking system believed that there is a "certain risk of inside information derived from loan business being used wrongfully at the expense of security customers."[3] This would, however, be violating existing securities laws. A conflict might occur between trust and other financial functions. For example, "it is alleged that several major bank trust departments in the United States held Penn Central stock despite its deterioration because the banks feared losing Penn Central's still significant deposits; and the banks were creditors of Penn Central."[4]

For a financial institution holding a stock and bond portfolio and acting as a broker at the same time, there could be a conflict of interest when it buys or sells out of its own account rather than going through the stock or bond market (the dealer/broker conflict). For example, if the institution knows that the price of a stock is rising - i.e., there are offers to buy at a higher price than the last sale quoted - and a customer offers to sell, the institution may buy the stock itself at the old price and sell it later at a higher price on the stock market.

Within the securities business, dealers often advise customers to buy securities of companies for which they are the main underwriter. This is a potential conflict-of-interest situation. But if the company is a good prospect, should not the advice be given?

Within the trust business, a number of conflicts of interest may arise when trustees can take advantage of the trust placed in them by charging excessive fees or by performing unnecessary services. Managers who have discretionary control over funds may leave large amounts in low-interest deposit accounts with their own firm, although competition and monitoring by clients will limit such occurrences. Pittsburgh's Mellon Bank is alleged to have acted in this fashion with respect to the uninvested cash balances of the State Public School Building Authority between 1966 and 1974. Trustees may use trust funds to dispose of unwanted securities or to support their own lending activities. Of the 50 larger companies in which Continental Illinois National Bank's trust department holds large equity investments, 75 per cent are commercial borrowers from the bank; there is, however, no indication that this conflict-of-interest situation was abused in any way. When an outstanding loan is soft, the commercial arm may suggest that the borrower withhold dividend payments or issue additional equity. This may be against the interests of the trust, but it is sound financial advice to the company.

For a conflict of interest to be abused, the agent must know more about a transaction than the client and also act in a way that is less than favourable to the client. Where markets are competitive, customers always have the opportunity, in the event of conflicts of interest, to turn to other institutions at the competitively determined market price, as long as information about the existence of such a conflict is available. But the mere existence of a conflict-of-interest situation may raise the fear of its potential abuse and lessen public confidence in fair treatment by the financial system.

Self-Dealing

Self-dealing occurs when a conflict of interest results in a non-arm's-length transaction for the sole advantage of the person or institution making the decision. For example, self-dealing occurs when the owner or manager of a financial institution approves a loan to himself or herself, a relative, or an associate at a favourable rate of interest or with little or no collateral. We mentioned in the previous chapter the Crown/Greymac/Seaway Trusts affair, which involved the "flipping" of more than 10,000 apartment units in Metropolitan Toronto and the use of associated trust companies to finance the purchase, which resulted in a massive increase in their value for mortgage purposes. Self-dealing also occurs when a subsidiary finances its parent company at favourable conditions. When an institution receives compensation at above-market rates for services rendered to affiliated firms, it is engaged in another form of self-dealing.

It is important, however, not to confuse all non-arm's-length transactions with self-dealing. The former is a transaction between two related parties; the latter is a harmful non-arm's-length transaction. Proposals have been made to impose a ban on all non-arm's-length transactions between associated firms within a holding group structure.[5] For example, Royal Trust would be prevented from buying from, or selling assets to, London Life because both institutions are part of the same holding group. Such bans would prevent an institution from doing, under a holding-group structure, what it could do as a diversified institution. Indeed, banks and other lending institutions regularly reallocate funds from one activity to another. A ban on all non-arm's-length transactions would prevent a reallocation of funds to the projects that offer the best risk/return combinations. This would not only reduce the profitability of the individual institution and of the holding group, but it would also be allocationally inefficient. Similarly, sales of computer services to Crown Life by Crowntek are non-arm's-length transactions because these two firms are linked through common ownership under the CrownX group. Yet such an arrangement might enhance the efficiency of the holding group and its subsidiaries.

At issue here is a difficult question: What is a transaction that will enhance the efficiency of the production and delivery of financial services and what is a harmful transaction? A first step in the determination of the nature of a non-arm's-length transaction is to assess if it was effected at market conditions. An interest-free loan or a loan extended at below-market rates would appear suspicious. Market conditions not only include interest rates, however, but also other conditions such as term to maturity, collateral, repayment conditions, and so on. A mortgage loan extended to a related party at market interest rates but backed by an overvalued piece of property is not a bona fide transaction.[6] This illustrates how difficult it is to assess the true nature of transactions.[7]

A second step is to determine who benefits from the non-arm's-length transactions. If it is someone who has the ability to influence the decision - a director, a manager, or a shareholder who owns a large portion of the voting stock of the company - the transaction may be suspicious. If it is an affiliated institution, there may be less reason for concern, unless it is only the first step in an elaborate series of transactions that will eventually benefit the owner or the manager of the corporation.

Consider the example of a financial institution belonging to a holding group that lends to its parent company at below-market conditions. That loan will benefit the parent company, particularly if it is used to finance some of its other activities. But this transaction may hurt the financial institution and result in lower profitability. The gain to the nonfinancial arm of the group will be cancelled out by the loss to the financial institution.

The incentive to self-deal depends on the ownership structure of the firm or the holding group. It has often been suggested that widespread ownership reduces such incentives. Indeed, transactions between subsidiaries will affect all shareholders equally, and no individual shareholder has sufficient control over the company to initiate transactions that will only be beneficial to himself or herself. One hundred per cent ownership by one or several individuals is a very strong incentive to self-deal, because the owners have the opportunity to enter into risky ventures financed by the institution for their own personal benefit. These ventures frequently involve third parties in order to circumvent the prohibitions against loans to the principals of the institution. But while the benefits accrue to the owners, a major portion of the risk is borne by the institution and consequently by its depositors, other creditors, or the deposit insurer. Also, the transactions involved may not fall under public scrutiny, at least not in the short run.

Cases where companies are wholly owned by a publicly traded company are another matter. As mentioned above, the benefit to the parent company from a non-arm's-length transaction with its subsidiary may be erased by a decline in the subsidiary's profitability. Also, the publicly traded parent company is subject to scrutiny by its shareholders, and more information will be made public than would normally be the case with an individual. When a parent company controls its subsidiary with less than 100 per cent ownership, there is greater incentive to self-deal because it may reap all the benefits from a self-dealing transaction, whereas the decline in profitability of the subsidiary is shared by all its shareholders.[8] But when minority shareholders control a sufficient proportion - say 35 per cent - of the voting shares of an institution, they are able to provide a check on self-dealing excesses and to protect their own interest. The *Canada Business Corporations Act* itself provides protection to minority shareholders through the "special resolution" clause requiring a majority of not less than two-thirds of the votes cast by shareholders with respect, for example, to reduction of, or constraints in addition to, the stated capital of the corporation and with respect to such matters as amalgamating, leasing, selling, or exchanging substantially all of the company's property, amending articles of its charter, or dissolving the company.

Furthermore, some non-arm's-length transactions may be made to the detriment of depositors or other creditors, if regulation or the covenant pertaining to the channeling of funds by the financial institution is not explicit enough. For example, an institution may use the funds entrusted to it through deposits to purchase bonds or other securities issued by a parent company, thus contributing to the financing of the latter's operations. If the parent is a sound company and its securities are purchased at close-to-market prices, little harm is done. Such a transaction, however, transforms the depositors into holders of bonds of the parent company, which in some cases could constitute an encroachment on their desires. Furthermore, there is the danger of **pyramiding** of the financial institution's capital base, as the deposits of one institution are used to supply capital to the other.

Generally then, self-dealing, when it occurs, leads to a misallocation of financial resources. It will also impose costs on the depositors, bondholders, and/or minority shareholders of the institution. But above all, self-dealing damages public confidence in fair treatment by the financial institutions that engage in it.

Mixing of Financial and Nonfinancial Activities

The direct mixing of financial and nonfinancial activities is currently not allowed except for some activities closely related to the provision of financial services such as real estate brokerage, and computer services. Within a holding-group structure, however, the mixing of related financial and nonfinancial companies does occur.

A serious situation may arise when a company faces difficulties. The concern here is that cross-ownership may blur the ability to decide which firm should be assisted and which one is beyond repair. As one central banker in the United States noted:

> In periods of stress, banks may be called on to supply credit to borrowers who, for one reason or another, temporarily do not have access to sources of funds or to make the even more difficult decision as to which borrowers are experiencing problems of a fundamental or irreparable nature. It is in these particular circumstances that banks must be in a position to make rigorous, impartial and objective credit decisions because it is precisely in such circumstances that the potential for compromise in the impartiality of the credit decision-making process is greatest and the potential for asset quality deterioration is the largest. It is in this light that consideration about the commingling of banking and other interests and concern about the ownership and control of banks become compelling.[9]

A nonfinancial entity, through self-deals, may use the associated financial institution to finance its operation at favourable conditions, thereby reducing the institution's profitability. Worse still, the financial institution might be placed in a position of severe risk should the nonfinancial side of the operation suffer losses. A further concern is that when the financial institution accepts deposits that are covered by insurance, much of the risk falls on the depositors and the public at large.

Under the umbrella of holding groups such as Power Corporation or EDPER, a number of financial holding companies and other financial institutions have direct links to nonfinancial corporations. These include some of the largest Canadian financial institutions, such as Royal Trust, Montreal Trust, London Life, Great-West Life, and so on. The public must be confident that the managers of financial institutions that have links to other businesses act prudently and impartially. Such confidence is acquired over a long period of time; once lost, the consequences within the financial system could be severe.

Mechanisms Currently in Place to Prevent Abuses

A number of mechanisms have been developed for controlling abuses of conflicts of interest and self-dealing. One such device is imposed by common law in the form of the fiduciary duty. Where such a duty exists, the law requires that the trustee place his customer's interests above his own. If a breach of fiduciary duty occurs, then the customer has recourse through the courts. For example, investment dealers are accountable under the "know-your-client" rule, which forbids them to enter into trades that are not, to the best of their knowledge, in the interest of their customers.

In a number of instances, industry self-regulation is an effective deterrent against the abuse of conflicts of interest, particularly when such abuse would result in loss of public confidence in the industry itself. Members of the industry are often in the best position to recognize and deal with abuses when they occur. Member financial institutions themselves usually find it in their own interest to eliminate such abuses, since the potential gains from them are, in most cases, far outweighed by the damage to the institutions' reputations that public knowledge would bring. Some institutions, such as Royal Trust, have put in place committees of the board of directors to review transactions that might constitute abuses of conflict-of-interest situations. To be most effective, these committees should be composed of board members who are outsiders to the financial institution and to any affiliated company, if the institution is a member of a holding group.

Other measures to deal with conflict-of-interest situations include regulations that separate areas of activities between which such conflicts are likely to occur. The so-called "**Chinese Walls**" are an example of such regulation. A Chinese Wall is a set of rules that prevents information from flowing between different departments of the same corporation. For example, in a financial institution involved in commercial-lending and trustee activities (a trust company, for example), a Chinese Wall would prevent information secured in the institution's commercial-lending department from being made available to the trust department, and vice versa. Thus, even though the commercial-lending department might deem it advantageous for the trust department to invest in the equity of one of its clients, it could not so inform the trust department. Chinese Walls could also protect the institution against claims from its customers that it withheld information from them. But Chinese Walls are a double-edged sword. They cut both ways. While they prevent harmful information from getting through, they also prevent the exchange of useful information. Chinese Walls are also of little use to preclude the flow of information at the executive level.

At the present time, the controls in place to limit self-dealing are rather weak and generally consist of a prohibition against some classes of transactions. For example, a bank is prohibited under the *Bank Act* from lending to any of its officers or employees, or to a corporation it controls, an amount greater than $25,000 (or greater than the officer's or employee's annual salary, if less than $25,000), unles the loan is secured by a mortgage. Also, lending to a firm in which a bank director has a significant interest is restricted.

The *Trust Companies Act* prohibits a trust company from lending to any of its directors or officers or to any corporation that is a substantial shareholder of the company. As we shall see in Chapter 7, similar regulations apply to other categories of institutions.

Widespread ownership of financial institutions substantially reduces the incentive to self-deal, as the expected gain to each individual shareholder from such a transaction would be rather small.

Confidence in Fair Treatment and Regulation

Confidence in fair treatment by financial institutions is as important as confidence in their soundness. Existing regulations, including government regulation, self-regulation by the industry, and corporate governance, have not been able to prevent abuses of conflicts of interest and self-dealing from taking place. Also, governments have been uncertain about how to approach the mixing of financial and nonfinancial activities that may give rise to conflicts of interest and self-dealing.

The prohibition of all non-arm's-length transactions, as recommended in the Green Paper, might enhance confidence in the system but at a cost in terms of efficiency. Here, the role of self-regulation – perhaps in the form of internal review committees, as well as stringent, minimum quality standards for directors – could be an important means of limiting harmful non-arm's-length transactions. While self-dealing is quite explicitly forbidden for some classes of transactions, these prohibitions have frequently been circumvented. The reduction of self-dealing and of abuses of conflict of interest may call for a separation of major functions. But above all, it is important to have full disclosure of all conflict-of-interest situations and of all non-arm's-length transactions that take place.

6 Serving All Canadians

Individuals and unincorporated businesses, corporations, and governments are major purchasers of the services offered by the Canadian financial system. The total financial assets of individuals amounted to some $753 billion at the end of 1985, compared with $268 billion for corporations and $174 billion for governments. But corporations had the largest amount of debt outstanding, with $278 billion obtained from financial institutions or raised in financial markets; they were followed by governments with $273 billion and by individuals and unincorporated businesses with $239 billion. Are individuals and businesses well served by the Canadian financial system?[1] Are products that are well tailored to the specific requirements of various groups readily available? Are points of sale accessible to all Canadians? Do individuals and businesses benefit from adequate information to guide their choices? How well the financial system serves the needs of Canadians is the ultimate measure of its efficiency.

Households require financing to purchase consumer goods or financial assets, and they also need a wide range of investment and insurance instruments. At the end of 1985, consumer credit outstanding amounted to over $59 billion, and mortgage loans totaled over $149 billion.[2] Basic chequing facilities and vehicles for longer-term savings accounted for the $255 billion in deposits held by individuals at that time. Mutual funds are available for those seeking higher if riskier returns: such funds reached $12 billion in assets in 1985. Income protection after retirement or in the event of the death of a primary income earner was afforded to individuals by the $192 billion in liabilities held by life insurance companies and pension funds.

Businesses need commercial loans to finance accounts receivable and other operating expenses. To finance some capital equipment, term loans or other long-term debt instruments will be required. Trade credit and other short-term financing amounted to about $89 billion in 1985; bank loans, to another $84 billion; bonds, to $50 billion; and commercial mortgages, to $32 billion. Businesses also need sources of equity financing in order to meet growth requirements that cannot be financed out of retained earnings.

Individuals and businesses also require information on the availability and characteristics of various investment and financing instruments, on the financial health of financial institutions and nonfinancial firms, and on the expected evolution of the economy. Many need to have funds managed on their behalf.

Serving the Requirements of Individuals

The Institutions

For many Canadians the banks are the main source of financial services. Personal deposits account for 43 per cent of total Schedule A bank liabilities booked in Canada. This is hardly surprising since 85 per cent of Canadians have a savings account.[3] Banks are the main source of consumer credit and an important source of residential mortgage loans (Table 6-1).

Credit unions and caisses populaires, which had their origins as "peoples' banks," still tend to serve individuals more than businesses (32.5 per cent of individuals have shares in financial cooperatives), and so do trust companies in their intermediation business. Individuals are also the prime customers of mortgage and consumer loan companies. Life insurance companies serve both

Table 6-1

Consumer Finance Provided by Financial Institutions, Canada, 1985

	Consumer loans	Residential mortgages[1]
	($ millions)	
Chartered banks	41,050.1	40,903.2
Trust companies	3,583.1	31,304.0
Mortgage loan companies[2]	1,991.6	5,014.6
Credit union locals	8,242.0	17,875.1
Credit union centrals	–	86.4
Financial corporations	5,397.4[3]	524.0
Life insurance companies	2,874.5	10,219.1
Others	0.5	5,057.4

1 Pension funds and the estate, trust, and agency business of trust companies, which are sources of mortgage funds, are not included in this table

2 Excluding those associated with banks.

3 Including consumer retail-sales financing.

SOURCE Statistics Canada, *Financial Institutions, Financial Statistics*, Cat. 61-006, 1985.

individuals and firms in their provision of individual and group life insurance.

Information is usually obtained by individuals from the financial institutions serving their ordinary day-to-day needs. Banks, trust companies, caisses populaires, and credit unions provide information on various financial instruments, budgeting, planning for retirement, and investment strategies. Life insurance agents offer financial-planning advice in the course of arranging for the sale of their products, insurance policies, annuities, or RRSPs. Trust companies offer investment-planning services and information on specific industries or companies as part of their fiduciary operations. Securities firms offer detailed information to their customers on the financial conditions of companies, and they supply portfolio-management advice. Financial planners provide an array of information on how to arrange one's financial affairs.

Addressing the Needs of Different Income Groups

Some institutions cater to a wide range of individuals; others have found a niche serving specific income groups. Schedule A banks provide basic services to all savers, large and small. In 1985, there were 18.2 million personal savings accounts of less than $1,000; 10.3 million accounts in amounts ranging from $1,000 to $9,999; and 3 million accounts of over $10,000.[4] Some 70,000 savings accounts were for amounts above $100,000.

Life insurance companies also serve a wide range of individuals in their provision of insurance products. Some 42 per cent of all life insurance policies were purchased by individuals with incomes over $25,000, while those with incomes between $10,000 and $25,000 purchased 54 per cent of policies.[5] In contrast, the estate, trust, and agency business of trust companies tends to serve higher-income people.

The owners of shares in publicly traded companies also tend to be in higher-income and higher-education groups and reside mostly in larger urban centres.[6] Only some 10 per cent of Canadians own shares in companies, and barely 6 per cent of the population owns corporate or government bonds (excluding Canada Savings Bonds) - the traditional products of investment dealers. **Discount brokers** and the TD Green Line provide services that are less expensive and more "popular," but they do not offer investment advice - a major difference with full-service brokers. Only a few institutions and financial planners offer advice on a fee-for-service basis.

With respect to information, while basic advice is available to almost everyone, some require and obtain more specialized services than others. Wealthier individuals seek the advice of lawyers, accountants, and tax and financial-markets specialists in their investment, estate, or tax planning. Financial planners generally advise higher-income individuals on how to arrange their financial affairs. The delivery of information is often tied to the delivery of products, such as mutual funds and RRSPs, from which most planners derive their income. The more complex and elaborate the product, the higher the earnings. Financial planners have shown little interest in taking business from persons with an annual gross income of less than $30,000 because of their limited capacity to purchase more sophisticated financial products. Thus persons of more modest means may have more difficulty in obtaining adequate information or in gaining access to certain types of financial products.

Most financial planners are in a conflict-of-interest situation because they mix advice to consumers with the selling of products and thus have an incentive to advise customers to invest in the products they are selling. It is not always clear that consumers are fully aware of the existence of such a conflict of interest.[7]

Service and Convenience

Surveys show that consumers want service and convenience. Banks and other financial conglomerates are devoting a great deal of effort to improving access to financial services. Over 7,000 branches of 10 Canadian banks make a wide range of products available across the country. The representatives of Investors' Syndicate, through associations with Montreal Trust and Great-West Life, can bring a diversified line of products (including mutual funds, RRSPs, trust and estate services, and insurance products) to Canadians, either directly or by cross-referrals.

Several financial holding groups, such as the Laurentian Group, are experimenting with one-stop financial centres where the representatives of several affiliated financial institutions offer their products at a single location. The experience of Sears Roebuck in the United States - which brings together, in its 317 financial centres, a life and casualty insurance company (Allstate), a securities broker (Dean Witter Reynolds), and a real estate company (Coldwell Banker) - shows, however, that consumers generally come to the store for one kind of transaction at a time. They come to shop for a house, a life insurance policy, or a mutual fund. The rationale behind the Sears financial-services network is to put consumers in a position where they can find a large number of financial products and services in one location. It links the name of Sears, regarded as a symbol of reliability, with a number of associated institutions. The only truly integrated financial transactions, according to the Sears experience, are those accompanying the purchase of a house; the consumer is then likely to enter into a transaction combining real estate, a mortgage loan, and casualty and life insurance. The prequalification for mortgages issued by several Canadian financial institutions associated with real estate brokers is another example of the integration of transactions covering related products.

The one-stop financial centre is being tested in a number of locations in Canada. But not all customers respond positively to this approach to the delivery of financial services; some, for instance, may be concerned with privacy or with the lack of investment diversification when all the products purchased are produced by the same financial conglomerate. Such diversification risk would be lessened if the one-stop centre offered services produced by different institutions. For higher-income individuals, getting sophisticated information is likely to be more important than finding all the services at one convenient location.

The Regulatory Environment

Most Canadians have relatively easy access to financial services. While it is normal that higher-income individuals rely on a greater range of financial services, that does not mean that the needs of Canadians of more modest means should not be adequately met.

It is too early to judge whether the idea of a one-stop financial centre is catching on and what form is preferred by customers. But the regulatory system should provide enough flexibility to allow consumers' choices to be met according to their preferences by encouraging diversification and the development of new instruments and services. One should not, however, overlook the fact that diversification through conglomeration may, in some cases, reduce access to the services of the financial sector. The development of markets may be retarded by the very existence of financial conglomerates. The West German experience is an illustration of a situation where competition between conglomerates does not guarantee access to a wide variety of services.[8]

Serving the Requirements of Businesses

The Institutions

Financial institutions provide financial services to Canadian businesses in a variety of forms, including deposits, loans, commercial mortgages, bonds, and shares. Business deposits in Canada account for some 20 per cent of liabilities of Schedule A banks, and loans to nonfinancial corporations account for some 30 per cent of total assets. Businesses are the main customers of Schedule B banks. Finance, leasing, and factoring companies cater almost exclusively to the financing needs of business.

Securities firms underwrite bonds and stocks, and initiate private placements, all of which are important alternatives to bank financing for many businesses. In fact, most financial institutions other than chartered banks, cooperatives, and loan companies provide the largest portion of their financing to Canadian business in the form of equity, bonds, or commercial paper. This is particularly true of life insurance companies, trusteed pension plans, investment dealers, and investment and closed-end funds.

Addressing the Needs of Different Sizes of Businesses

An indication of the business customers of chartered banks can be obtained by looking at the distribution of their business loans by size of authorized borrowing limits (Table 6-2). While the borrowing limit does not exactly correspond to a firm's size, size is a major determinant of that limit.

There is a significant difference between the way small and large firms finance their operations. Smaller firms tend to have less equity and to rely more on short-term debt than do larger firms (Table 6-3). Smaller firms also rely more heavily on bank borrowing. Larger firms have access to a wider range of financing facilities, including the stock market. Almost all commercial paper, corporate bonds, and shares purchased by financial institutions are from larger corporations. The very large firms have access to a wide range of instruments, such as **junk bonds**, stripped bonds, exchange-rate and interest-rate swaps, note-issuance facilities, and so on. They can also secure financing abroad in financial centres such as London, New York, Paris, and Tokyo.

Because they sometimes lack access to equity markets and to some of the more elaborate borrowing facilities, small and medium-sized businesses have higher debt-to-asset ratios than larger concerns. Work reported in the Economic Council's 21st Annual Review showed a deterioration of these ratios between 1979 and 1981, particularly for small businesses but even more so for medium-sized firms.[9] This deterioration was understandable in an environment where rates of inflation were high and real rates of interest low, as debt was then the cheapest form of financing. But increased

Table 6-2

Distribution of Chartered-Bank Loans Outstanding to Nonfinancial Corporations, by Size of Authorized Limits, Canada, First Quarter 1986

	Size of authorized borrowing limit (in $ millions)							
	50 and more	25 to 50	5 to 25	1 to 5	0.5 to 1	0.2 to 0.5	Less than 0.2	Total
	($ millions)							
Canadian-dollar loans outstanding	21,890	5,436	15,421	13,160	4,837	5,821	17,363	83,928
	(Per cent)							
Percentage distribution	26.1	6.5	18.4	15.7	5.8	6.9	20.7	100.0

SOURCE *Bank of Canada Review*, Table C-7, August 1986.

Table 6-3

Distribution of Corporate Financing, by Category of Instruments and by Size of Firms' Assets, Canada, 1983[1]

	Size of assets					
	$249,999 or less	$250,000 to 999,999	$1,000,000 to 4,999,999	$5,000,000 to 9,999,999	$10,000,000 to 24,999,999	$25,000,000 or more
	(Per cent)					
Debt	53.7	49.9	53.1	51.1	44.2	41.2
Short-term	39.1	33.7	37.6	36.1	29.1	18.5
Bank loans	12.8	11.4	12.8	12.9	9.6	4.6
Long-term	14.6	16.2	15.5	15.0	15.1	22.7
Bank loans	3.5	3.1	3.4	4.9	4.1	6.6
Shareholders' equity	45.9	49.4	45.2	45.9	52.1	51.6
Deferred taxes	0.3	0.7	1.8	3.0	3.6	7.2
Total	100.0	100.0	100.0	100.0	100.0	100.0

1 Latest year for which data are available.
SOURCE Estimates by the Economic Council of Canada, based on data from Statistics Canada.

indebtedness, together with rising nominal interest rates, dramatically raised the portion of business income devoted to interest payments.

Additional data now available indicate that as of 1983 the debt-to-asset ratios of smaller firms had not significantly improved and, indeed, had deteriorated for some size classes of firms (Table 6-4). While the ratios for smaller firms tended to be higher, on average, than for larger corporations, smaller firms tended to exhibit a much wider range of debt-to-asset ratios; in particular, a much larger percentage of smaller firms had very high debt-to-asset ratios. In fact, 18 per cent of corporations with assets of less than $250,000 in 1983 had more debt than assets. Smaller corporations also exhibited a much wider range of rates of return than did larger corporations. For example, 26 per cent of firms with less than $250,000 in assets had negative rates of return.

These low rates of return and high debt-to-asset ratios combined to yield low interest-coverage ratios – a measure of the ability of firms to cover interest payments out of current income (Table 6-5). Interest-coverage ratios declined during the latter part of the 1970s for all sizes of firms and were particularly low in 1982, as a result of the low profitability and high accumulation of debt experienced during the recession period. While low interest-coverage ratios and high debt burdens tend to be a problem for firms of all sizes, these problems are particularly acute for smaller firms.

Table 6-4

Independent Corporations in the Primary and Secondary Sectors with a Debt-to-Asset Ratio Greater than 77 Per Cent, by Size of Assets, Canada, 1975-83

	Size of assets					
	$249,000 or less	$250,000 to $999,999	$1,000,000 to $4,999,999	$5,000,000 to $9,999,999	$10,000,000 to $24,999,999	$25,000,000 or more
	(Per cent)					
1975	33.1	18.9	17.9	15.6	7.3	10.0
1976	31.3	20.0	20.2	14.1	9.4	7.6
1977	27.1	21.4	19.4	16.3	11.0	8.7
1978	34.9	24.9	21.5	16.1	13.6	11.6
1979	29.3	22.8	21.7	16.0	17.8	9.7
1980	32.8	25.3	21.4	19.3	19.2	12.8
1981	36.1	23.0	23.3	26.7	20.6	14.4
1982	36.6	26.3	25.4	21.5	19.0	17.3
1983	35.6	28.5	25.0	20.4	15.2	14.3

SOURCE Calculations by the Economic Council of Canada, based on data from Statistics Canada.

Several factors contribute to the higher debt-to-asset ratios experienced by smaller firms. First, the owners of many small and medium-sized businesses do not want to give up control over their venture and will attempt to seek equity financing only if they are forced to do so. Second, businesses find it profitable to finance themselves by borrowing rather than by raising equity, particularly during inflationary periods. Moreover, the taxation system encourages them to do so, since interest on debt is tax-deductible. Furthermore, small businesses that do seek equity financing face relatively higher costs than large companies in getting access to stock exchanges because of the higher costs of floating smaller issues. With the exception of some venture-capital firms and merchant bankers, few alternatives are offered to small businesses.[10]

The increase in competition over the past 10 years or so has not significantly increased the availability of equity financing for small businesses. In response to the competition created by foreign banks and foreign dealers who sought the business of larger Canadian

Table 6-5

Interest-Coverage Ratio[1] of Corporations, by Size of Assets, Canada, 1975-83

	Size of assets					
	$249,999 or less	$250,000 to $999,999	$1,000,000 to $4,999,999	$5,000,000 to $9,999,999	$10,000,000 to $24,999,999	$25,000,000 or more
	(Per cent)					
1975	6.2	6.2	6.5	5.9	6.8	7.8
1976	3.2	4.8	5.1	5.3	6.1	6.9
1977	3.3	4.9	4.9	5.1	6.0	7.2
1978	4.3	5.4	5.7	5.7	7.0	7.2
1979	5.5	5.4	5.4	5.8	6.5	7.7
1980	4.3	4.6	4.1	4.6	5.2	6.8
1981	4.2	4.1	3.4	3.6	3.8	4.8
1982	3.6	3.2	2.8	2.8	3.0	3.0
1983	4.4	4.3	3.5	3.3	3.9	3.9

1 Ratio of income (before taxes, depreciation, and interest) to interest payments.
SOURCE Estimates by the Economic Council of Canada, based on data from Statistics Canada.

corporations, large Canadian financial institutions have attempted to make inroads on international markets and in foreign countries. They have not entered the small-business-finance area to any greater extent than previously.[11]

On matters of financial advice, although large firms normally employ their own accountants, tax consultants, and legal experts, they also seek the advice of banks, trust companies, and securities firms on such matters as corporate finances, large-project financing, mergers, and takeovers. They are also likely to turn to trust or insurance companies and investment counsellors for the management of large pools of funds, particularly pension funds.

Small business customers frequently obtain advice from the institutions with which they deal on how to arrange their overall finances, on where to obtain specific loans from, or backed by, government agencies, and on how to manage payrolls and collect bills. Banks also offer some credit-checking services to their customers. There is, however, a continuing debate on how well the information needs of smaller businesses are being catered to.

The Regulatory Environment

Overall, then, it is fair to say that a variety of institutions cater to the needs of Canadian business. And, not surprisingly, the larger the size of the business, the greater the availability of a wide range of financial services. Any reform of financial regulation should encourage institutions to maintain and broaden the range of business financing instruments. Greater diversity is likely to address, if only partially, the equity problems of small and medium-sized businesses by making a wider range of instruments available.

Regional Availability of Financial Services

The accessibility of financial services depends on the location of customers. Banks, trust companies, credit unions, and caisses populaires have retail outlets spread across the country. These networks are supplemented by a system of agents, many of whom work out of their own homes, and by services provided by mail. In a free market, a branch system will be put in place to serve those communities where it is profitable to do so. If the branch of a financial institution in a particular community consistently takes a loss, it will not remain for long in that location. Similarly, a branch will not be established at a location unless the potential exists for that branch to return a profit. Thus the existence of branches of financial institutions will depend on the number of customers, on their income and wealth profiles, and on the kinds and sizes of businesses in the locality.

Regional Distribution of Retail Outlets

The outlets of deposit-taking institutions engaged in retail banking are the most visible of all the distribution networks. They include the branches of banks, financial cooperatives, and trust and loan companies. Securities firms also distribute their products through retail outlets. Considered here are the institutions that cater to most of the needs of individuals and businesses. Insurance companies are the only major group of institutions that does not have a branch network, as insurance products are distributed through sales agents. A summary measure of the regional availability of financial services is given by the distribution of the branches of these financial firms, which follows relatively closely the provincial distribution of population and income (Table 6-6).

Close to 57 per cent of the retail outlets considered here belong to the chartered banks. There are more branches of banks than of any other category of institutions in every province except Quebec, where the caisses-populaires movement has more branches than the banks. Excluding Quebec, whenever a locality is served by only one institution, that institution is a bank in 61 per cent of the cases (39 per cent, if Quebec is included). In fact, banks play a crucial role in many provinces in providing access to financial services (Table 6-7). This is strikingly so in Newfoundland, Prince Edward Island, and even Ontario. Financial cooperatives play a greater role in Manitoba, New Brunswick, Saskatchewan, and particularly Quebec. The lesser presence of banks in Quebec and in parts of New Brunswick can be explained by the strength of the caisses-populaires movement.

But of much greater significance is the fact that, excluding the insurance business, over 1,700 localities in Canada are served by only one "pillar." The bank branch or the local financial cooperative is the only available point of sale for a great number of Canadians who live outside the larger urban centres. The services of trust companies or investment dealers are not directly available in many areas of the country. It can be argued that the use of services provided by securities firms do not require face-to-face meetings for each transaction, as orders can be placed by telephone. The fact remains that direct contact is not available in most rural areas.[12]

Table 6-6

Distribution of Branches of Four Major Categories of Financial Institutions, Canada, by Province, 1985

		Four major categories					
	Population	Income[1]	Banks	Credit unions	Trust companies	Investment dealers	All branches
				(Per cent)			
Newfoundland	2.3	1.4	1.9	0.1	1.2	1.0	1.3
Prince Edward Island	0.5	0.3	0.4	0.3	0.7	1.0	0.4
Nova Scotia	3.5	2.4	3.4	2.8	4.4	4.4	3.3
New Brunswick	2.8	1.8	2.5	3.4	2.2	2.9	2.7
Quebec	30.0	22.3	19.3	37.1	10.7	20.8	23.6
Ontario	35.7	38.4	38.8	28.5	53.3	39.6	36.8
Manitoba	4.2	3.8	4.8	4.7	2.7	2.6	4.4
Saskatchewan	4.0	4.0	5.4	8.8	3.2	3.6	6.1
Alberta	9.3	13.7	11.2	6.8	10.5	9.4	10.6
British Columbia	11.4	11.4	11.8	7.6	11.1	14.7	10.5
Yukon	0.1	0.4[2]	0.2	-	-	0.2	0.1
Northwest Territories	0.2		0.2	--	-	-	0.1
Canada	100.0	100.0	100.0	100.0	100.0	100.0	100.0

1 Based on 1984 data.
2 Yukon and Northwest Territories combined.
SOURCE Population and income figures based on data from Statistics Canada, other figures based on Canadian Payments Association, *Directory*, 1985; Trust Companies Association, *Directory of Members and Certain Non-Members*, February 1985; and Investment Dealers Association of Canada, *Membership Directory*, 1985.

Table 6-7

Role of Banks and Financial Cooperatives in Providing Access to Financial Services, Canada, by Province, 1985

		Localities served by only one type of institution			
	Number of localities[1] served by financial institutions[2]	Number	As a proportion of all localities served by financial institutions	Proportion served by[3] A bank	Proportion served by[3] A cooperative
			(Per cent)		
Newfoundland	69	66	95.7	100.0	-
Prince Edward Island	15	8	53.3	87.5	12.5
Nova Scotia	122	82	67.2	54.9	45.1
New Brunswick	116	82	70.7	39.0	61.0
Quebec	889	672	75.6	4.9	95.1
Ontario	554	341	61.6	83.3	16.4
Manitoba	161	100	62.1	38.0	62.0
Saskatchewan	322	201	62.4	31.8	68.2
Alberta	205	90	43.9	61.1	24.4
British Columbia	146	61	41.8	59.0	41.0
Yukon and Northwest Territories	17	15	88.2	100.0	-
Canada	2,616	1,718	65.6	39.3	60.0

1 Metropolitan areas, such as those of Montreal, Toronto, and Vancouver, are counted as one locality.
2 Banks, trust companies, financial cooperatives, and investment dealers.
3 In Alberta, 15.5 per cent of localities are served only by a branch of Alberta Treasury Branches.
SOURCE Based on Canadian Payments Association, *Directory*, 1985; Trust Companies Association, *Directory of Members and Certain Non-Members*, February 1985; and Investment Dealers Association of Canada, *Membership Directory*, 1985.

The Role of Financial Cooperatives

Access to financial services has been improved by the development of the caisses populaires and credit unions. These institutions have emerged as an alternative structure for the production and delivery of financial services based on diffused local decision making.[13]

The first caisse populaire emerged in the province of Quebec at the turn of the century under the leadership of Alphonse Desjardins. At that time, banks catered more to commercial and industrial customers. Although they channeled savings from the whole community, funds were largely directed towards commercial and industrial enterprises. The personal-loan market was almost completely ignored by banks and other financial institutions. The solution, according to Desjardins, was to establish institutions in which individuals would be the co-owners of the firm and the purchasers of its services at the same time, so that their own savings would fund credit accorded to themselves. The financial cooperatives brought together individuals with common geographical or occupational links - the inhabitants of a parish or a group of civil servants, for example - and provided access to banking services for individuals who could not, until then, avail themselves of the services of financial institutions. The importance of the role played by the financial cooperatives is evidenced by their dramatic membership growth between 1930 and 1950 (Table 6-8).

Financial cooperatives in Quebec and New Brunswick play a different role than those in the rest of the country. The caisses populaires in French-speaking areas have been organized around the parish, and their raison d'être is to serve local communities. Because of their very nature and their roots, the caisses populaires in those two provinces have played a direct role in the economic and social development of the regions they serve. With credit unions in the English-speaking areas of the country, the association is more often based on a professional link and frequently located in medium-sized and larger municipalities.

Table 6-8

Membership of Canadian Financial Cooperatives, Canada, Selected Years, 1920–85

	Members	Compound annual growth rate
	(Thousands)	(Per cent)
1920	32	-
1930	46	3.7
1940	201	15.9
1950	1,036	17.8
1960	2,554	9.4
1970	4,769	6.4
1980	7,346	4.4
1984	8,696	4.3
1985	8,708	0.2

SOURCE D. Albert, "Les coopératives financières au Canada," a background paper prepared for the Economic Council of Canada, 1986.

Although individual caisses populaires and credit unions provide access to basic financial services, they cannot, by themselves, cater to more diversified needs because of their limited size. They cannot independently supply the funds needed by the medium-sized and larger firms; nor can they offer mutual funds or participate in money markets. As the cooperative movement grew in size, local financial cooperatives pooled their resources within central organizations to participate in activities that required larger sums of money. They also associated themselves with trust, life, and general insurance companies. In the process, they somewhat shifted their focus, as evidenced by the change in the composition of their assets in recent years. Between 1976 and 1985, the proportion of the assets of credit unions and caisses populaires that is devoted to commercial loans rose from 1.1 to 5.8 per cent, while the ratio of personal loans to total assets declined from 24.7 to 18.7 per cent. That the financial-cooperative movement has reached maturity is shown by the dramatic slowdown in the rate of growth of its membership.

Availability of Other Services

As mentioned earlier, the analysis of the distribution of retail outlets does not reflect the availability of all financial services. The trustee services provided by trust companies are available in all the larger urban centres and in a number of smaller localities as well,[14] but for residents of smaller urban and rural areas and for some residents of larger urban centres, those services are provided by lawyers. The management of estates and trusts obtained over the years does, indeed, represent a significant portion of the income of some lawyers.

Life and general insurance services are distributed either through a system of insurance agents or through independent brokers, many of whom simply operate out of their own homes. While financial planners are active in smaller communities, at least some of their services, including the provision of funds and RRSPs, can often be purchased through a local bank, a financial cooperative, an insurance agent, or a broker.

The mapping of branches of financial institutions across the country is only one aspect of the evaluation of the accessibility of financial services. Another relates to the proximity of the decision centre to the various regions in Canada. It is often argued that the centralized decision-making process within Canadian financial institutions is detrimental to the interests of customers located in outlying areas. The face-to-face contact is preferred, since the flow of information tends to decline in quality as the number of intermediaries increases.

From an institution's point of view, the supply of services depends on the costs involved in relation to revenues. The cost of delivering services is not the same in every municipality across Canada, but financial institutions have a standard pricing system for the whole country. This results in the subsidization of those areas with higher delivery costs by customers located in the areas where delivery costs are lower. The unwillingness or inability of financial institutions to price their financial services on the basis of the differences in costs between regions may explain in part why there is a large number of municipalities where one financial institution finds itself in a relatively monopolistic situation.

Regional Availability and Regulation

The supply and availability of financial services to Canadians differ according to the kinds of customers (individuals or businesses), to their size, and to their location. While basic retail banking and insurance products are quite accessible across the country, the more specialized services are more likely to be available only in large urban centres.

It is argued elsewhere in this report that there should be a functional separation at the production level of financial services, but it must be stressed that the distribution of various products at one point of sale should not be constrained so as to limit their availability. There is a compelling argument for permitting networking and cross-selling of all kinds, so that as many Canadians as possible may have access to all the products offered by financial institutions.

Consumer Protection

The purchasers of financial services need protection from any wrongdoing or from the risk of insolvency of the financial institution with which they are dealing. The provision of information on the quality of the product and on the characteristics of its supplier is a first step towards guarding customers against these eventualities. However, the mere availability of information may not be sufficient protection for the customer. For many consumers of financial products and services, regulation – either by the industry concerned or by governments – is a substitute for information in that it relieves them of the need to understand the day-to-day workings of financial institutions. It protects them from losses resulting from failures, fraud, and abuses of conflict of interest, and it assures them of equitable treatment. For many Canadians, consumer protection through some form of regulation is a necessity.

There are two aspects to consumer protection. First, consumers need protection from unfair or unequal treatment by financial institutions. In this regard, they require protection from abuses of conflict of interest or from excessive fees in cases where an institution is able to exercise market power, either because of its size or because of the protection afforded by legislation. Consumers may also need to be protected through some form of quality control over the financial services they purchase. Second, the purchasers of financial services need protection from loss as a result of the failure of the institutions providing these services.

Protection from Wrongdoing

Conflicts of interest, self-dealing, and insolvencies were discussed at length in the previous chapter, but only in the context of their impact on confidence. Even when they do not weaken confidence in the financial system, abuses of conflict of interest are harmful because the purchasers of financial services may suffer a loss. Worse still, they may not be aware of that loss. For example, only a financial expert might be able to judge whether the monies of a trust fund were invested to the benefit of the client or to the advantage of the trustee.

If a consumer good such as an automobile is found to be defective, the consumer has recourse against the manufacturer; moreover, the consumer can easily recognize when the product is defective. In the case of a financial product or service, the fact that the purchaser is being unfairly treated is not likely to be evident. In many cases of abuse, by the time the customers realize their loss, the funds and the perpetrator of that abuse, who is able to move financial assets easily, are gone.

Second, consumers need assurance of the quality of the financial services they receive, particularly with respect to financial advice. Incorporation and licensing requirements contribute to the establishment of such norms. While many trust companies and other financial-service institutions such as Investors Syndicate have quite comprehensive training programs for their own personnel, anyone who wants to do so can become a financial planner without having to meet any standard of competence. Financial planners must meet licensing requirements for the products they sell, but their qualification to offer financial advice is not verified by any government authority or self-regulatory body. As anyone can hang out a shingle advertising those services, there is a case for requiring proof of competence from financial planners through a licensing system. The Quebec, Ontario, and Alberta securities commissions called upon the Canadian Association of Financial Planners to propose a plan for self-regulation by 15 August 1986. The Quebec government is particularly concerned about the qualifications of planners who provide advice. It would like financial planners to show that they have received relevant training. The Commission des valeurs mobilières du Québec has put forth some concrete proposals to that effect.

Investment counsellors have to meet the requirements of provincial securities commissions in relation to their transactions on securities markets. In addition, Ontario investment counsellors have to meet capital and some proficiency requirements and they have to consider the extent of insurance or bonding necessary to cover insurable risks in the business of giving advice to the public. In general, requirements vary from province to province.

Lawyers manage quite extensive estate and trust funds, and the management of those funds is regulated only to the extent that lawyers are regulated by the law societies. There is a case, from a consumer-protection point of view, for regulation to apply to lawyers beyond the rules set out by a law society, so that they would have to meet the same fiduciary requirements as managers of trusts within trust companies. In particular, a case can be made for lawyers to be subjected to the same "prudent man" rules as other managers of funds.

Protection from Loss Caused by Failures

For consumers, the solvency of financial institutions is critical. Indeed, there is widespread support for some form of protection to ensure that customers do not see their life savings disappear through the failure of a deposit-taking institution. Of course, in any truly competitive market, mismanaged firms should be allowed to fail. But if the loss of financial assets is complete, such failures may seriously undermine confidence in the system as a whole (see Chapter 4). Furthermore, Canadians have clearly indicated that they expect – and are willing to pay for – some form of basic protection from losses, even when those losses do not threaten confidence in the financial industry.[15]

The degree of consumer protection is uneven among groups of financial institutions. There is currently no formal protection mechanism in the insurance industry. Unsettled customers' claims against four general insurance companies that failed between 1981 and 1985 are presently estimated at about $175 million. However, the insurance companies are currently in the discussion stage of setting up compensation funds for their customers. The customers of securities firms are covered by a national contingency fund to which all dealers who are members of Canadian stock exchanges must subscribe. In the case of claims resulting from the insolvency of a member, the first $500,000 would be paid out by the stock exchange where the firm mainly conducts its business. Any amount in excess of $500,000 would be covered by the fund. There is presently about $9 million in the fund. Should that amount be insufficient to cover claims arising from the failure of a securities firm, other dealers would have to assume responsibility for the shortfall. So far, all claims arising from the financial difficulties of member firms have been covered.

The most important protection is that afforded the majority of customers of deposit-taking institutions. The Canada Deposit Insurance Corporation (CDIC) insures deposits in the amount of $60,000 or less, with an initial term to maturity of five years or less, in banks and federally incorporated trust and loan companies, as well as deposits made outside Quebec in provincially chartered trust and loan companies. In Quebec, provincially chartered institutions, including caisses populaires, are insured by the Régie de l'assurance-dépôts du Québec. In Ontario, deposits in credit unions are insured by the Ontario Share and Deposit Insurance Corporation (OSDIC). Deposits and shares in credit unions in other provinces are provided with an unlimited guarantee by their own stabilization funds,[16] except in New Brunswick where the amount of the guarantee is at the board's discretion.

The Canada Deposit Insurance Corporation

The CDIC was established in 1967 to protect depositors and to contribute to the maintenance of public confidence in deposit-taking institutions. Its operations are funded by a flat annual premium equal to one-tenth of 1 per cent of insured deposits levied on member institutions. The CDIC has met all of its obligations vis-à-vis depositors in the failures of deposit-taking institutions that have taken place since its inception. The more recent failures of insured trust and loan companies and of two banks have, however, saddled the corporation with a sizable deficit. The protection afforded by the CDIC has been quite effective, in the sense that no qualifying depositor has lost a single dollar of deposits left with the failed institutions; depositors have, nevertheless, had to bear some costs in delays in securing refunds from the CDIC and in forgone interest on the funds on deposit.

The design of deposit insurance has recently been the subject of much debate, particularly with respect to the premium structure and the extent of coverage. While deposit insurance protects consumers and contributes to preserving confidence in deposit-taking institutions, it may also give rise to excessive risk-taking, as seen in Chapter 5, particularly in the context of a flat-rate premium. To a large extent, the debate in Canada has been fueled by CDIC's deficit, which might have been lower had market discipline been enhanced by requiring the more risky institutions to assume a larger share of the cost of insurance and had depositors been given an incentive to choose among deposit institutions according to their relative riskiness.

Risk-Related Premiums

The purpose of introducing a system of **risk-related premiums** is to lower the incentive for managers of deposit-taking institutions to take excessive risks. Indeed, under a system of risk-related premiums, deposit insurance premiums would be set according to the riskiness of the insured institution, with higher-risk institutions paying higher premiums. These higher premiums would bite into the higher returns generally associated with more-risky investments. But, more importantly, these institutions may have more difficulty in raising funds as potential investors would be alerted by the higher insurance premium. The resulting higher cost of funds may significantly lower the institutions' returns. Thus these institutions would not be able to shift risks and costs onto the insurer and eventually onto well-managed institutions and their customers.

In order to implement a system of risk-related premiums, some method of evaluating the riskiness of the institution would have to be designed. There are two possible approaches. The first is to devise a measure of an institution's overall risk by relating the probability of failure to a number of financial variables that can be monitored. When the probability of failure increases, the premiums are raised. The problem is that this approach is backward-looking and does not capture the current behaviour affecting the institution's risk exposure. The second approach would be to evaluate the riskiness of the institution's assets in relation to its capital base. This solution, however, would require a careful examination of the institution's nonmarketable assets (i.e., its loan portfolio), which could prove rather costly.

The possibility of introducing risk-related premiums has been studied, and it was concluded that this solution is not currently feasible since it would be difficult, if not impossible, to properly evaluate the riskiness of institutions.[17] A further serious concern is that higher premiums would identify the more risky institutions. This could result in loss of confidence and in a run on deposits, possibly ending in the failure of the institution. Even with deposit insurance and a higher interest rate on deposits, there is no guarantee that some depositors would not move their deposits from the institution thought to be risky, simply because people do not want the bother of waiting for compensation from the insurer.

Co-insurance

Under **co-insurance**, only some part - say, 80 or 90 per cent - of eligible deposits would be insured, so that depositors would bear some risk. Some have proposed that co-insurance apply only to deposits above a certain minimum, so that the first $20,000 (for example) would be fully insured. The proponents of co-insurance argue that it would make depositors take better account of the riskiness of the institutions to which they entrust their money. By their reasoning, market forces would force risky institutions either to pay adequate risk premiums in the form of higher interest rates or to become less risky if they wanted to keep deposits. The effectiveness of co-insurance in enhancing market discipline rests on the availability of adequate information on the performance and financial health of deposit-taking institutions, and the ability of depositors to understand that information. But those who argue that co-insurance should start with the first dollar of deposit do not address the question of the need for deposit insurance in the first place - namely, the need to protect the small depositor, who is unable to evaluate the riskiness of individual institutions. Also, much of the contribution of deposit insurance to public confidence in deposit-taking institutions might be lost. If co-insurance applied only to deposits above some minimum level, it would have a reduced impact on market discipline, since fewer deposits would be subject to it; but it would also have a less negative impact on confidence.

The primary objective of the Canada Deposit Insurance Corporation is consumer protection. From such a perspective, a case can be made for broad coverage. The fact that it is the small and less experienced customer who needs such protection the most justifies a limit on the amount of deposit insurance but rules out co-insurance. A second objective of the CDIC is to contribute to confidence in deposit-taking institutions and in the financial system as a whole. From this perspective, a case can be made for the broadest possible coverage, with no co-insurance and no risk-related premiums. Risk-related premiums might be considered, however, in order to reduce the incentive to take excessive risks.

7 A Framework for Regulatory Reform

Mounting Pressures in the Canadian Financial System

The financial system is widely perceived as being concentrated and protected by regulation. Yet, over the past 15 years there has been a significant increase in competition among financial institutions.

The New Competition

Some individual financial markets continue to exhibit an above-average degree of concentration, with a small number of firms accounting for a relatively large share of the market (see Chapter 3). Nevertheless, concentration in most markets - the mortgage market is an exception - has declined in recent years, and it is expected to decline further as competitive pressures increase. Competition has come from diversified institutions that have entered many different markets, as well as from specialized firms that offer services not readily available from larger conglomerates. In their drive to compete, several groups of institutions have attempted to diversify their operations, thus blurring to some extent the traditional separation between main functions. In particular, large financial conglomerates and holding groups have emerged, though they have not yet had a significant impact on concentration.

Competition in Canada's financial markets has been hindered by the existence of both legal and nonlegal barriers to entry and exit. Examples include the various incorporation and licensing requirements at the federal and provincial levels; capitalization requirements; and prohibitions imposed on institutions to prevent them from operating in specific markets; and the need to have approval to wind down operations and surrender a charter. The lack of harmonization among various regulatory authorities across the nation has also hampered the competitive efforts of Canadian financial institutions, with the rules of the game varying, depending on the jurisdiction and the institution being regulated. Nonlegal factors also come into play. For instance, the need for a branch network in order to be competitive at the retail level has limited the number of participants in that market. This may, of course, change with the development of new technology and the introduction of automated banking machines.

Ownership

The analysis in Chapter 3 showed that concentration of ownership has increased as a result of the growth of holding groups and a number of mergers and acquisitions. In fact, today there are three different models of ownership. Schedule A chartered banks are widely held, with no individual shareholder owning more than 10 per cent of outstanding shares. Credit unions and mutual insurance companies are also widely held institutions. Several trust and loan companies, on the other hand, are closely held by individuals or firms. Finally, other trust and insurance companies have majority shareholders, with large portions of their shares being held by the public at large. Chapter 5 has shown that ownership restraints can be an important element in protecting Canadians from harmful transactions between related parties.

Public Confidence and Solvency

Despite the rash of insolvencies, public confidence in the financial system as a whole remains strong. A partial loss of confidence has, however, affected some smaller banks and trust companies. The failures of financial institutions were largely the result of managerial misjudgments, such as the taking of excessive credit and funding risk, lack of diversification, and the mismatching of assets and liabilities - practices that could not withstand the unfavourable economic developments of the late 1970s and early 1980s (see Chapter 4). In some cases, the risk of insolvency was also increased by levering without taking proper account of contingent liabilities. In most cases, abuses of conflict of interest and self-dealing do not seem to have been the main cause of financial difficulties, but frequently they came into play after institutions were on their way to failure.

Regulatory agencies operated effectively in a stable financial environment, but they could not contain the sudden onslaught of financial difficulties in the 1980s, nor could they supervise the struggle by owners and managers of failing financial institutions to rescue their firms (see Chapter 5). The availability of deposit insurance was, however, an important element in maintaining public confidence in the system despite the failures and occasional instances of abuses.

Access

Most Canadians are generally well served by the Canadian financial system (see Chapter 6). It is normal for larger customers to have a greater diversity of instruments to choose from and for higher-income individuals to rely on more-diversified services. Nevertheless, smaller businesses do face equity-financing problems, attributable in part to shortcomings in the supply of such financing. While financial services are generally available across the land, many areas are served by only one point of sale. Regulations restricting networking, cross-selling, and diversification efforts tend to reduce the availability of some products to certain parts of the country.

An Antiquated Regulatory Framework

The Canadian regulatory system, based on a narrow concept of banking, insurance, trust, and securities trading, has not coped well with the new trends in financial markets. Canada has not yet adapted the rules of the game to the new realities, nor has it ensured compliance with the spirit of the law. Cash-management accounts offered by securities dealers, life insurance companies' short-term deferred annuities, and the banks' off-balance-sheet items have not been grasped within the regulatory mould. Financial holding companies have so far escaped any supervision, and at the other end of the spectrum, so have individuals who offer their services as financial planners. Moreover, the capacity of the regulating agencies to spot impending financial crises and to take prompt action to forestall insolvency situations has come into question in recent years, with difficulties originating mainly with the information and enforcement procedures. Furthermore, the regulatory process has been unable to deal adequately with instances of self-dealing and abuses of conflict-of-interest situations.

One problem of the current regulatory structure is that it does not provide for a level playing field; rather, it imposes different costs and constraints on different categories of institutions performing the same activity (see Chapter 2).

The shortcomings of the present regulatory framework can be attributed to its complexity and to a lack of clarity with regard to the sharing of responsibilities between the federal and provincial governments. The current division of powers is a legacy of the *Constitution Act* of 1867, which gave to the Parliament of Canada responsibility over banking, trade, and the medium of exchange, and more generally over matters of national interest; to provincial legislatures it assigned jurisdiction over property rights, contracts, and matters of regional interest. Consequently, depending on the institution involved, the same function can be regulated at the federal or at the provincial level and, in the latter case, by different provinces. For example, deposit taking is currently subject to regulation by the federal Inspector General of Banks, the federal Department of Insurance, various provincial governments, the Canada Deposit Insurance Corporation, or the Régie de l'assurance-dépôts du Québec.

This jurisdictional imbroglio is compounded by a lack of harmonization between the numerous authorities. Regulatory practices differ from one province to another with respect to incorporation requirements, licensing, supervision, and the powers given to regulators to request changes in corporate operations, and so on.

In short, the existing legislation is out-of-date. With the exception of the decennial revisions to the *Bank Act* and a few limited attempts in some provinces, most of the legislation governing financial institutions has not been reviewed for many decades.

The Challenge of Regulatory Reform

The process of regulatory reform has to take into consideration many factors and developments. For example, the new competition that has emerged in financial markets is, by and large, a healthy development. Without competition, financial resources are not adequately allocated. But other factors must also be taken into consideration: without public confidence in the solvency of the financial system and in fair treatment by financial institutions, the system cannot operate; furthermore, without adequate information and access, Canadians will not obtain the full benefits of a modern financial system. But increased competition can lead to insolvencies, which may in turn impact negatively on public confidence in the financial system. On the other hand, insolvencies are also an essential ingredient for a healthy marketplace. They are needed to free the financial industry from firms that are poorly managed. Yet in those cases, shareholders and depositors alike may face losses.

Similarly conflicting concerns arise with respect to diversification. Diversification undoubtedly has a positive impact on competition; it also increases access to financial services by offering new products to businesses, governments, and individuals. But diversification may also give rise to conflict-of-interest situations and to self-deals. Furthermore, while a greater diversity of products may be supplied in one location through one-stop financial centres or financial supermarkets, this may not be the most appropriate delivery system to meet the requirements of all customers. Just like diversification, specialization may also have a positive impact on competition and on the availability of financial services where expert knowledge and close contact with customers are important elements in the business transaction. On the other hand, specialization may result in fewer products being made available to Canadian consumers. Thus there are positive and negative aspects to diversification, just as there are positive and negative aspects to specialization.

Similarly, as discussed in Chapters 4 and 5 and later on in this chapter, there are positive and negative aspects to closely held ownership; and different issues may also arise with respect to deposit insurance, depending on the perspective taken - market discipline, confidence, or consumer protection.

In undertaking to reform financial regulation, one must be very conscious of the need to reconcile the sometimes-conflicting objectives of competitive flexibility, institutional solvency, and consumer access and protection. The difficulties involved are one reason for the multiplicity of models for financial regulation.

Alternative Models for Financial Regulation*

Indeed, at one time or another, various comprehensive models for regulating a financial system have been put in place or have been proposed. These models can be differentiated by four characteristics: the type of regulation (regulation by function vs. regulation by institution, or separate regulatory authorities covering each type of institution vs. a super-regulatory structure); the approach to the ownership of financial institutions (separate ownership vs. cross-ownership); the extent of the involvement of institutions in different functions; and the relationship between the capital base that an institution is required to maintain and the function it is authorized to perform (Figure 7-1).

The *original pillar* system was based on separate regulation and separate ownership of broad categories of financial institutions. It was basically a regulation-by-institution approach. Because the activities of most institutions in the early 1950s were restricted to a primary function, regulation by institution also amounted *de facto* to regulation by function. That this outcome was more by accident than by design was evident from the subsequent extension of powers granted to various categories of institutions, which often allowed them to engage in activities outside their original function. For example, the move of trust companies into the short-term deposit market in the late 1960s enabled them to become more involved in banking.

An often-proposed alternative is to provide a *limited extension of powers* for various groups of institutions, with or without maintaining a separate regulatory structure. Ontario's Dupré Report, for example, favoured enhancement of the investment powers of various groups of institutions but suggested that cross-pillar diversification be realized only through a financial holding group. The Blenkarn Report and the Senate Committee Report recommended an expansion of investment powers of financial institutions by any means - in-house, or through subsidiaries or upstream and downstream holding companies. The House Committee would also change the regulatory structure, however, while the Senate Committee would maintain the existing framework of a single regulator governing each type of institution. The framework recommended by the Senate Committee Report remains, in its concept, close to the current pillar system, providing as it does for a separate regulatory authority for each broad category of institution, and also for separate ownership. Some cross-ownership would be allowed, however, either through subsidiaries or through holding companies.

One problem with the extension-of-powers approach is that it only takes into consideration the current needs and wishes of financial institutions. For example, extending commercial-lending powers to a maximum of 20 per cent of assets for trust and life insurance companies, as suggested in the Senate Committee Report, may be quite satisfactory today but quite constraining a few years from now. Nor does such a model address the issue of the jurisdictional overlap or inconsistencies, or the lack of harmonization between the various regulatory authorities. In fact, the enlargement of institutional powers and of the range of permissible activities is likely to proceed at a different pace under different jurisdictions. Moreover, different regulators may have different views of what is prudent for an institution to do, which could result in increased differences between institutions. In these circumstances, it might become more difficult to achieve a level playing field, and the regulatory balkanization of the financial system could increase. The scope for diversification would appear to be limited, and the standards established to ensure solvency and the absence of various abuses would vary, as they do today, between different jurisdictions. Furthermore, regulators might lack the expertise required to supervise activities that fall outside the function for which they were originally responsible. In this context, the Senate Committee Report notes that the trust-company regulators should have little difficulty supervising commercial-lending or deposit-taking activities,

*The remainder of this chapter is substantially identical to the statement published by the Council in November 1986 under the title: *Competition and Solvency: A Framework for Financial Regulation*.

Figure 7-1

Models of Organization of the Financial System

	Original pillar system	Current pillar system	Limited extension of powers with or without subsidiaries	Consolidation of regulatory structures	Universal powers	Multifunction institutions	One function – one institution
Approach to regulation	One regulator for each category of institution: regulation by institution	One regulator for each category of institution: regulation by institution	One regulator for each category of institution: regulation by institution	One super-regulatory body: regulation by institution	One regulator for each category of institution: regulation by institution	Separate regulator for each main function: regulation by function	Separate regulator for each main function: regulation by function
Ownership structure	Distinct, by institution	Distinct, by institution	Distinct, by institution; some cross-ownership through subsidiaries or holding company	Distinct, by institution; some cross-ownership through subsidiaries or holding company	One ownership for all functions	One ownership for all functions	Cross-ownership through holding company
Institutional involvement in different functions	Restricted to main function	Generally limited to original main function	Cross-function inroads, as allowed by law	Generally limited to original main function	Unlimited	Unlimited	Restricted to one function
Capital base	One capital base for each institution; one base supporting one main function	One capital base for each institution; same base possibly supporting several functions; possibility of pyramiding	One capital base for each institution; same base possibly supporting several functions; pyramiding controlled	One capital base for each institution; same base possibly supporting several functions; pyramiding controlled	One capital base	Separate capital base for each function through bookkeeping exercise	One capital base for each institution; no pyramiding
Models	Canada in the 1950s and 1960s	Status quo	Senate Report	To different degrees: Green Paper and Blenkarn Report	West German and French models	ECC 1976 Report	ECC 1986 Report

in which such institutions have been involved for many years. But it stresses that the Inspector General of Banks has no experience in supervising trust activities, which should militate against giving banks trustee powers. Allowing groups of institutions to diversify according to the perceived expertise of their regulator would take the system further away from a level playing field. Finally, there is the further problem that the same capital base would be supporting different activities and different functions.

In contrast to such an approach, the achievement of diversification through the establishment of subsidiaries, each being involved in separate functions – another alternative put forward by the Senate Committee and Blenkarn Reports – would help to maintain a separate capital base and a separate regulatory authority. It would not, however, insulate the parent company from the financial difficulties experienced by its subsidiaries, thus creating problems in ensuring confidence in the continuing soundness of financial institutions. Diversification through a holding group – an alternative considered in most reports – would provide better insulation. The complete ban on all non-arm's-length transactions that would be imposed by the Green Paper would, however, negate most of the benefits to be gained from diversification.

To deal with the current harmonization problems within a regulation-by-institution approach, the *consolidation of various regulatory authorities* has been proposed. The Green Paper would combine various federal regulatory authorities and would bring some financial holding companies under federal jurisdiction. The Blenkarn Report recommended the establishment of a super-regulatory agency that would bring together federal and provincial authorities, as well as industry representatives. The super-regulatory agency would also assume the management of deposit insurance and of other compensation funds. While the harmonization problem would be addressed, the scope for diversification and for a level playing field would appear likely to remain uneven in view of the fact that regulation by institution would give different powers to, and confer different obligations on, different groups of financial institutions.

A second alternative would be to provide for full diversification, which would result in the creation of *financial institutions with universal powers*; this is in line with the so-called West German or French models. This approach could lead, in the longer run, to increased concentration and reduced competition and accessibility, as institutions would compete for the total business of an individual rather than for some specific portion of it. (In West Germany, for example, banks with "universal powers" have been a factor in the slower development of equity markets.) Furthermore, the regulator responsible for an institution would have to regulate all of its activities. As a result, there would likely be uneven regulation of the same function among different kinds of institutions falling under different legislations, particularly since different regulators would have their own views as to how regulation should be applied. Some functions could be badly supervised in some institutions because of a lack of expertise on the part of the regulators. Abuses of conflict-of-interest situations would be more difficult to control, as they could be more easily hidden within the larger institutions. Nor would this approach provide adequate scope for a level playing field or for ensuring solvency.

Henry Kaufman, a noted Wall Street analyst, recognized these difficulties in a 1985 article in *The New York Times*:

> At the extreme, there will be institutions that would be lenders, equity investors and underwriters. It is very difficult to manage successfully the simultaneous performance of these functions. There are bound to be compromises within an institution that will deal inequitably with the creditor or equity position. . . . The financial system would look more like a zoo with the bars let down, with all of the attendant adverse consequences. In financial life, as in personal life, each of us cannot perform all roles best. The responsibility of each is different, and so it is with the trust and responsibilities embodied in a credit relationship.

Another difficulty is that the same capital base would be supporting different functions, thus increasing the risk of insolvency of the institution.

A third, broad alternative is the implementation of regulation by function in the context of a well-diversified institution performing different functions – *the multifunction institution*. This model is, to some extent, similar to what the Council recommended in its 1976 report on deposit-taking institutions. As each function would be regulated by its own expert authority, such a model would contribute to a level playing field. Although a separate capital base could be established by a bookkeeping exercise, however, we have come to the conclusion that this approach would not be fully satisfactory from the point of view of solvency and consumer confidence. If one function of a conglomerate faced financial problems, customers might have a legal recourse against the rest of the conglomerate. And even in the event of only limited recourse, there might remain a problem with confidence if one operating division were in difficulty. It would also be more difficult for the regulators to monitor bookkeeping entries within a large conglomerate, particularly as far as internal movements of funds are concerned. Furthermore, the supervision of the diversified institution would become a true nightmare, with continuous requests from different authorities, a great deal of overlapping, and no one having ultimate responsibility for the solvency of the institution.

Quebec's Bill C-75, which opened up various financial activities to the insurance industry, recognized the difficulties involved in regulating different functions within a single institutional framework. In his appearance as a witness at the hearings of the House of Commons Standing Committee on Finance, Trade and Economic Affairs, Jacques Parizeau, a former Quebec Finance Minister and author of the Bill, testified that

> there is a provision in Bill C-75 that has not been noticed all that much (Section 33.3). It implies that as an insurance company diversifies its operations the Minister can require that whenever operations other than insurance represent more than 2 per cent of total revenue of that insurance company a subsidiary must be set up. In other words, the main thrust here is that for purposes of inspection we should not allow operations to diversify without subsidiaries being set up.

Another difficulty that was brought up at the committee hearings – and the reason for keeping major functions separate in distinct institutions – is the different accounting practices that make it almost impossible to provide consolidated statements.

In short, while the "extension of powers, with or without a consolidation of regulatory structure," the "institutions with universal powers," and the "multifunction institutions" models for the organization of the financial system would increase, to different degrees, the scope for a level playing field, for confidence, and for access, they would also have shortcomings - some of them more serious than others.

After due consideration of the alternatives, the Economic Council has opted for a major overhaul of the regulatory system, but within a different organizational structure than any of those outlined above. The Council believes the weaknesses of the present regulatory system are so severe that fundamental reform has become imperative.

A New Framework for the 1990s: One Function - One Institution

In order to maintain world-class financial institutions in Canada and to serve all Canadians well - be they individuals or businesses, be they of considerable worth or of more limited means, and independently of their location - there is a need to strike the best balance, through regulatory reform, between enhanced competitive flexibility, strengthened institutional solvency and public confidence, and adequate consumer protection and accessibility. In doing so, the cost of regulation should be minimized - that is, its cost in terms of administration and also in terms of disruption of, and interference with, the normal course of business of financial institutions. Furthermore, there is a need to be forward-looking and to encourage flexibility, so that the fast pace of change will not render the revised regulatory framework antiquated in a few years' time. Historically, the managers and directors of financial institutions and government regulators have shared the responsibility for supervising the conduct of financial business. The new framework should continue to be based on a system of checks and balances between the managers of financial institutions and the regulators. This will call for improvement both in direct government regulation and corporate governance.

In line with these principles and given the importance of guaranteeing a level playing field, we first reaffirm the position taken 10 years ago in the Council's report on deposit-taking institutions:

1 **We recommend that governments adopt a regulation-by-function approach to the reform of the Canadian financial system.**

But we also opt for a specific form of regulation by function (a departure from the 1976 report) that would go a long way towards achieving a balance between regulating for competition and regulating for solvency:

2 **We recommend that each financial institution be limited to the performance of a single major function, falling under a single regulatory authority, such as banking, securities underwriting and trading, life insurance, and property and casualty insurance.**

Under this "one-function/one-institution" approach, each institution performing a single major function would fall under its own separate regulatory authority. That authority would regulate the various aspects of the function and would at the same time regulate for the solvency of the institution. A function is in large part defined in terms of the liabilities of the financial institution. (A more precise definition can be found in the glossary.) The functions would be specified in various governing legislations. The operations of an institution would be limited to activities associated with a single function - a rule that would oblige a few institutions to spin off some activities to related institutions. Diversification across functions would be allowed through cross-ownership, as indicated in Recommendation 5 below. Although the recent internationalization of financial markets and the development of technology have facilitated the prudent mixing of various assets and liabilities, the performance of major functions still calls for different techniques and involves separate markets. For instance, the insurance industry deals, on its liability side, with different risks and uses different techniques than other financial sectors. A distinction could even be made between life and casualty insurance, as they each deal with different categories of risks. The securities-underwriting-and-trading function uses specific techniques and involves distinct markets, as do deposit taking and the maintenance of a payments system. Banking, securities underwriting and trading, and casualty and life insurance are securities underwriting and trading, and casualty and life insurance are undoubtedly major functions that warrant a separate regulatory authority. We recognize that estate, trust, and agency (ETA) business could be viewed as an "activity," falling under Recommendation 4 below, or as a function. If viewed as the former, the regulator would have to determine if this activity could be "prudently" mixed with banking, securities dealing, or any other function. Because of the potentially serious situations of conflict of interest that could arise in such mixing, ETA business would most likely end up on its own, as a separate function. Of course, the above-mentioned list is not meant to be exhaustive, and other candidates for "functions" may be considered.

A one-function/one-institution approach requires that the major functions be well defined. This is already the case for life and casualty insurance, and for securities underwriting and trading, which currently operate under distinct regulatory authorities. But one of the enduring shortcomings of the Canadian regulatory framework has been its inability to provide a definition of a bank and of banking business.

3 We recommend that any institution involved in the provision of a means of payment be considered a bank and be considered as operating under the *Bank Act*, with the understanding that the Act will be amended to recognize the special characteristics of the credit unions and caisses populaires.

This is a forward-looking definition of banking, flexible enough to remain relevant for years to come. Indeed, it is based on the broad concept of "means of payment" - that is, any instrument widely accepted in payment for goods and services and for discharge of debt. Any institution that accepts deposits redeemable on demand or transferable by cheque - the main means of payment today - would be considered a bank. In the future, should the securitization process continue and should units in securities pools become a means of payment, institutions that provide such units would then fall under the *Bank Act*. The provision of a means of payment has to be distinguished from the extension of credit to facilitate the purchase of goods and services. Credit cards fall in the latter category. Point-of-sale terminals are a means of transferring deposits, and the rules governing such transfers should be established by the banking system. This is the position of the Canadian Payments Association, as spelled out in a recent statement.

This recommendation would cause all deposit-taking institutions, such as credit unions and loan and trust companies, to be subjected, in one form or another, to the *Bank Act*. (This has been recommended by the 1964 Report of the Royal Commission on Banking and Finance - the Porter Report - although it did not provide a definition of banking.) Investment dealers would have to reconsider the nature of cash-management accounts, and life insurance companies might have to review the structure of their short-term deferred annuities. This is different from the approach adopted in the Green Paper and in the House and Senate Committee Reports, which would allow for the banking function to be performed by nonbank institutions. That institutions not currently operating under the *Bank Act* have been able to participate in the provision of the means of payment has been the result of historical developments, at both the federal and provincial levels, and has constituted a departure from the original constitutional agreement. As documented in Chapter 2, several court decisions have confirmed, over the years, that banking falls under federal jurisdiction, and they have also, at times, interpreted banking as providing the means of payment. As discussed in greater detail later on, this approach does not necessarily lead to greater centralization of the regulatory apparatus.

Special consideration would have to be given to financial cooperatives, particularly to preserve their local character, which has been instrumental in providing accessibility to financial services in many regions. One possible approach would be to create, under the *Bank Act*, a specific category called "cooperative banks." Such a category already exists in some countries (West Germany, for example). Arrangements could be such that the centrals would fall under the banking regulatory authority, while the locals would retain their autonomy. Reserves would be managed, and leverage monitored, at the provincial level through the central organizations, although reserves would be calculated on the basis of deposits in all locals. (Details should be worked out as to whether reserves should be held by the locals or the centrals.) Already, membership of financial cooperatives in the Canadian Payments Association is mainly realized through the centrals.

The next step is to define the activities that are permissible for each major function.

4 We recommend that the range of permissible activities and investment powers of financial institutions be determined by what is considered prudent for each function.

This is a question of matching assets and liabilities, and techniques of operation, with specific functions. For instance, commercial lending may not be an appropriate activity for securities firms, given the different techniques involved and the potential for conflict of interest. With the development of technology and with financial innovation, the concept of what constitute prudent activities for one function may well change over time. The responsibility of determining what is or is not prudent for a one-function institution should be shared between management and the regulator responsible for the function performed by the institution. In participating in this decision-making process, the regulator should remain on top of a continuously changing financial world and should show appropriate flexibility in adapting to new situations. Furthermore, a clear distinction should be maintained between the concept of "activity" and the concept of "function." In particular, the determination of what constitutes a "prudent activity" should not be the occasion to mix different functions within one institution.

In a one-function/one-institution environment, cross-function diversification could be effected through cross-ownership of financial institutions.

5 We recommend that diversification into any function be allowed only through a financial holding group that would bring together distinct corporate entities performing different major functions. Institutions that are members of a holding group should be allowed, within limits set by the relevant regulator, to sell assets and to lend funds to one another without any prior regulatory

approval, except when one member has been identified as facing financial difficulty. Institutions with activities that remain within a major function should not be required to join financial holding groups.

Full diversification would be permitted, as any institution would be able to belong to a holding group. The movement of funds between the members of a holding group would be crucial in that it would be a key to the process of diversification and would enable institutions to take advantage of profit opportunities in different areas that such a process would entail. On the other hand, the one-function/one-institution framework would be aimed at keeping a clear separation between major functions so as to simplify the supervisory process and to minimize potential abuses. Such a separation would make it easier for the regulator to identify and follow transfers of funds. But to strengthen control over possible abuses, a limit should be placed upon such movements. While the easiest route would be to impose a limit on the total amount of funds outstanding that an institution can have invested in, or loaned to, other members of the holding group, it should be recognized that different ways of moving funds have different impacts. For instance, the sale of assets between two member institutions of a holding group should be distinguished from a loan. The latter would involve the creation of a cross-liability within the group, whose true market value might be more difficult to assess than that of an external asset. Different limits could thus be imposed, depending on the avenue used to reallocate funds within a holding group. In any event, guarantees given by one institution to another member of a holding group should be prohibited. These are off-balance-sheet items, whose monitoring by the supervisory authority often turns out to be problematic. Furthermore, the value of the contingent liability involved in such guarantees is difficult to assess.

Member institutions of a holding group would not be allowed to invest in the equity of other members. Equity injections would only come from the holding company itself (the major shareholder in the institution) or from minority shareholders. This would strengthen the one-function/one-institution framework and help to prevent the pyramiding of the capital base.

Funds could thus be reallocated within a holding group through some limited cross-lending and cross-selling of assets and through the movements of dividends and equity investments between the holding company and its subsidiaries. While one of the strengths of a holding group is its ability to come to the aid of a member in financial difficulty, one has to ensure that such action does not endanger the safety of other members or that funds are not unduly moved out of the troubled institution. Prior approval to move funds within a holding group would automatically be needed when the relevant regulator has established, on the basis of objective solvency tests, that a member institution is facing serious financial difficulty and has placed it on a special "watch list" and informed other regulators. This assumes, of course, that monitoring for solvency has been strengthened and that an effective early-warning system has been put in place. It also assumes that the regulatory authority would become aware of the existence of serious financial difficulties that could endanger the continued solvency of the firm at an early stage and that the regulator's decision on the request to transfer funds would be given promptly. We appreciate that this would require a large degree of collaboration between regulators, auditors, and management. Furthermore, because such an approach might appear to increase the regulatory burden on the institutions involved, an alternative to securing prior approval would be a full disclosure of non-arm's-length transactions. In particular, the need to secure prior approval could be seen as involvement of the regulatory authority in management decisions. A problem with disclosure, however, is that in order for it to be effective, regulators should be given the power to reverse the transactions that they deem to be harmful. But even if regulators had the power to make and enforce such requests, this type of action could be quite disruptive to the institution involved. Thus disclosure may not be an appropriate alternative to prior approval for all types of institutions. The holding company should preferably be inactive, and the holding group would not require any special form of regulation. The holding group should, however, be monitored for its overall solvency.

6 We recommend that regulatory authorities take special measures to monitor the financial health of financial holding groups.

To this effect, the holding company would be required to supply, on behalf of the group, global financial statements to the regulator of each member of the group. Quarterly audited statements, although preferable, might be quite costly. Financial holding groups would, under this approach, provide quarterly financial statements, but only the annual ones would be audited. Accounting methods differ between different categories of institutions, thus making it impossible in certain cases to provide true consolidated statements. Until harmonization in accounting practices is achieved, holding groups should submit statements that reflect, as closely as possible, the global position of the group.

While a one-function/one-institution structure would be maintained at the "production" level of financial services, retail outlets or points of sale must be able to offer a variety of financial services originating from different institutions. This would ensure access to a variety of financial services in many areas of the country that are served by only one or a few financial institutions. Consequently,

7 **We recommend that all forms of networking, cross-selling, and cross-referral within the financial system be allowed. Tied selling should, however, be prohibited.**

The Benefits of the Proposed Changes

The implementation of the above seven recommendations would undoubtedly necessitate important changes in the organization of the Canadian financial system at both the production and the delivery level. A one-function/one-institution environment would be quite different from the existing pillar system, because a specific function would become the primary target of regulation. It would keep a separate regulatory authority for separate categories of institutions - a feature of the existing pillar system. But it would depart from the current separate-ownership approach, as cross-ownership would be allowed through the establishment of holding groups - a route necessitated by the need to maintain a separate regulatory structure for each category of institution. (It is important to note that the one-function/one-institution approach only deals with the production level of financial services; any retail outlet would be able to distribute any product offered by any category of institution.)

The primary advantage of this new configuration of the financial system is its simplicity. Regulators would only have to worry about one function. As they would only monitor activities in which they have expertise, they would be in a position to do a better job. In addition, there would be only one regulator per function. This would be an advantage over the extension-of-powers and super-regulatory approaches. Agents performing the same function would fall under the same regulation and would benefit from a level playing field; a separate capital base would support each major function - again, an improvement over the extension-of-powers and institutions-with-universal-powers approaches. Furthermore, by prohibiting the pyramiding of capital and lateral interdirectorships, whereby the same directors are on the boards of two or more members of a holding group, the separation between major functions would be strengthened. (The prohibition of such interdirectorships would open the door for outside directors - individuals not associated as officers or directors, nor affiliated with major shareholders of the family of companies - who would be able to sit on special committees of the board, as required by Recommendations 14 and 15 below. But this would not preclude the holding company from having representatives on the board of its subsidiaries.) In the one-function/one-institution model, the concerns with the promotion of competition and the maintenance of solvency and confidence would thus be simultaneously addressed. Accessibility would be enhanced by allowing retail outlets to distribute any financial product.

Second, this new configuration would offer individual financial institutions great flexibility in meeting the various financial requirements of their clients. Diversification into any area would be open to any institution through the holding-company route. Banks would be allowed to participate in such organizations, as would credit unions, life and general insurance companies, investment dealers, and others. This holding-company approach is, to some extent, similar to the framework that emerges from the Green Paper and the Dupré Report. Diversification loses its attractiveness, however, if funds cannot be reallocated within an organization in order to benefit from the best opportunities. In contrast with the position taken in the Green Paper, our framework would provide for flexibility in moving funds, within certain limits, between members of a financial holding group, except when an affiliate is facing financial difficulty, at which time approval by the regulatory authority must be sought. That certain transactions should be prevented from occurring in the presence of financial difficulties does not justify stifling the operations of a healthy holding group by imposing a complete ban on non-arm's-length transactions. Other measures discussed later on are aimed at preventing the abuses of conflicts of interest and self-deals that may arise in the context of movements of funds between the affiliates of a holding group.

Furthermore, our approach provides for a great deal of flexibility in the way a holding company operates. Diversification might only take place at the production level, with various products distributed by distinct sales networks; for example, life insurance salesmen might only sell life insurance policies, while mutual funds might be distributed by financial planners. On the other hand, distribution might take the form of a "financial supermarket," or one-stop financial centre.

One-stop shopping would not necessarily be tied to a holding-group structure, as any institution would be able to enter networking agreements. Firms that wanted to remain specialized could do so, as the requirement to operate under a financial-holding umbrella would only apply to an institution that wished to perform more than one of the defined major functions.

This approach also recognizes the special characteristics of certain groups of institutions and provides for their integration into the global framework, while preserving their respective identities. Particularly, the framework recognizes the important role played by financial cooperatives in providing access to financial services from coast to coast.

The framework is also forward-looking in the sense that it does not cast in stone the existing organization of the financial system. The definition of major functions could be changed over time, if warranted. We have also pointed out that the notion of "prudent activity" is in constant evolution - a fact that should be recognized by the regulatory authority. Our proposed definition of banking has to do with the nature of the means of payment and not with deposit-taking activities per se or the conjunction of deposit-taking activities and lending activities.

These are benefits that we believe to be substantial. They outweigh the costs of changing the existing regulatory framework and the organization and practices of institutions.

Costs

The implementation of the proposed package would require some changes in the current regulatory structure, particularly with respect to the sharing of responsibilities between the federal and provincial governments. Historically, the involvement of both levels of government has provided a system of checks and balances between matters of national interest and concerns of a regional nature. The problems with the existing regulatory framework do not rest on the fact that both levels of government have jurisdiction over financial activities but, rather, on a lack of clarity in the sharing of responsibilities and a lack of harmonization between various authorities. We firmly believe that the maintenance of a payments system and the safety of deposits are matters of national interest and that the regulation of the deposit-taking function should fall under federal jurisdiction. This would apply to the deposit-taking activities of trust companies, financial cooperatives, and mortgage-loan companies.

It is less clear at what level other possible functions, such as life and general insurance or securities trading and dealing, to name but a few, should be regulated. The fact that financial markets are national (or even international) in scope does not necessarily require that they be centrally supervised at the federal level. It does call, however, for intergovernmental cooperation and for some degree of uniformity among provinces. Furthermore, in bringing under federal supervision the provision of the means of payment, the special interest of provinces in specific areas should be recognized. In particular, provincial governments have historically been involved in the regulation of financial cooperatives. A happy medium should be found between the need to regulate the deposit-taking function at the national level, as a means of enforcing strict and uniform standards, and the more local nature of financial cooperatives. Our framework recognizes the special nature of financial cooperatives within the *Bank Act* and submits to this Act only the central organizations.

The maintenance of a payments system as a matter of national interest has been recognized by both the federal and provincial governments. The establishment in 1980 of the Canadian Payments Association under federal direction is an implicit recognition of federal jurisdiction in this matter. The CPA includes not only banks but also trust companies and financial cooperatives, many of which are provincially regulated.

While there are legal grounds for federal supervision of all banking activities, we recognize that the problems involved are more of a political nature. If it is to come about, the proposed realignment of regulatory responsibilities between the federal and provincial governments will need to be achieved through consultation and agreement. It must be the outcome of negotiations from which all parties involved would hope to benefit. Our approach does, therefore, require greater cooperation. In contrast with the proposals for federal supervision of holding companies or for the establishment of a super-regulatory agency, our recommendations do not involve greater centralization of the regulatory apparatus to any significant degree. For example, local credit unions and caisses populaires would remain under provincial jurisdiction (some cooperative centrals already abide by many federal rules), and federally regulated trust companies already account for about two-thirds of all trust companies' assets in Canada.

The federal government might choose to delegate to a provincial government responsibility for the supervision of the banking institutions that operate only within the confines of that province. For instance, under such an arrangement, the government of Alberta could have responsibility over the Alberta Treasury Branches. This course of action - delegating federal regulatory powers to a province, for application and enforcement within that province - is akin to similar arrangements already adopted in other fields, such as transportation.

The reorganization needed within the institutions themselves appears much less formidable. For all practical purposes, major functions are already performed by distinct corporate entities. Some activities or services offered, such as brokers' cash-management accounts and life insurers' short-term deferred annuities, might have to be modified. The loss of such activities would be compensated by the diversification into banking activities that these companies could achieve by associating themselves with a bank through a holding company.

In their criticism of the Green Paper, the Blenkarn Report and the Senate Committee Report note that there are costs involved in setting up holding companies. But these costs have not prevented the mushrooming of financial holding companies over the last few years. The costs that the Green Paper proposals would entail are to be found, instead, in the ban on any internal movement of funds.

Financial cooperatives and trust companies would be affected the most by the proposed changes. The obligation to hold non-interest-bearing reserves against deposits would impose some costs on these institutions. On the basis of 1984 figures and given the kind of deposits held by trust companies and local credit unions, it has been estimated that the net loss on the extra reserves required would be approximately $15 million for the trust companies and $14 million for the local credit unions, or about 5 per cent of their after-tax income. These figures take into account the fact that these institutions, particularly the caisses populaires and credit unions, already hold reserves, some of which are in the form of non-interest-bearing cash. Trust companies and credit unions could ease the cost of holding reserves by encouraging their depositors to shift funds from demand to notice accounts, thus lowering their reserve requirements. It should be noted that the imposition of reserve requirements would provide for a more level playing field for all deposit-taking institutions. And, as banks, these institutions would all gain access to the Bank of Canada as a lender of last resort. Furthermore, the cost of holding reserves could be significantly lessened if the Bank of Canada were to pay interest on them, as recommended in the Senate Committee Report. While this proposal may have merit, the Council has not investigated all aspects of this issue – including the impact on monetary policy – and therefore takes no position on this matter at this time.

In contrast, bringing the banking activities of financial cooperatives and trust companies under the *Bank Act* would not increase their tax burden. Currently, there are no significant differences in the taxation of trust companies and banks. Credit unions, which would come under the special cooperative-bank category, would be able to retain their current taxation status as long as locals remained small.

Finally, we have considered the cost of breaking up each existing trust company into two separate corporate entities, should the ETA business be deemed a separate function. The cost does not appear to be high, particularly since the breaking-up would only be required at the production level but not at the distribution level. Indeed, trust companies could continue to deliver, through their branch system, both banking and trust services. Most of their capital base would be assigned to the banking entity, as very little capital is needed to manage funds. The spawning of subsidiaries is nothing new in the financial industry. Because mortgage-loan companies are not subjected to reserve requirements, mortgage business has been shifted, particularly in recent years, from the banks to their mortgage subsidiaries. This transfer has taken place without pain and has not presented any significant problem at the delivery level. Mortgages are still handled by banks at the branch level, but they are registered in the books of the mortgage-loan subsidiary. The banks and their mortgage-loan subsidiaries conduct their business as separate corporate entities and fall under different regulatory authorities. While the establishment of subsidiaries is a common occurrence, the reorganization process should be such as not to affect unduly the value of the outstanding shares of a company. This should be a particular concern in the restructuring of existing trust companies.

Implementation

Because of the magnitude of the changes involved, institutions and regulators should be given time to adapt.

8 We recommend that the process of reorganizing the financial system allow sufficient time for institutions and regulators to adapt and that a set of target dates be established.

For example, institutions should be given enough time to modify some of their practices, to change their bookkeeping, to find partners when the need arises, and so on. Also, individual institutions should be given the opportunity to spread the cost of reorganization over several years. This should be the case particularly when institutions have set aside non-interest-bearing funds to meet the newly imposed reserve requirements or if they have to separate some of their activities, as could be the case with existing trust companies. Time should also be provided for institutions to acquire the expertise needed to enter new areas. A free-for-all stampede into new activities should be avoided; indeed, it could result in a number of failures if institutions were to enter new areas unprepared. Finally, there should also be concern over the need to protect, at least during an interim period, the smaller institutions. There is the possibility that the larger institutions might be able to dominate new areas of activity and, in the process, hinder the development of the already-established smaller firms. This appears to be a major concern in Great Britain, where the securities industry is being deregulated. There are predictions that the majority of securities firms will disappear in the process and that a significant proportion of the business will go to non-British firms. In Canada, while opening up the Ontario securities industry to nonindustry members, the provincial government has been careful to ensure that the process would be gradual, so as to protect from larger nonindustry institutions those investment houses which might be an easy prey because of a generally weak capital base.

Furthermore, a large number of Acts would have to be amended to allow for the implementation of the new framework: these include the federal *Bank Act*, the *Canadian and British Insurance Companies Act*, the *Foreign Insurance Companies Act*, the *Trust Companies Act*, and the *Loan Companies Act*, as well as provincial legislation and regulation covering life insurance companies, trust companies, credit unions, and securities firms, to name but a few. Time will be needed to proceed with such a busy legislative agenda. But there is urgency in getting the process of regulatory reform under way. Consequently,

9 We recommend that the federal and provincial governments amend all legislation of financial institutions as expeditiously as possible, with a view to implementing the one-function/one-institution approach.

Strengthening Regulatory Capacity

In the negotiations that would be undertaken between the federal and provincial governments to reorganize and streamline the regulatory process and to adapt it to the comprehensive organizational structure proposed in this report, the current division of power, with respect to the supervision of non-deposit-taking activities, would serve as a basis for the talks.

When all the dust has settled, an institution whose function falls under provincial responsibility might still have to deal with 10 different provincial authorities. In such an environment, cooperation and coordination among provinces, and significant consultation with the federal government, would be paramount. Provincial governments should formally cooperate in setting similar regulatory requirements for similar functions falling under their jurisdictional responsibility.

Harmonization does not mean that governments would lose their individuality or their capacity to innovate. But rather than introduce new legislation that would only take effect within a specific jurisdiction, changes would be proposed in an open forum, to be discussed and assessed by all governments.

10 We recommend that provincial governments put into place mechanisms to ensure interprovincial uniformity in the regulation of financial institutions and activities under provincial jurisdiction.

The approach recommended here would offer greater flexibility than some of the other proposals made recently, such as those favouring the federal supervision of holding groups or the creation of a super-regulatory agency. Indeed, there is no overwhelming reason for financial holding groups to be regulated at all – there is even less reason for them to be regulated at the federal level – and a super-regulatory agency could become unwieldy and too bureaucratic. The framework proposed here would keep separate regulators for separate major functions, each one supervising homogeneous institutions for which it would have developed the needed expertise. Harmonization would certainly require greater cooperation between authorities. But there is much to be gained. The costs of supervision and inspection could be lowered for governments and for institutions through improved coordination.

Beyond the lack of well-defined jurisdictional responsibility and the lack of harmonization dealt with in previous recommendations, another important shortcoming of the existing regulatory system has been the inadequacy of the powers held by regulators.

11 We recommend that the regulators of each type of financial institution be granted increased powers of surveillance and enforcement. We further recommend that any regulatory authority uncovering problems with a member company of a holding group alert the regulators of the other members of the group.

The Blenkarn, Dupré, and Senate Committee Reports have discussed at length the increased powers to be granted regulators. A summary of their recommendations – which we support – can be found in Appendix A. In this context, we wish to stress the need for increased powers to conduct detailed on-site inspections and for the authority to issue cease-and-desist orders, some of which are already included in recently tabled legislation.

Adequate regulation for solvency is of paramount importance. Many of the financial difficulties experienced by financial institutions in the 1980s have not been dealt with satisfactorily because of a breakdown in the regulatory process. The adequacy of a monitoring system to ensure solvency is crucial to our proposal for regulatory reform. In particular, regulatory authorities should be able to identify, at an early stage, institutions that are facing financial difficulties, particularly when they are members of a holding group. (In this sense, Recommendation 11 reinforces Recommendation 5.) Thus it is important that the federal and provincial governments take appropriate measures to put into place an adequate regulatory system for the solvency of financial institutions. Such a system should go beyond the simple analysis of financial statements. It should consider the composition of portfolios, the structure of liabilities, the risks assumed, and so on. More generally, it should be able to monitor institutions to ensure prudent behaviour. In particular,

12 We recommend that the development of an early-warning system with respect to the solvency of all financial institutions be encouraged so that preventive measures can be taken at an early stage.

This has been advocated by the Wyman, Senate Committee, and Dupré Reports. Such a system is currently in operation at the Office of the Inspector General of Banks and for some provincially regulated institutions. Such systems should be in place for all groups of institutions.

The supervisory authorities have the responsibility to keep abreast of developments in financial markets, so as to ensure that they do not threaten competition and solvency. When difficulties are looming on the horizon, authorities have a responsibility to intervene. The streamlining of jurisdictional responsibility, particularly under the one-function/one-institution approach – which would enable the regulatory authority to devote its full expert attention to the supervision of one function – the defining of "prudent activities" attached to specific functions, and greater harmonization and co-operation between authorities, along with their enlarged powers, would enable regulators to be much more effective in maintaining a competitive and solvent financial system in Canada. It goes without saying that regulators should be given the appropriate means, in terms of staff and budget, to achieve this objective.

The supervisory authority should only have the responsibility of enforcing the law, however, and it should not implicitly modify it by "looking the other way." Changing rules and regulations is a prerogative of the Parliament of Canada and of the provincial legislatures.

13 We recommend that all Acts and legislation governing financial institutions have sunset clauses and be subject to review at the same time.

This would, indeed, reduce the need for regulators to substitute themselves for the legislators. Furthermore, changes in an Act dealing with one group of institutions always have an impact on other groups. A simultaneous review of all Acts would make less likely a repetition of occurrences such as the one where revisions to the *Bank Act* granted banks the power to enter into the traditional areas of other institutions without considering amendments to the Acts governing those institutions (e.g., the entry of banks into the mortgage area). As the reforms proposed in this report involve the modification of all existing Acts, this could be the starting point for an orderly ongoing review process.

Prevention of Abuses; Ownership; and Consumer Protection

Conflicts of Interest and Self-Dealing

The cross-ownership structure implied by our proposed model could contribute to a larger number of conflict-of-interest situations and could lead to more abuses. Increased diversification can, indeed, lead to potential conflicts of interest and to self-deals, particularly when several functions are brought under one ownership (see Chapter 5).

Abuses of conflict of interest, self-dealing, and fraud are a source of concern in all the other reports that we have surveyed. The Green Paper would prohibit all non-arm's-length transactions so as to minimize the risk of abuses. It also recommends the establishment of "Chinese Walls" and the creation of a Financial Conflict of Interest Office. The Blenkarn Report would provide the freedom to engage in non-arm's-length transactions, except those likely to have a significant impact on the institution's solvency. The Dupré Task Force would generally prohibit non-arm's-length transactions, with the exception of those whose true market value can be objectively ascertained by independent means. The Senate Committee Report recommends the implementation of a three-pronged procedure to control and review non-arm's-length transactions.

Earlier, we urged (Recommendation 5) that when one member of a holding group is identified by the regulator as experiencing financial difficulty, prior regulatory approval be necessary for moving funds between members of the group. But apart from this special case, we recognize that other constraints on the reallocation of funds within a conglomerate or a holding group, intended to reduce abuses, would jeopardize the very benefits of diversification and conglomeration. At issue here is the difficult question of what is a transaction that enhances the efficiency of the production and delivery system of financial services and what is a harmful transaction. Indeed, as noted in Chapter 5, a distinction has to be made between non-arm's-length transactions and self-deals. Thus, we do not endorse the Green Paper's complete ban on non-arm's-length transactions; however, some selective ban, as suggested in one form or another in the Senate, Dupré, and Blenkarn Reports, appears warranted. In particular,

14 We recommend that no financing be made available by any financial institution to any director or manager of the company. When the institution is closely held, no financing should be made available to any shareholder that owns more than 10 per cent of outstanding voting shares. We further recommend that any financing made available to any company with which directors, shareholders, or managers are associated be reviewed by a special committee of the board of directors.

Some legislation already contains provisions of this sort. The *Bank Act* generally prohibits loans to employees and directors unless they are secured by a mortgage or, if unsecured, have a term of less than a year or are below a specified amount. The federal legislation governing trust and loan companies, the *Canadian and British Insurance Companies Act*, and the *Investment Companies Act* contain an outright ban. The *Foreign Insurance Companies Act* contains no prohibition. As for the caisses-populaires legislation in Quebec, loans to officers and employees must not be made at preferential rates. In the credit-union legislation of Ontario, Saskatchewan, Alberta, and British Columbia, special approval from the institution's board of directors is usually required. Under the Ontario *Loan and Trust Corporations Act* revisions, loans to officers and directors are permitted, provided that they receive prior approval from the board of directors and that they are a normal part of business. Our recommendation would provide for uniformity across institutions. Institutions should ensure that the special committees of the board referred to in our recommendation are effective. More generally, their examination should extend to significant non-arm's-length transactions.

15 We recommend that each financial institution be required to establish a committee of the board of directors to examine non-arm's-length transactions.

The committee, composed of members, a majority of which, if not all, would be outsiders to the firm or the holding group - even when the institution or group is closely held - should have the authority to prohibit a transaction, or to reverse one already made, if it deemed it not to be in the interests of minority shareholders, depositors, or other customers.

A control on certain transactions is not the only form of protection against abuses. The availability and dissemination of information is another form of protection.

16 We recommend that financial institutions disclose to their customers the major conflict-of-interest situations in which they find themselves and that the relevant supervisory authorities monitor such disclosure.

Any institution should be required to disclose its ownership links with other financial institutions. When an institution is associated with a securities dealer, it should be required to release the names of companies for which that dealer acts as an underwriter. It should also be required to release the names of mutual funds originating with associated companies. Ultimately, the determination of the matters to be disclosed would rest with the relevant regulatory authority.

The Mixing of Financial and Nonfinancial Activities

Financial and nonfinancial activities have been historically kept separate by regulation in order to avoid abuses with regard to conflict of interest and self-dealing. The mixing of financial and nonfinancial activities can lead to abuses and financial difficulties, particularly in the context of the existence of minority shareholders. Such a mixing can strain the liquidity back-up provided by financial institutions when an associated nonfinancial corporation faces difficulty. Furthermore, the mixing of financial and nonfinancial activities can lead to the misallocation of resources as a result of the favourable treatment afforded the nonfinancial companies. Consequently,

17 We recommend that a financial holding group not include a nonfinancial corporation among its subsidiaries, except for ancillary-support companies.

The rationale in the current legislation for permitting financial institutions to own some nonfinancial subsidiaries is that the latter either provide services to the institutions themselves (e.g., computer services) or are closely related to the activities of the financial institutions (e.g., real estate brokerage). Some definition of ancillary services is provided in the federal *Trust Companies Act* [section 68(2)], *Loan Companies Act* [section 60(2)], and *Canadian and British Insurance Companies Act* [section 65(1)]. It should be ultimately left to the regulator to decide which ancillary activity is appropriate and which is not.

Recommendations 14 to 17 would reduce instances of conflict-of-interest abuses and self-dealing without restricting in any way the flow of information between various financial institutions and without placing undue constraint on the allocation of financial resources among affiliated companies. In particular, the one-institution/one-function structure would substitute for "Chinese Walls" in the separation of functions between which conflicts of interest might arise. Of course, neither would preclude the flow of information at the executive level. Trustees would have to disclose to their clients any ownership links with other institutions that could place them in a situation of conflict of interest. Furthermore, the duties of a trustee, as defined in trustee legislation, provide guidelines to resolve many conflicts.

Abuses of conflict-of-interest situations, self-deals, and fraud may affect minority shareholders, depositors, and other customers of financial institutions. Borrowers are affected when the management of an institution does not sufficiently uphold their interest. Recommendations 16 and 17 should deal with such instances. With respect to minority shareholders and to depositors, it is the former that bear the initial impact of a self-deal, through lower profitability and a decline in the value of the shares of the firm. Depositors basically remain unaffected until the firm fails. Recommendations 14, 15, 17, and 19 are aimed at protecting the minority shareholders; Recommendations 5, 14, 15, and 17 are directed also at the protection of depositors.

Ownership restrictions limiting the stake of individuals and companies in a financial institution are often viewed as a further, and sometimes better, safeguard against abuses, particularly when depositors are involved.

Domestic Ownership

As discussed in the Blenkarn Report, closely held ownership improves the performance of financial institutions, particularly smaller ones, through a hands-on management approach; but it also facilitates self-dealing. As shown in Chapter 5, however, the incentive to self-deal in a closely held institution depends on whether the owner is an individual or a firm and on the level of control over the institution. An individual owner may find it easier to abuse the trust of depositors if he or she does not share ownership with minority shareholders. On the other hand, incentives to abuse conflict-of-interest situations and to self-deal are somewhat less when one company owns 100 per cent of another. In this case, the benefit to the parent company from self-dealing with its subsidiary may be erased by the resulting decline in the profitability of that subsidiary. In the presence of minority shareholders in the subsidiary, the parent will reap the benefits of the transaction, whereas the decline in the subsidiary's profitability is shared by all shareholders - hence the need for the latter to control a sufficiently large proportion of shares to protect their interests.

Closely held ownership by a large company facilitates the raising of funds, particularly new equity. Closely held ownership by an individual may limit the financial resources available for growth. Some argue that a system with a majority shareholder and a large float of shares in the hands of the public would provide for closer involvement of the owners in the management of the firm but would also provide access to a larger pool of financial resources.

The various reports have taken different positions on the ownership issue. The Green Paper would allow institutions, independently of their size, to be closely held - with the exception of Schedule A banks. While favouring widespread ownership, the Blenkarn Report opts for a sliding scale based on asset size, in recognition of the benefits of a major shareholder for smaller institutions. Furthermore, nonfinancial institutions would be prohibited from owning more than 30 per cent of the voting stock of a financial company. The Dupré Task Force supports widespread ownership; and the Senate Committee, while not imposing direct domestic-ownership restrictions, recommends that where a financial institution has a controlling interest in another firm operating in a different pillar, either the parent company or its affiliate must have 35 per cent of their shares traded publicly.

While widespread ownership is the best insurance against abuses, the reorganization of the financial system implied by our previous recommendations would result in a number of institutions being closely held within a holding group. The next two recommendations are aimed at reconciling the concept of widespread ownership with the holding-group structure.

18 We recommend that no single individual or company, whether Canadian or foreign, own more than 10 per cent of the capital of an independent financial institution or holding group with over $10 billion in domestic assets. Closely held institutions or holding groups with over $10 billion in domestic assets as of 1 January 1987 would not have to undergo any change in ownership, but any subsequent increase in equity should be widely distributed, and the financing of future growth in assets should be subject to specific guidelines as to the mix between debt and equity.

The criterion that no shareholder should have an interest greater than 10 per cent is a well-accepted measure of widespread ownership and the one retained in the *Bank Act*. The proposal of a sliding scale relating the ownership structure to the size of the institution implies that abuses are related to size; they are not, in fact, although their impact might be.

The ownership test should be applied at the highest level. Banks, investment dealers, insurance and trust companies, and others could be closely held by a holding company, as long as the holding company meets the ownership criteria. (The regulators of the subsidiaries would be responsible for enforcing the ownership rule on the holding company.) The test should also apply to domestic assets only, provided that liabilities booked in Canada are not used to support foreign assets and that foreign operations do not endanger the solvency of the institution.

The $10-billion cutoff for closely held ownership of holding groups and independent financial institutions is aimed at recognizing that many firms are currently closely held and that there are advantages in such an ownership structure for smaller institutions, particularly those in their early stage of growth and development. Because closely held institutions with assets of more than $10 billion as of 1 January 1987 would have their ownership structure grandfathered, they would not be required to engage in a divestiture process that could be complicated and disruptive to financial markets, at least in the short run. Constraints on the funding of the expansion of the capital base have been imposed on grandfathered institutions so that future growth will be accompanied by a dispersion of ownership. (Leverage would be controlled by the relevant regulatory authorities.)

On the basis of 1985 data, the **grandfather clause** would apply to the following companies: in the trust industry, Canada Trust (Royal Trust is already a member of a holding group); among holding groups: Trilon, and possibly Power Financial. The other institutions with assets of more than $10 billion are already widely held. This is true of all chartered banks and of the Desjardins Group. Lowering the cutoff point to $5 billion would have required a much higher number of exceptions.

On the other hand, several institutions that currently fall under a widespread-ownership rule have assets below the $10-billion mark. These are the Bank of Alberta, the Western and Pacific Bank, and the Bank of British Columbia. These banks would not have to meet the 10-per-cent rule under our proposal; nor would banks that are members of a holding group. The ownership requirements of the *Bank Act* should be amended accordingly.

What should be done when a holding group or an independent institution reaches the $10-billion limit? One approach would require that any further expansion in capital be effected through widely distributed new equity issues; another would be to oblige the institution to become widely held. This could be done gradually, so that widespread ownership would be achieved by the time the assets reached a specified level – say, the $15- or $20-billion mark. The latter solution appears to be preferable if the objective of a widespread-ownership structure for the Canadian financial system is to be achieved.

19 We recommend that financial institutions linked together within a holding group be wholly owned by the holding company, unless at least 35 per cent of their voting shares are widely held by other investors.

As we have shown, 100-per-cent ownership of one firm by another reduces the benefits of various abuses and of self-dealing for the parent company. On the other hand, a sufficiently large number of shares in the hands of minority shareholders might provide a useful set of checks on the majority shareholder, particularly when mismanagement or abuses of various sorts could affect depositors who have entrusted their money to the financial institution. The 35 per cent figure in Recommendation 19 provides a protection for minority shareholders, similar to that offered by the *Canadian Business Companies Act* through the "special resolution" clause requiring a majority of not less than two-thirds of shareholders to implement certain modifications to the corporation's operations (see Chapter 5). It might also be advisable to guarantee to minority shareholders a representation on the board of directors. The alternative, in the absence of a publicly held float of 35 per cent of the voting shares, is for the institution to be wholly owned by the holding company.

This recommendation will require some changes in the internal organization of existing holding groups. For example, Crown Financial Group owns 92 per cent of Crown Life and 75 per cent of Coronet Trust; Power Financial owns 98 per cent of the Investors Group and 85 per cent of Great-West Life Corporation. Two avenues are open for members of a financial holding group that would not meet the criteria outlined in Recommendation 19. Additional issues of shares could bring the level of minority participation to 35 per cent, or an exchange of shares of the holding company for shares of the member in question could bring to 100 per cent the stake of the holding company. Swaps of shares do take place on the Canadian financial market, the latest involving Great-West Life and Great Westco.

The possibility of bypassing the ownership restrictions would still remain. Therefore,

20 We recommend that when an individual or a nonfinancial corporation has interests in more than one financial institution or financial holding group operating in Canada, with combined unconsolidated domestic assets of more than $10 billion, such interests in each shall not exceed 10 per cent.

This would prevent an excessive concentration of power in the financial sector. Particularly, an individual or company could not wholly own a number of institutions whose assets were less than $10 billion individually but well beyond that figure when combined. Furthermore,

21 We recommend that any purchase of more than 10 per cent of the capital stock of a financial institution be subject to prior approval from the relevant regulatory authority.

This recommendation reinforces the ownership restrictions and is aimed at preventing purchases or takeovers that would have an adverse effect on competition in the financial industry. Bill C-9 (formerly C-103), introduced in the wake of the takeover of Canada Trust by Genstar and of Genstar by Imasco, already contains such a clause. Our recommendation would extend the requirement of prior approval to all categories of institutions. An alternative would be the full disclosure of the names of all purchasers, with the relevant regulators being granted the power to reverse such transactions.

Foreign Ownership

The ownership rules recommended above should apply to both Canadian and foreign institutions. Given the openness of the Canadian economy and the growing internationalization of financial markets, we have to give further consideration to the role to be played by foreign institutions within our proposed new configuration.

The other reports have diverging views on the treatment of foreign institutions. The Green Paper would maintain the existing limits on foreign ownership. Currently, few constraints exist in the life insurance industry; foreign banks have to establish subsidiaries to be registered under Schedule B of the *Bank Act*, and limits on the growth of the assets of these subsidiaries are imposed; foreigners are restricted in their ownership of registered securities firms in Ontario, although they can operate freely in the so-called "exempt market"; few restrictions exist for securities firms operating in Quebec. The Blenkarn Committee recommended that foreign interests be treated in the same fashion as Canadian firms. The Senate Committee Report, while allowing free entry by foreigners, would establish control over the transfer of ownership to foreign interests.

Competition on domestic markets is enhanced by the entry of foreign financial institutions. Allowing foreign institutions to be active in Canadian financial markets also furthers the cause of our own institutions in countries that require **reciprocity**.

22 We recommend that foreign institutions be allowed to enter gradually all financial areas and that such entry be based on reciprocity by the country of origin.

This would enhance competition on domestic financial markets and the deployment of Canadian financial institutions around the world. Free entry - an important contributor to increased competition and accessibility of financial products - should, however, be associated with reciprocity conditions that allow for the development of Canadian institutions abroad. We recognize that this could involve a lengthy negotiation process, but the basis for reciprocity has to be well defined. For example, because of different jurisdictional structures between Canada and the United States, U.S. banks, by incorporating a subsidiary under the *Bank Act*, would gain access to Canada from coast to coast, while Canadian banks wishing to operate south of the border would have to abide by regulations that limit interstate branching and operations. For Canada, being restricted to New York State would indeed reflect a limited interpretation of reciprocity.

Institutional Practices and Management

Beyond the issues of ownership and abuses, our investigation has pointed to the existence of other areas of concern. For example, auditors are a key group of officials who have drawn criticism from some reports because of the ambiguity of their accountability and of a perception that they have failed to react adequately to situations of abuse or financial difficulty. We agree with many of the measures proposed in the reports of the Senate Committee, the Dupré Task Force, and the Blenkarn Committee. Without dwelling on details,

23 We recommend that the reporting accountability of the auditors - and actuaries, where applicable - of financial institutions be clarified so that they will be required to report to the relevant supervisory authorities any material wrongdoing they have uncovered or serious concerns they may have about the financial health of the institutions.

Auditors are required to report situations that would make a material difference to financial statements, as prepared and presented by management to shareholders. While it is an accounting concept, "materiality" is not well defined. Generally, the auditors' report indicates whether the institution's financial statement presents fairly its financial position and the results of its operations for the year, in accordance with prescribed accounting principles. As discussed in Chapter 4, while some of these reporting requirements are set out, to varying degrees, in several Acts, the auditors' obligations remain vague and incomplete and they do not go far enough.

The Senate Committee Report recommends that the audit committee of the institution establish guidelines for the auditors, subject to regulatory approval, as to what is or is not "material." Given that conditions on financial markets are in a constant state of flux and given the usually rapid development of new instruments and practices, it should be the regulator's responsibility to review, on a continuing basis, what is to be considered material. It remains the auditor's responsibility, as the first person in the field, to make his own judgment as to the materiality of the information – a judgment for which he will be accountable to the relevant regulator. In particular, auditors should look into the risks undertaken by the audited institution, as these may endanger its future financial health. They should also look at the level of provisions for losses. Our recommendation calls for a clarification of the auditors' reporting responsibilities. In a report on the operations of the Office of the Inspector General of Banks, submitted in April 1986 to the Minister of State for Finance, the consulting firm, Coopers and Lybrand, called for an extension of reporting to include the management of risks by banks.

In certain groups of institutions, especially life insurance and property and casualty insurance companies, the actuary plays an important role in establishing the ability of a company to meet its future commitments. Thus their inclusion in our recommendation aimed at strengthening the reporting accountability of professionals involved in the assessment of the soundness of financial institutions.

Auditors should be supported by a strengthened internal audit committee. Such committees do currently exist in many institutions but with rather limited powers. While the establishment of an audit committee of the board is mandatory under the *Bank Act*, the role and procedures of such committees vary between banks. In general, their role is to ensure the production of accurate and reliable data. In many cases, audit committees do not review provisions for losses, although in some banks they may play a wider role in assessing outstanding credit. It is important that such committees take a more active role in assessing credit risks and provisions for losses.

It should be noted, however, that external auditors and the internal audit committee cannot perform their tasks without the full cooperation of the institution's management. Indeed, the monitoring of the performance of a financial institution depends on information flowing through a number of individuals whose closeness to the firm's management increases as one moves along the chain of responsibility. For example, the Inspector General of Banks depends on the external auditors, who depend on the banks' internal auditors, who in turn depend on management. Thus,

24 We recommend that the management of financial institutions be liable for the quality of the information provided auditors.

While management is already liable for keeping proper records and providing information to the auditors, our recommendation would go further, imposing a liability on management with respect to the quality and completeness of the information provided.

Two additional issues with respect to internal practices must retain our attention – namely, investment strategies and leverage.

Investment strategies for many groups of institutions, particularly trust and life insurance companies, and for pension funds have, until now, been governed by qualitative rules. These were aimed at increasing solvency. But they restrict the investment choices of institutions, and they reduce competition and the availability of financial products to all Canadians. Most of the other reports have recommended their replacement by quantitative rules. On the other hand, while quantitative rules force portfolio diversification, they do not guarantee the soundness of individual investments. Prudent investment may call for some blend of the two approaches. Investment rules should be the outcome of a process of consultation and cooperation between the relevant regulatory authorities and the management of institutions.

Concern with solvency and confidence calls for an adequate capital base. It would, however, be inappropriate to go beyond such a statement, as the minimum capital base needed to operate a financial institution safely varies among lines of business and over time, particularly as a result of financial innovation. The pyramiding of capital among institutions, however, should definitely be prevented.

25 We recommend that when more than 10 per cent of the common stock or subordinated debt eligible to be counted as part of the capital base of a financial institution is owned by another financial institution, that portion of the capital be deducted from the capital base of the owning institution.

Double-counting of capital would be prohibited under the strategy presented by most, if not all, other reports. The pyramiding of capital could not take place within a holding group, as our proposed framework would prevent subsidiaries of a holding company from investing in the equity of associated institutions. With respect to other institutions, care should be taken to ensure that measures designed to prevent pyramiding of the capital base do not, at the same time, prevent the normal investment of funds in good-quality equity capital - hence the 10-per-cent cutoff point.

The Canada Deposit Insurance Corporation

The reform of deposit insurance is also a much-needed part of modernizing the existing regulatory structure. The one-function/one-institution approach, accompanied by more-efficient supervision, enhances the solvency of the financial system. Nevertheless, deposit insurance and compensation funds continue to play an important role in enhancing confidence and access. But care should be taken to ensure that they do not reduce competition and market discipline. In fact, many issues that have been the subject of much debate in relation to deposit insurance - such as the amount to be covered by insurance or the introduction of risk-related premiums and of co-insurance - take on a different significance, depending on whether they are looked at from a market-discipline, a confidence, or a consumer-protection point of view.

From the point of view of competition and market discipline, risk-related premiums are called for to reduce the negative impact of deposit insurance on excessive risk-taking. From a confidence point of view, risk-related premiums should be rejected, as they may negatively influence public confidence when they single out higher-risk institutions. Furthermore, in order to increase the stability of deposits, there should be no limit on deposit insurance coverage. From a consumer-protection point of view, co-insurance from the first dollar of deposit, when it becomes effective in achieving market discipline, negates the very raison d'être of deposit insurance. Indeed, with co-insurance, the consumer who erred in leaving funds on deposit with a higher-risk institution may have to face some capital loss in case of failure. The original objective of deposit insurance - the protection of less-sophisticated depositors - is being lost. A system of co-insurance starting beyond a minimum level of deposit (say, $20,000) would afford some protection to the consumer. Furthermore, co-insurance by itself cannot increase market discipline unless it is accompanied by information that would enable a depositor to assess accurately the financial health of the deposit-taking institution. On the other hand, some limits on the dollar amount of deposits covered by insurance might be imposed, since the objective is to protect only the unsophisticated depositor and thereby provide access for all Canadians to the services offered by deposit-taking institutions, regardless of their income or degree of sophistication.

There is disagreement between the various reports on the level and form of deposit insurance - disagreement originating with the specific focus of each report, ranging from the importance of imposing market discipline to the importance of protecting the consumer. The Wyman Report came out in favour of co-insurance from the first dollar of deposit; the Dupré Report opted for a sliding scale of coverage, with deposits under $20,000 being fully insured and those over $80,000 having no coverage. The Blenkarn Committee recommended that the present coverage be retained, while the Senate Committee Report favoured a system close to that put forward in the Dupré Report, except that the actual numbers were somewhat different.

In the context of a fast-changing financial world, the maintenance of confidence and of consumer protection is of paramount importance. Consumer protection takes on special importance in a framework where the restrictions on the distribution of financial services are removed. In such an environment, deposit insurance should not be weakened. Consequently,

26 We recommend that all deposits, up to a maximum of $60,000, be fully insured by the Canada Deposit Insurance Corporation. We further recommend that a more generous limit be applied to deposits that form part of an RRSP.

Because they would operate under the *Bank Act*, deposit-taking institutions would qualify for CDIC insurance. The present arrangements with the Régie de l'assurance-dépôts du Québec (RADQ) could be continued as part of a delegation of powers in that province. Currently all deposits in the Quebec branches of provincially incorporated financial institutions are covered by the RADQ, while deposits in the out-of-province branches of Quebec-incorporated institutions are covered by the CDIC. Mechanisms are in place to avoid an overlap in the supervision of institutions covered by the CDIC and the RADQ. Finally, the RADQ has a liquidity back-up agreement with the CDIC. Furthermore, should an instrument other than deposits become the means of payment, it should be protected by a form of insurance that would be developed at the appropriate time.

To avoid any unnecessary disruption to the existing financial environment, we have opted for the current $60,000 limit on coverage. Lowering that limit could reduce confidence in the financial system, and there is no compelling reason to raise it. Those reports which proposed that the maximum be raised to $100,000 did so in the context of the introduction of co-insurance. A more generous limit should apply to deposits that form part of an RRSP in order to protect the retirement income of older Canadians, particularly since it is likely to be the financially less-sophisticated individuals that would keep their funds in deposits, as distinct from a more diversified portfolio. Other measures, particularly closer supervision, would deal - albeit in imperfect fashion - with the excessive risk-taking induced by the existence of deposit insurance.

As a general rule, government should not provide a guarantee to uninsured depositors. When a major disaster looms on the horizon, however, government might consider facilitating mergers with financially viable institutions or taking over financial institutions that face serious difficulties. In such cases, measures should be considered to ensure that the shareholders bear at least some of the costs of the mismanagement of the institution.

27 We recommend that the Canada Deposit Insurance Corporation be granted the power to set premium rates.

The premium rates should be set by the CDIC's board of directors, which should include industry representatives. Because of the many technical problems with their implementation, referred to in Chapter 4, risk-related premiums cannot be introduced in the near future, although they are undoubtedly the best way to enhance market discipline in the context of the existence of deposit insurance. Furthermore, in envisaging the introduction of risk-related premiums, their possible negative impact on confidence should be fully considered.

28 We recommend that the Canada Deposit Insurance Corporation share supervisory powers with the federal regulator of banks.

The CDIC should be involved in the supervision of banks, on the premise that he who ultimately pays the bill must be satisfied with the performance of those who may cause him to engage in expenditures. The object of this recommendation is to provide the insurer with the ability to require changes in institutional behaviour in order to protect its contingent liability. We recognize that CDIC participation in the supervision of banks would require cooperation with the other relevant regulatory authorities.

Consumer Protection

Consumer protection should not be limited to deposits in financial institutions but should also extend to other financial transactions.

29 We recommend that life and general insurance companies, and investment dealers, be required to develop their own customer protection plans.

Such plans, some of which are already in place or in the development stage (see Chapter 4), should be strengthened and well publicized to enhance consumer confidence.

The opening of retail outlets for the delivery of a large number of services produced by distinct financial institutions raises important issues with respect to consumer protection. Although tied-selling would be prohibited (see Recommendation 7), there is a need to reinforce consumers' awareness of their sovereignty in the choice of the originator of the financial products they purchase.

30 We recommend that any institution delivering, in a single transaction, two products originating in separate institutions be obliged to inform customers of their option to buy the second product from other distributors.

The responsibility is placed on the delivering institution to inform the customer in the manner deemed most appropriate.

There is also a need to protect consumers with respect to the quality of the advice they receive. Currently, lawyers, financial planners, and investment counsellors have escaped regulation in some of their activities - although the latter are subjected to more extensive regulation, as discussed in Chapter 6.

31 We recommend that financial planners and investment counsellors, together with lawyers managing estate and trust accounts on behalf of customers, meet minimum standards of behaviour, to be recognized through a special licence.

Financial planners have already been the object of attention by regulators. While self-regulation is appropriate in many cases, the protection of the consumer, which is at stake here, calls for more. Particularly, the licensing of financial planners would oblige them to establish separate trust accounts on behalf of the clients and force them to be covered by liability insurance. This would afford greater protection to the users of the services of financial planners. For planners, as well as investment counsellors and lawyers, licensing should also relate to advice and management activities. In the longer run, financial planners, investment counsellors, and lawyers should be required to adopt a "prudent-man rule" type of management for the funds that have been entrusted to them.

Conclusion

A sound and efficient functioning of the financial system is of vital importance to the Canadian economy. By providing for the maintenance of a payments system, for the safekeeping of funds, and for the intermediation of risks and of funds, the financial sector contributes to the accumulation of capital and facilitates trade among Canadians, and between Canadians and the rest of the world. It contributes to saving, investment, employment, economic growth, and social progress.

What is clear is that in matters of trade, investment, lending, and borrowing, decisions are being made on the basis of worldwide opportunities. Canadian financial institutions have shown extraordinary adaptability in fashioning services to meet this global challenge. It is important that the domestic regulatory structures governing financial institutions also adjust, at both the federal and provincial levels.

It is essential to foster competition if financial markets are to perform their vital role efficiently. Financial markets will continue to face waves of change from new technologies and from the cycles of expansion and contraction of international financial flows. The existing regulatory framework has not been able to keep pace with changes in the marketplace. Canada must therefore adopt a new framework for financial regulation that will give full play to competition and at the same time buttress the solvency of institutions.

The new framework outlined in this report imposes changes on the institutions themselves, on regulators, and on governments. The framework requires governments and regulators to introduce some new definitions of the basic functions of financial institutions. It forces these institutions to create a separate corporate entity for each function and then uses the mechanism of cross-ownership to give the institutions the scope to compete in all service areas.

The framework relies on a combination of ownership limits, corporate governance, and regulatory inspection to ensure that cross-ownership will not lead to harmful transactions that might endanger the solvency of institutions or the fair treatment of consumers. Managers, directors, auditors, and regulators have a shared responsibility for the health of the system. But we recommend strengthening the power of the regulator to act if the others fail to meet their obligations.

The framework also requires federal and provincial governments to work out ways to harmonize financial regulation. It is not necessary to centralize all financial regulation, but it is certainly essential to harmonize the rules of the game. Inconsistencies among jurisdictions create invitations to bypass the tightest regulations and thus weaken the whole system.

The changes being proposed require significant internal adaptation, but they are not radical. They do not involve changes in the relationship between the institutions and their customers. The proposed adjustments are worthwhile when they are placed in the context of a system that would be better able to finance Canada's economic growth, to build world-class financial institutions that can compete on international markets, and to safeguard the soundness and solvency of the institutions upon which Canadians rely.

Appendix A

Reports on the Canadian Financial System

	Green Paper and Wyman Report	Senate Committee Reports	Report of the Dupré Task Force	Blenkarn Report	Economic Council of Canada Report
Stated objectives of the reports	To develop a regulatory approach to financial institutions in order to better serve the public interest. To study and make recommendations on reforms to, and on the object, funding, organization, and public relations of, the Canada Deposit Insurance Corporation and on the supervision of member institutions.	To study the Green Paper and the Wyman Report.	To examine the organization and operation of financial institutions in Ontario and determine what pressures on the financial system may require attention from government.	To study the Green Paper, the technical supplement, and the Wyman Report, and to develop a regulatory approach.	To improve the private and public efficiency of the financial system by finding the best balance between the forces at play.
Role assigned to financial sector	To allocate credit, ensure the safekeeping of funds, and provide means of payment.	To transfer funds efficiently from lender to borrower.	To facilitate the flow of funds from savers to users of savings, and to allocate those funds efficiently without compromising the solvency of financial institutions.	(Not explicitly stated.)	To ensure the intermediation of funds and risks, the supply of information, the safekeeping of funds, and the maintenance of a payments system.
Institutional and related issues	To improve consumer protection. To promote competition, innovation, and efficiency (undefined). To enhance the convenience and options available to consumers in the market place. To promote international competitiveness and domestic economic growth. To control self-dealing and conflicts of interest. To broaden sources of credit. To ensure soundness of financial institutions and the stability of the system.	To improve market discipline in the financial sector, regulatory discipline, and consumer protection.	To maintain solvency as a means of ensuring consumer protection and maintaining efficiency (undefined). To enhance market efficiency. To define ownership of financial institutions. To control conflicts of interest and self-dealing.	To protect the consumer. To improve competition and efficiency (undefined). To maintain the stability and soundness of the financial system. To control conflicts of interest and self-dealing. To improve corporate governance. To define ownership of financial institutions.	To examine diversification, conglomeration, ownership, conflicts of interest, self-dealing, solvency, and market discipline, as they affect the conditions of efficiency – namely, competition, confidence, and access.

	To promote harmonization of federal and provincial regulatory policies. To improve market discipline in the financial sector.				
General approach to regulation	Regulation by institution. Diversification to take place through a holding company. Mutual companies to be permitted to raise funds for the expansion of downstream affiliates through the issue of subordinated debentures. Establish Schedule C banks to be given the same powers and to be subject to the same reserve requirements as current Schedule A and Schedule B banks, but they would be closely held institutions.	Regulation by institution. Financial institutions to be allowed to diversify their operations through four general avenues: - within-institution expansion of powers; - subsidiaries; - upstream and downstream holding companies; and - networking.	Regulation by institution. Ownership links between financial institutions to be permitted only through a financial-holding-company device.	Regulation by institution. Financial institutions to be allowed to diversify their operations through four general avenues: - within-institution expansion of powers; - subsidiaries; - upstream and downstream holding companies; and - networking.	Government to adopt regulation by function. Each institution to be limited to the performance of a single major function, falling under single regulatory authority. Any institution providing a means of payment to be considered a bank, operating under the *Bank Act*. Process of reorganization to be gradual, with target dates to be established. All levels of government to undertake to amend all legislation as expeditiously as possible to accommodate the new framework. All Acts and legislation governing financial institutions to have sunset clauses and to be reviewed at the same time.
Financial holding companies	Requirement to form a holding company for all investors who hold more than 10 per cent of two or more regulated financial institutions, one of which is federally incorporated. Avoid double-counting of capital. Cooperative credit associations registered under the federal *Co-operative Credit Associations Act* to	Double-counting of capital not to be permitted. Securities firms to be treated like any other financial institution, in terms of being able to be part of an upstream or downstream holding company or to be subsidiaries of a financial institution operating under another segment. Securities firms to be	This device to be made available to domestically owned banks, as well as to other types of financial institutions. Means must be found to ensure that mutual companies will not be disadvantaged vis-à-vis stock companies in their capacity to affiliate with other institutions, whether by way of holding companies or subsidiaries.	Rejects the compulsory aspect of financial holding companies. Double-counting of capital in downstream holding companies and subsidiaries (except real estate subsidiaries) not to be allowed, and such investments not to be limited to a specified percentage of assets or capital of the parent institution.	Diversification into any function to be allowed only through a financial holding group. Members of group can sell assets and lend funds to one another, within pre-set limits, except when one member is facing serious financial difficulty. Financial holding groups to supply financial statements for the group as a

	Green Paper and Wyman Report	Senate Committee Reports	Report of the Dupré Task Force	Blenkarn Report	Economic Council of Canada Report
Financial holding companies	be allowed to create downstream financial groups similar to FHCs. Mutual companies to be allowed to create downstream affiliates.	given powers similar to those of other financial institutions, in terms of being able to acquire subsidiaries and to form downstream holding companies. Schedule B banks could be part of a holding company.		The Canadian Co-operative Credit Society to be given the same powers of diversification as those contemplated for non-bank financial institutions. Ways and means must be developed to enable CCCS to establish a bank, should the provincial central so desire.	whole and to be monitored for solvency. Financial holding groups not to include non-financial corporations, except for ancillary services. Federal and provincial governments to monitor holding groups for solvency. Avoid pyramiding of capital.
Commercial lending	Non-bank financial institutions can only engage in commercial lending through an affiliated Schedule C bank.	An all-inclusive maximum of 20 per cent of assets to be established for trust companies, insurance companies, and credit unions.	For trust and loan corporations: - approval of the Superintendent of Deposit Institutions; - restrictions to 10 per cent or less of total assets; and - minimum capital of $15 million.	Investments for which no specific aggregate limits exist are to be considered as basket-clause investments. Basket-clause investments for all non-bank financial institutions to be established at 15 per cent of assets.	To be dealt with prudently as any other investment power.
Networking	Removal of restrictions that inhibit networking between institutions. Prohibition of tied-selling in all networking arrangements.	To be allowed, but tied-selling prohibited.	To be allowed, but regulatory approval to be required. Institutions to be required to disclose to their customers the existence of networking arrangements and the availability of alternative sources for similar services.	Networking to be permitted for trust and loan companies, insurance companies, cooperatives, and banks after the 1990 *Bank Act* revision. Tied-selling to be prohibited. Institutions not to be allowed to share confidential information without the written consent of the client.	All types of networking, cross-selling, and cross-referral to be allowed. Tied-selling to be prohibited. Institutions selling two products originating with different institutions to advise customer of option to buy the second from another distributor.
Investment powers	Quantitative rules to replace present quality tests.	Quantitative or prudent-portfolio approach to investment to be monitored by the investment	Specific asset mix proposed. Current rules to be	Specific asset mix proposed for selected financial institutions.	Investment powers to be determined by what is considered prudent for each function.

		committee of the board of directors.	replaced by a prudent-investment standard. Creation of investment committee of the board of directors to adopt policies designed to avoid undue concentration.		
Conflict of interest and self-dealing	Complete ban on non-arm's-length transactions. Creation and maintenance of a "Chinese Wall" between fiduciary operations within a trust company and all other financial operations of the trust company and of its affiliated companies. Creation of a Financial Conflict-of-Interest Office to assist individuals who wish to make a claim for damages against financial institutions.	Implementation of a three-pronged procedure incorporating a system to review non-arm's-length transactions: - tier one: selective ban on self-dealing transactions; - tier two: creation of a Business Conduct Review Committee to review in advance all non-arm's-length transactions; - tier three: pre-clearance with the primary regulator for certain kinds of non-arm's-length transactions. Combination of enhanced disclosure, effective corporate governance, and the establishment and monitoring of "Chinese Walls" to control abuses in financial institutions. Financial holding companies to be prohibited from engaging in non-financial activities.	Activities with related parties to be prohibited, subject to limited exemptions (unless true market value can be objectively ascertained by independent means). Approval to be given by the Lieutenant-Governor in Council to otherwise prohibited transactions. Obligation for professionals to disclose any conflict-of-interest breach. All related party transactions to be disclosed in financial statements. A securities firm should be prohibited from underwriting any security of a non-industry investor or of a person or company related to that securities firm that holds more than 10 per cent participation. Directors representing the ownership interest of a financial intermediary in a securities firm to be required to be absent when any matter in which the intermediary that they represent has an interest, is being discussed or voted upon by directors. New requirements for exempt market participants.	Freedom to engage in non-arm's-length transactions, except those that are likely to have a significant impact on the institution's solvency. National Financial Administration Agency (NFAA) to monitor all non-arm's-length transactions. Creation and maintenance of a "Chinese Wall" to prevent the flow of information between certain departments within an institution. 30-day pre-notification to NFAA or the appropriate regulator for related-party transaction greater than $1 million.	Committee of board of directors to examine non-arm's-length transactions. No financing to be made available to any director or manager. When institution is closely held, no financing to be made available to any shareholder that owns more than 10 per cent of outstanding voting shares. Any financing made available to any company with which directors, shareholders, or managers are associated is to be reviewed by special committee of the board. Positions of conflicts of interest to be disclosed to customers.

	Green Paper and Wyman Report	Senate Committee Reports	Report of the Dupré Task Force	Blenkarn Report	Economic Council of Canada Report
Domestic ownership	No ownership restrictions.	Where a financial institution has a controlling interest in another financial institution operating in a different segment, either the institution itself or its affiliate must have 35 per cent of its shares traded publicly. Ownership restrictions imposed on Schedule A banks are to remain in place.	Approval of new entrants and of changes in ownership and control. In favour of widespread ownership. Non-industry investors to be permitted to own in the aggregate up to 49 per cent of voting rights in, and 49 per cent of the participating securities of, a securities firm registered in Ontario provided that no single non-industry investor owns more than 20 per cent of either the voting rights or participating securities.	Limits to be established on the basis of domestic-assets size. Non-financial institutions to be prohibited from owning more than 30 per cent of a financial affiliate. Ownership to be applied at the first level where there is a non-financial interest. Five years to meet these requirements.	Widespread ownership most desirable. Widespread ownership to be defined as no one owning more than 10 per cent of institution or holding company. Ownership to be widespread for all independent institutions or financial holding groups with domestic assets of over $10 billion. Existing closely held entities with over $10 billion in assets to be grandfathered, but increases in equity to be widespread. Financial institutions in holding group to be wholly owned by the holding company unless 35 per cent of their voting shares are widely held by other investors. Restrictions to be imposed on sizable ownership in more than one financial institution. Any purchase of more than 10 per cent of capital stock of a financial institution to receive prior approval.
Foreign ownership	Accepts existing foreign ownership restrictions.	Transfer of ownership or control of financial institution to foreigners restricted. No control of new entrants.		No special foreign ownership rules. Distinction between Schedule A and Schedule B banks to be eliminated.	Foreign institutions to be allowed to enter gradually, on condition of reciprocity.

Capital base	Initial capital requirements should be raised significantly; CDIC, in conjunction with the regulator, should formulate appropriate levels.	Higher initial capital requirements to be imposed.	Minimum capital of $15 million to be required for loan and trust corporations that want to enter commercial lending.	Minister of Finance to have discretionary power to review and revise minimum initial capitalization. Life and trust companies to be allowed a five-year transition period to comply with new capitalization requirements. Stock and mutual insurance companies to be allowed to issue preferred stocks and subordinated debentures.	Capital base to be what is considered prudent for function.
Leverage	New leverage rating system to be developed with the risk profile of assets being a key determinant.	CDIC to have the authority to alter leverage ratios of member institutions.	Increases in borrowing multiples in excess of 10 times for trust and loan corporations to be subject to prior approval. Information as to increases in the borrowing multiples to be deposited with a standing committee. Annual review and possible correction of the borrowing multiples for each trust and loan corporation by the Superintendent of Deposit Institutions.	Permissible leverage for all deposit-taking institutions to be reduced to between 10 and 20 times. Operation with a leverage above the limit to be allowed only when solvency and market conditions are deemed appropriate.	Leverage to be determined by regulators.
Reserve requirements	Removal of requirements on bank term deposits with a term to maturity of at least a year and not encashable for at least a year from their date of issue.	Bank of Canada to pay interest on bank cash reserves. Interest not to be paid on bank excess reserves.		Elimination of the requirement for banks to maintain non-interest-bearing cash reserves.	Reserve requirements to be the same for all institutions performing a banking function.
Deposit insurance	Co-insurance system covering 90 per cent of individual deposits between $0 and $100,000 to be phased in over a reasonable period – three years, for example.	Full insurance for the first $25,000 and 80 per cent for the next $50,000, with amounts adjusted for inflation.	Under $20,000: fully insured. $20,000 to $60,000: 75 per cent insured. $60,000 to $80,000: 50 per cent insured.	Present coverage of up to $60,000, applying to all deposits irrespective of their term to maturity, to be retained.	Present coverage of up to $60,000, applying to all deposits, to be retained. More generous limit on coverage of deposits in RRSPs.

	Green Paper and Wyman Report	Senate Committee Reports	Report of the Dupré Task Force	Blenkarn Report	Economic Council of Canada Report
Deposit insurance			Over $80,000: not insured. Deposits in RRSPs to be included.		
Uninsured deposits				Government not to bail out uninsured depositors. Regulatory agency to develop and implement an uninsured-depositor cash-advance program.	
Compensation funds	Compensation funds for insurance companies to be based on same principles and structure as deposit insurance.	Securities industry and life insurance industry encouraged to develop contingency funds and welcome to join the CDIC.	Accelerate the development and implementation of industry compensation funds with a co-insurance element.	Two separate mandatory tax-free funds to be created for life and casualty, as well as property insurance companies. Funds to be self-supporting.	Insurance and securities industries to be required to develop consumer protection plans.
Brokered deposits	CDIC to have powers to: - impose freeze on brokered deposits; - put ceiling on the ratio of brokered to total deposits; and - impose a modest annual growth rate.	The extent of brokered deposits to be reported if in excess of a certain amount.	Disclosure conditions.	NFAA to develop procedure to monitor brokered deposits.	
CDIC	All deposit-taking institutions to be required to apply for insurance. Granting of insurance to be a matter of discretion for CDIC. Approval for insurance to be a condition for granting a new charter. CDIC to establish standards for insurance.	CDIC to have the power to specify minimum requirements where regulations and by-laws of members are not adequate. CDIC to have a range of powers to restore an institution back to financial health. The power to close down an institution must be a ministerial or judicial decision.		CDIC is to become part of the National Financial Administration Agency (NFAA).	CDIC to share supervisory powers with bank regulators.

CDIC to have the power to vary and amend the contract of insurance appearing as a Schedule to its Act.

CDIC to have the power to set premiums.

CDIC to review the contracts of insurance annually.

CDIC to have the power to terminate a federally incorporated member's insurance for cause.

CDIC to have the authority to step in and take action if it becomes concerned that necessary action is not being taken by the responsible regulator.

CDIC should maintain its own complete and current data bank of information on insured institutions.

CDIC to develop performance-measurement standards as an early-warning system and a performance-rating system.

Member institutions required to furnish CDIC with the prescribed information it needs.

CDIC to engage a small core of highly competent professionals to monitor the performance, and to carry out inspections, of member institutions.

CDIC to be given the power to levy significant penalties to ensure compliance with its Act, regulations, and guidelines.

CDIC to undertake specific measures to limit its liabilities upon deciding that an institution is no longer viable.

CDIC to be granted a special status to make direct representation to the authority overseeing the liquidation process, but should not act as a liquidator.

CDIC to become involved in the supervision and regulation of institutions that fall below some minimum threshold level in terms of the early-warning system.

CDIC to be constituted as a separate institution with its own board of directors.

Membership in CDIC to be a privilege and subject to standards.

The powers associated with an insurer with respect to solvency to be delegated to, and exercised by, the primary regulators.

CDIC to report to the Minister of Finance, with the relationship modeled after that of the Bank of Canada.

In the normal course of events, CDIC to delegate its regulatory authority to the primary regulators.

	Green Paper and Wyman Report	Senate Committee Reports	Report of the Dupré Task Force	Blenkarn Report	Economic Council of Canada Report
CIDC	CDIC to set and maintain proper financial standards and to have adequate capacity to supervise member institutions.				
CDIC funding	Premiums to be raised from 1/30th of 1 per cent to 1/10th of 1 per cent of insured deposits over the next two years with the target size of the fund to be fixed at 0.75 per cent of insured deposits. CDIC to issue $1 billion of floating-rate preferred shares.	Existing deficit to be financed by a series of surcharges over a 10-year period. CDIC to operate on the basis of a series of independent pools or segregated funds, with a target of 0.75 per cent of the insured deposits. CDIC to have the ability to borrow both from the fund and from the provincial equivalents, and to float guaranteed debt issues.		Premiums to be raised from 1/30th of 1 per cent to 1/10th of 1 per cent of insured deposits until the end of December 1986. Future premiums to include a surcharge retiring the current deficit in between 10 and 25 years.	Board of directors with industry representatives to set premium rates.
Supervisory structure and powers	Consolidation of the Office of the Inspector General of Banks and the Department of Insurance supervisory functions into a unique supervisory body. The proposed unique supervisory body would have the following powers: - to gain access to the records and accounts of an FHC and member firms; - to issue cease-and-desist orders; - to prohibit changes in the control of supervised institutions; - to appoint a curator; - increased powers to take control of assets of supervised institutions;	Favours the present system, which aligns regulators and institutions according to the core function. Greater discipline with respect to all four regulatory components: - CDIC; - primary regulators; - auditors; - corporate governance. Cross-pillar activities to be monitored by one of the primary regulators. Increases in regulatory powers to be restricted to areas where existing powers limit the ability to monitor the soundness and	Regulation, supervision, and policy direction of financial institutions (Ontario) to be transferred to an Office of Financial Institutions (OFI) of the Ministry of Treasury and Economics. Formation of a policy committee within this new Office to review and advise on all issues pertaining to the regulation, supervision, and policy direction of financial institutions. The OFI to develop a mechanism to recover regulatory costs through direct levies on institutions.	Creation of a National Financial Administration Agency (NFAA) to administer consumer protection plans and to act as the regulatory and supervisory agency for all federally, and where appropriate, provincially incorporated institutions. NFAA to establish conditions for membership with respect to protection plans and to act as a direct provider of deposit insurance, as administrator of insurance policy-holder compensation plans and as a lender of last resort to provincial cooperative stabilization funds.	Regulators to have increased powers. Regulators of a member of holding group in difficulty to inform regulators of other members of group. Early-warning systems to be developed for all institutions.

- to deem specific transactions not to be at arm's length;
- to force the divestiture of prohibited investments or loans;
- to obtain information on loans; and
- to obtain information on the ownership of an FHC and member firms.

solvency of an institution or to restore problem institutions.

Primary regulators to be required to develop a computerized data base to serve as the building block for an early-warning system.

Provincial and federal regulatory authorities to disclose and exchange information between themselves and with the CDIC, including information on risks being assumed by institutions.

Regulatory authorities to be given the power to investigate conflict-of-interest complaints raised by the public.

The Government of Ontario to direct relevant regulatory authorities to develop and implement an early-warning system.

Amendments to be made to the statutes governing Ontario financial institutions, to require them to assemble and transmit any required data to the relevant regulatory authority.

NFAA to develop the necessary capability to perform on-site inspections of chartered banks.

One or two auditors of a bank to be appointed by, and report to, the NFAA in accordance with NFAA instructions.

NFAA to conduct annual (or as often as deemed necessary) meetings with the shareholders' auditors and the audit committee of a bank.

NFAA to develop the necessary procedure for institutions to report and disclose the fee income relating to restructured loans and amount of non-accrual loans and interest.

NFAA to have the power to appoint a curator, with grounds to take immediate control of troubled institutions and:
- to issue cease-and-desist orders;
- to suspend or remove directors and executive officers;
- to obtain information on the ownership of an FHC and member firms;
- to require declaration of interests of substantial shareholders;
- to force divestiture of prohibited investments or loans;
- to specify asset values;
- to deem specific transactions not to be at arm's length;
- to require restoration of assets illegally paid out.

	Green Paper and Wyman Report	Senate Committee Reports	Report of the Dupré Task Force	Blenkarn Report	Economic Council of Canada Report
Supervisory structure and powers				Statutes creating financial intermediaries to be amended to increase the penalties and the provisions making a matter illegal. Criminal Code to be amended to impose criminal penalties in the case of gross negligence.	
Federal-provincial harmonization	CDIC to expand its public-relations role with member institutions, depositors, and governments.	Federal government to take the initiative to establish, with provincial governments, a Permanent Committee of Ministers Responsible for Financial Institutions and responsible for achieving policy harmonization.	Governments of Canada, the provinces and the territories should initiate discussions to establish a Council of Ministers Responsible for Financial Institutions, to review and consult on matters pertaining to the policies and regulatory practices governing financial institutions. Council to be staffed by a permanent secretariat.	Federal and provincial governments to pursue discussions to harmonize legislation, regulation, supervision, and enforcement of the Canadian financial system within the framework of NFAA. All federal legislation to be reviewed and revised on a decennial basis.	Provincial governments to put in place mechanisms to ensure interprovincial uniformity of regulation and to act as spokesman.
Corporate governance	Directors of an FHC and affiliated institutions should exercise a higher standard of performance and attention than currently required under the *Canada Business Corporations Act*.	Directors to exhibit a degree of skill that may reasonably be expected from persons of their knowledge and experience. Comprehensive indemnification provisions for a director against costs and expenses incurred in respect of a civil, criminal, or administrative action to which he is a party.	Each corporation should have a continuing statutory responsibility to satisfy the regulatory authority of the fitness as to character and competence of its directors.	Standard of care to be increased from that of a prudent person to that of a prudent director. All directors to be registered with NFAA. Standards of supervision to be increased, including more extensive use of specialized oversight board committees.	
Auditors, actuaries, and appraisers	CDIC to take a leading role in working with the Canadian Institute of Chartered Accountants, appraisal institutes, member institutions, and	CDIC, primary regulators, industry representatives, and the CICA to work together to develop reporting and assessment standards that will more	Amendments to the statutes governing Ontario financial institutions to require the appointment of an audit committee composed of outside directors	Actuary, auditor, and appraiser to be engaged by a financial institution under the supervision of NFAA would be required to obtain prior approval	Auditors to report any material wrongdoing and serious concerns about financial health of institutions.

	regulators to develop accounting and valuation standards. CDIC to have a leadership role in determining uniform examination standards, including programs, frequency, and minimum qualifications.	accurately reflect exposure to risk. Financial institutions to be required to submit to annual audits by two firms, one of them appointed by the primary regulator. Auditors to be required to attend the meetings of the audit committee. Auditors to be required to report to the audit committee all instances of self-dealing, malfeasance, and transactions outside the apparent powers of the institution. Copies of the post-audit reports to management and the audit committee of the board to be provided simultaneously to the primary regulator.	and to impose a general duty upon the committee. The Lieutenant-Governor in Council to be given the power to make regulations that auditors must consider in their deliberations. Amendments to the statutes to require the auditors of a financial institution to: - attend all meetings of the audit committee; - make reports on the work conducted by auditors; - assess the financial stability of institution, as deemed desirable; - and, in particular, to report to the audit committee every instance of: self-dealing; apparent fraud, malfeasance, or other financial irregularity; transactions beyond the powers of the institution; transactions that could have an adverse effect on financial stability; transactions involving a liability that would constitute an off-balance-sheet item.	of NFAA. NFAA, in conjunction with the Canadian Institute of Actuaries, the CICA, and the Appraisal Institute of Canada to be encouraged to develop guidelines and standards for financial reporting. NFAA to require these professional groups to establish a review committee on the adequacy of solvency standards. Severe disciplinary measures to be instituted against those advisors who fail to observe the standards and code of conduct.	Auditors and actuaries to be accountable for the accuracy and completeness of their reporting, and regulators have the authority to review their appointments. Management to be liable for quality of information supplied to auditors.
Lawyers, financial planners, and investment counsellors					Lawyers managing estates and trusts, financial planners, and investment counsellors to meet minimum standards of behaviour and to be licensed.

Appendix B

B Structure of the Canadian Financial System

The Canadian chartered banks that operate under Schedule A of the *Bank Act* are the better known of the financial institutions, as they have traditionally played a key role, particularly on the retail side of financial services. Various kinds of bank deposits, redeemable at face value and/or transferable by cheque, offer an attractive outlet for the savings of Canadians and contribute to the existence of an efficient payments system. Funds raised through deposits are channeled mainly into nonmarketable instruments, such as business, consumer, and mortgage loans. A general characteristic of deposit-taking institutions is that they invest mainly in nonmarketable securities. It has been shown that the fixed money value of deposit liabilities creates the appropriate incentive to carry out effective monitoring and enforcement, in order to ensure that funds are used for their intended purpose and that borrowers fulfil their obligations. Such monitoring and enforcement is needed because, given the very nature of nonmarketable securities, there is no imposed market discipline. The costs of collecting information, monitoring portfolios, and enforcing repayments are lower within a centralized institution; in addition, because of the fixed nature of the liabilities, improved loan performance directly contributes to profits. Banks also hold a portfolio of government and corporate securities.

Banks offer many other services, such as safekeeping, letters of credit, purchase of securities, and registered retirement savings plans. They can participate in the underwriting of government securities, and they are involved in the supply of information in various forms, from advice to individuals on the availability and characteristics of savings instruments to assistance provided to businesses, particularly small ones, in managing their financial affairs. Canadian banks are very active abroad, where they accept deposits and extend loans but where they also participate in the underwriting of corporate securities and in **syndicated loans**.

The subsidiaries of foreign banks that currently operate in Canada under Schedule B of the *Bank Act* provide similar services, although they are less involved in the retail side of banking - i.e., in personal deposits, consumer loans, or small business and mortgage loans.

Trust companies have recently taken a more prominent place as their deposit-taking activities have risen in importance. Most of the funds raised are invested in mortgages, but some find their way into corporate bonds and shares, government bonds, and business loans. The administration of estates and trusts is also an important activity - an activity from which this group of institutions has derived its name. Trust companies are managers of mutual funds, registered retirement savings plans (RRSPs), estates, pension plans, and personal and corporate trusts. Trust companies also supply financial information of all kinds.

Life insurance companies are involved in retail operations through the sale of life insurance policies. The proceeds are channeled into mortgages, government and corporate bonds, and, to some extent, corporate shares. They are also involved in the management of pension funds and mutual funds, particularly those used as vehicles for RRSPs. Property and casualty insurers invest funds raised through the selling of fire, theft, and accident policies in government bonds and in corporate bonds and shares.

Banks and trust and insurance companies transform a claim on an ultimate borrower (e.g., a mortgage or a consumer loan) into a claim on themselves (e.g., a deposit or an insurance policy). They are financial intermediaries. In contrast, market intermediaries bring together ultimate borrowers (corporations or governments) and ultimate suppliers of funds (individuals or institutions) without performing any transformation of assets - e.g., as a real estate agent brings together the buyer and the seller of a house. This distinction between financial and market intermediaries goes well beyond the nature of a financial transaction; it has important consequences for the risks involved and the capital base necessary to support a transaction.

Investment brokers and dealers are market intermediaries. As brokers, they intermediate between the buyers and sellers of securities, and they contribute to the maintenance of a market for bonds and stocks. As dealers, they hold a portfolio of securities and transact in financial markets on their own account. As underwriters, they assist in the raising of funds by governments and corporations. They also provide a wide variety of information on the economy as a whole, on specific sectors of activity, and on the financial situation of many companies. They offer investment advice to investors, individuals, and corporations, including financial institutions. They also advise corporations and governments on the best opportunities available for raising funds.

Caisses populaires in Quebec and credit unions in the rest of the country are sometimes considered as a fifth pillar of the Canadian financial system. They offer many of the same services as chartered banks, collecting deposits and investing in mortgages, consumer loans, and (to a lesser extent) business loans.

But the financial system does not limit itself to the four or five pillars. Other institutions are active in many different markets. Among financial intermediaries, mortgage loan companies, mainly associated with Schedule A banks, invest funds, raised mostly through term deposits, in mortgages (especially residential mortgages). Mutual funds and closed-end funds offer investors the possibility of placing their savings in a diversified portfolio of corporate and government securities and mortgages. They also free individuals from the need to manage closely their portfolios of securities. Financial corporations (sales-finance and consumer-loan companies) provide credit to individuals, retailers, and wholesalers to finance the purchase of goods and services. They also provide industrial loans and financing for inventories and capital expenditures. Companies specialized in business finance include financial-leasing corporations, factoring companies, venture-capital firms, and merchant bankers. Leasing corporations provide businesses with lease-financing arrangements for equipment. Factoring companies purchase the accounts receivable of businesses and take over the collection of these accounts. Venture-capital firms and merchant bankers provide more-risky capital, often in the form of equity. Merchant bankers may act as underwriters for new corporate equity and bond issues; they are also often instrumental in bringing about mergers and acquisitions. Pension funds receive contributions from individuals and their employers, and invest them in a broad range of assets, including corporate shares, government bonds, and mortgages. Among market intermediaries, investment counsellors assist financial institutions in the management of funds. Financial planners help individuals in organizing their own finances and in setting up portfolios of securities that best correspond to their needs.

Other groups, whose main areas of activity fall outside the financial sector, are also involved in the supply of financial services and financial information. Many nonfinancial corporations offer credit facilities, often tied to the sale of their own products. Merchandisers, such as Eaton's, The Bay or Sears and many oil companies, have issued their own credit cards; manufacturers and wholesalers offer lines of credit to their customers. Accountants play an important advisory role in helping firms and individuals run their financial affairs. Lawyers quite often administer trusts or estates on behalf of their clients.

Table B-1

Main Balance-Sheet Items of Selected Groups of Financial Institutions as a Proportion of Total Assets, Canada, 1985

	Selected assets as a proportion of total assets		Selected assets as a proportion of total assets
	(Per cent)		(Per cent)
Assets:		*Liabilities:*	
Chartered banks (schedule A):			
Bonds		Deposits	
Treasury bills	3.9	Demand	16.9
Government	1.2	Notice	18.4
Corporate	1.1	Term	27.0
Corporate shares	3.0	Nonresident	18.5
Investment outside Canada	5.0	Debentures	2.0
Loans			
Business	28.5	Share capital	2.6
Consumer	13.8	Contributed surplus	0.1
Mortgage	14.7		
Nonresident	2.4		
Lease contracts	0.6		

Table B-1 (concl'd.)

	Selected assets as a proportion of total assets		Selected assets as a proportion of total assets
	(Per cent)		(Per cent)
Assets:		*Liabilities:*	
Chartered banks (schedule B):			
Bonds		Deposits	
Treasury bills	3.1	Demand	1.3
Government	0.7	Term	50.3
Corporate	0.6	Nonresident	27.5
Corporate shares	0.6	Debentures	0.2
Loans			
Business	36.4	Share capital	4.8
Consumer	1.0	Contributed surplus	0.1
Mortgage	4.1		
Nonresident	7.7		
Lease contracts	3.0		
Trust companies:			
Bonds		Deposits	
Treasury bills	3.0	Demand	11.4
Government	3.6	Notice	10.4
Corporate	5.0	Term	66.9
Corporate shares	6.1	Bank loans	0.2
Loans		Notes	1.5
Business	2.5	Accounts payable	3.2
Consumer	5.5		
Mortgage	57.7	Share capital	1.9
Lease contracts	1.3	Contributed surplus	1.0
Commercial paper	3.7		
Assets:		*Liabilities:*	
Life insurance companies:			
Bonds		Bank loans	0.4
Treasury bills	0.8	Accounts payable	0.6
Government	15.0	Debentures	0.5
Corporate	12.4	Actuarial reserves	52.9
Corporate shares	4.0	Liabilities held for business	
Loans		outside Canada	24.9
Consumer	3.0		
Mortgage	22.8	Share capital and	
Commercial paper	1.3	contributed surplus	0.8
Assets held for business			
outside Canada	29.1		
Property and casualty insurance company:			
Bonds		Premiums	60.5
Treasury bills	3.5	Bank loans	0.3
Government	38.1	Accounts payable	4.5
Corporate	11.2	Debentures	0.1
Corporate shares	13.2		
Loans		Share capital	3.5
Mortgage	2.2	Contributed surplus	2.8
Commercial paper	1.6		
Accounts receivables and accruals	12.5		

Table B-1 (cont'd)

	Selected assets as a proportion of total assets		Selected assets as a proportion of total assets
	(Per cent)		(Per cent)
Assets:		*Liabilities:*	
Investment dealers:			
Bonds		Bank loans	16.8
Treasury bills	23.0	Accounts payable	45.1
Government	5.1	Other call loans	26.2
Corporate	2.7	Notes	3.8
Corporate shares	0.6		
Commercial paper	16.2	Share capital	0.9
Accounts and loans receivable	39.9	Contributed surplus	--
Local credit unions:			
Bonds		Deposits	
Government	1.0	Demand	12.9
Corporate	0.6	Notice	28.0
Corporate shares	0.4	Term	46.6
Loans		Accounts payable	2.2
Business	5.8		
Consumer	18.7	Share capital	4.4
Mortgage	47.8		
Farm	2.5		
Assets:		*Liabilities:*	
Investment funds (mutual funds):			
Bonds		Bank loans	0.2
Treasury bills	6.8	Accounts payable	1.9
Government	8.7		
Corporate	2.5	Share capital and	
Corporate shares	36.2	contributed surplus	81.9
Loans			
Mortgage	10.9		
Commercial paper	4.4		
Investment outside Canada	24.2		
Financial corporations:			
Bonds		Bank loans	2.1
Treasury bills	0.1	Accounts payable	2.7
Government	0.1	Notes	36.1
Corporate	0.3	Debentures	24.5
Corporate shares	0.1		
Loans		Share capital	3.9
Business	17.7	Contributed surplus	1.6
Commercial retail-sales financing	20.4		
Wholesale financing	18.2		
Consumer	4.9		
Consumer retail-sales financing	27.3		
Mortgage	3.2		
Lease contracts	4.2		
Commercial paper	0.1		

SOURCE Based on data from Statistics Canada.

Appendix C

C Financial Deregulation in Some Foreign Countries

The configuration of financial systems differs from one country to another. Differences can be found in the regulation of the various functions, interest rates, and international capital flows.

With respect to the regulation of functions, the U.S. system is probably the closest to that of Canada. There is a separation between banking, on the one hand, and securities underwriting and trading, on the other. Life-insurance selling and underwriting is also kept separated from the other functions, although in smaller communities - i.e., communities with fewer than 50,000 inhabitants - some banks have the right to undertake such activities. Trust activities, however, are not separated from banking. Financial and nonfinancial activities have - at least in the past - been kept separate.

The Japanese financial system is quite similar to that of the United States, with a separation between banking and securities trading and dealing; as in the United States, several trust banks are involved in both banking and trust activities. Life insurance companies are kept separate from the other groups of institutions. Long-term and short-term banking are also kept separate. (There are three long-term credit banks that specialize in the supply of longer-term loans.) There is a greater mixture of financial and nonfinancial firms, however, as many of the banks belong to large industrial conglomerates - e.g., Mitsui Bank, and Mitsubishi Bank.

In West Germany, the so-called "universal banks" can engage in most financial activities, from accepting deposits to the trading and underwriting of corporate securities. The existence of "universal banks" does not imply that the financial system is concentrated. In fact, it appears to be less concentrated than in Canada, with a much larger number of banks. There is also a significant interrelationship between financial and nonfinancial activities, as many of the banks have large interests in nonfinancial corporations. The French financial system is similar to that of West Germany, although there appears to be a greater variety of institutions. Finally, the United Kingdom finds itself somewhere in between the United States and West Germany with respect to the mixing of functions.

With respect to the regulation of interest rates, the United Kingdom and West Germany have a system quite similar to that of Canada, with no legal restrictions on interest rates. In France and Japan, interest rates are regulated - although this is changing.

The United States and Great Britain have no restrictions on the international flow of funds or on the international operations of domestic institutions. France and Japan still have some exchange controls in place, while West Germany has some restrictions with respect to the involvement of domestic institutions in foreign transactions. Here, again, the situation is changing rapidly.

In all these countries, deregulation has become a buzz word. But deregulation does not mean the same thing in Japan, Britain, France, or the United States; and it is undertaken in a different environment than that which characterizes the Canadian financial system of the 1980s. In Japan, deregulation means removing controls on interest rates; it means opening up the financial system to the rest of the world and removing controls on the cross-border movement of funds; it also means giving greater powers to some institutions and, in particular, removing the separation between short-term and long-term credit institutions. With deregulation, banks will be allowed to underwrite government bonds; but banking will remain separate from corporate underwriting, and life insurance will also continue to remain a separate function. Thus, for Japan, deregulation means freedom from interest and exchange controls, and a configuration similar to that of Canada.

Deregulation in France means giving a greater role to market forces in the determination of interest rates, and a movement towards substantially easing foreign-exchange controls. In the United States, movement towards deregulation was mainly a reaction to ceilings on interest rates imposed under Regulation Q and to the prohibition of interstate banking. The erosion of the separation between core functions is also, to a large extent, the outcome of the attempt to circumvent interest-rate ceilings and geographical restrictions. These restrictions became particularly costly with rising interest rates and increased consumer demand for new products and improved services. Money-market funds, NOW ("notice-of-withdrawal") accounts, certificates of deposit, cash-management accounts, and even the Sears experience were all prompted by the combination of economic factors and constraining regulation. It was only in the United Kingdom that changes in the financial system were directly prompted by the separation of functions. Building societies are vying for broader investment powers; other institutions attempt to enter into securities underwriting and trading; and there are strong pressures on the stock exchange to open up to more participants. The changes implemented on 27 October 1986, in London - in what is commonly referred to as the "Big Bang" - aimed at opening up to competition the London securities markets: brokers' commissions will be freed; securities firms will be able to trade on behalf of clients and on their own account; the government bond market will be open to many more participants; outsiders will be allowed in the securities industry, as banks and other financial institutions are given the right to acquire important stakes in securities firms.

Glossary

Account receivable. An account opened through the purchase of goods and services but not yet settled.

Activity. An investment, a service offered, or a transaction in which a financial institution or intermediary is involved. Examples are the acceptance of deposits, mortgage or commercial lending, and investment in bonds or equity.

Arbitrage. The process by which investors simultaneously purchase and sell assets in different domestic or international markets in order to take advantage of price discrepancies.

Cash-management account. A brokerage facility offered by some investment dealers that enables the customer not only to buy and sell securities on credit or in cash but also to keep funds in a deposit and transfer those funds by cheque. In addition, the account can usually be accessed by a bank credit card.

"Chinese Wall". A set of rules that prevent information from flowing between different departments of the same institution.

Closely held corporation. A firm that belongs to a single owner or is controlled by a few investors.

Co-insurance. A deposit insurance system in which only a proportion - say, 80 or 90 per cent - of eligible deposits would be insured, so that the depositor would bear some risk. Under some proposals, co-insurance would apply only to deposits above a certain minimum.

Conflict of interest. A situation in which the interest of one person and the interest of someone else (including a financial institution) acting on behalf of that person are at variance. Such a situation can also occur when someone, acting on behalf of several customers whose interests are at variance, must choose (or at least has the opportunity to choose) to serve the interest of one over the interest of the others.

Conglomerate. An organization that offers financial products unrelated to each other; for example, an institution that offers brokerage and insurance services, and accepts deposits, would be a conglomerate. According to such a definition, Schedule A banks, trust companies, and financial cooperatives are conglomerates.

Contestable market. A market into which there is a freedom of entry and from which exit is absolutely costless.

Contingent liability. A commitment to make a payment that is contingent on a specified event taking place - e.g., a guarantee that a loan would become payable by the guarantor in the event that the borrower were to default.

Corporate governance. A form of regulation internal to the institution. The management and directorate of a financial institution are structured, and internal rules and regulations are formulated, so as to achieve the desired corporate behaviour. An example is the institution of, and powers given to, committees of boards of directors to supervise various aspects of the business of financial institutions. Audit committees and committees to oversee non-arm's-length transactions are cases in point.

Cross-lending. Lending by one member of a financial holding group to another member of the same group.

Cross-referral. The referral of potential customers by one institution to another, for further servicing of their needs.

Cross-selling. A form of networking in which the agent of one financial institution sells the products of another institution.

Direct government regulation. An approach to regulation in which the rules and regulations governing the behaviour of financial institutions are set down in law by government, and government officials ensure compliance with those rules. The *Bank Act*, the operations of the Office of the Inspector General of Banks and of the Ontario *Loan and Trust Corporations Act*, and the Ontario Ministry of Financial Institutions are examples.

Discount broker. Discount brokers buy and sell securities for their clients at a reduced rate of commission. Unlike full-service brokers, discount brokers do not provide investment advice.

Distribution level. The level at which a financial product is sold to the customer. Insurance and mutual fund salesmen, branches of banks, or trust companies are part of the distribution level.

Early-warning system. A system involving a set of monitoring arrangements, normally based on data supplied by financial institutions and designed to indicate to regulators at an early stage when solvency problems in an institution are beginning to develop. The early-warning system focuses on a number of critical variables, such as capital adequacy, asset quality, management ability, earnings, and liquidity.

Electronic transfer of funds. The transfer of funds between financial institutions by telephone, linked computers, or other electronic means, rather than by means of a written payment order.

Estate, trust, and agency business. The business of trust companies in which they act as trustees for the estates or trust funds of individuals or corporations, and over which they hold varying degrees of discretionary power. The ownership of assets held in trust remains with the estate or trust and not with the trustee. Corporate trustee activity also includes serving as transfer agents and registrars for public corporations.

Exempt-securities market. A market for securities that are exempt from regulation by a securities commission; for example, in Ontario and most other provinces, a securities firm or any financial institution that engages in transactions on government securities or in deals with a value in excess of $97,000 is not required to operate under registration.

Financial futures. A contract that entitles the holder to purchase or sell a security for an arranged price, at a specified time in the future.

Financial holding company. A company whose assets are composed mainly of shares in other financial institutions. Royal Trustco and Montreal Trustco are examples of a financial holding company.

Financial holding group. A group consisting of a holding company that has controlling interest in two or more financial companies operating in different areas of the financial system - e.g., trust companies, life insurance companies, mutual funds, investment counsellors, general insurance companies, and sometimes investment dealers and banks. The financial activities of the subsidiaries are usually more important than those of the parent holding company. Trilon and Power Financial are examples of a financial holding group.

Floating-rate preferred share. A share whose dividends are fixed at about 65 to 75 per cent of the prime interest rate and whose price thus fluctuates very little. A floating-rate preferred share has the appearance of a bond, but from the point of view of the shareholders, the income generated from such shares is not declared as interest income (as in the case of a bond) but rather as a dividend that entitles the holder to a dividend tax credit.

Function. An activity or group of activities in which a financial institution or financial intermediary is engaged, characterized by a set of criteria that distinguishes it from others. These criteria involve specific management or accounting techniques, specific markets, and/or specific risks. Examples of functions are: banking, as defined by the supplying of the means of payment; insurance; and securities dealing and trading. The first two examples are functions defined with respect to the special characteristics of the liabilities of the institutions involved.

Grandfather clause. A clause that exempts an institution from abiding by newly introduced legislation, on the grounds that it was legally engaged in the now-prohibited activity before the law changed.

Interest-rate swaps. A transaction in which the borrower trades the terms of his debt obligation with another borrower (e.g., floating-rate debt for fixed-rate debt); but the principal of the loan is not exchanged.

Intermediation of funds and risks. The transferring of funds between two economic units, individuals, firms, institutions, or governments. When the transfer involves an intermediary that, in the process, issues a claim on itself, it is called "financial intermediation." Banks are involved in financial intermediation by raising funds through deposits - a claim on themselves. When it involves an intermediary whose only role is to bring the two parties together, it is called "market intermediation." Securities brokers are involved in market intermediation.

Inventories. Goods held by a firm, for sale or use at a later date.

Junk bonds. High-yielding bonds that are issued by companies with a low credit rating or by companies wishing to finance highly levered takeovers.

Lender of last resort. An institution, such as the Bank of Canada, that provides liquidity to financial institutions that are otherwise solvent but cannot obtain needed funds from other sources.

Level playing field. A situation in which all the institutions involved in similar activities are subject to the same rules (e.g., the same reserve requirements apply to all deposit-taking institutions).

Leverage ratio. The ratio of an institution's liabilities to its capital base.

Means of payment. Any instrument widely accepted in payment for goods and services and for discharge of debt and other kinds of business obligations. The means of payment include currency and deposits redeemable or transferable on demand. In future, units in security pools may become a means of payment.

Networking. An arrangement whereby one institution provides facilities to sell the products of another institution. This may be accomplished by the one institution leasing physical space to the other institution or by cross-selling.

Non-arm's-length transaction. A transaction between two related parties; for example, a financial transaction between two institutions associated through ownership links or between an institution and its owners, directors, or managers.

Nonmarketable instruments. Financial instruments for which there are no secondary markets where they can be bought or sold after having been issued; personal and business loans are current examples.

Note-issuance facility (NIF). An agreement between a corporation and a bank, whereby the corporation may issue short-term paper (notes) in its own name and the bank is committed either to purchase any notes that the corporation is unable to sell, or to provide standby credit.

One-stop financial shopping. A system whereby a customer can handle all of his financial affairs under one roof. A one-stop financial centre would gather in one location institutions offering deposits, loans, insurance services, securities trading, fiduciary services, financial-planning services, and so on.

Option contracts. A contract that allows the holder to buy or sell a specified quantity of a specific asset at an arranged price.

Option demand. A situation in which a person or business may want access to a particular service but does not want to purchase it now. Accordingly, the customer would be willing to pay a small fee in order to secure access to the service at a later time.

Predatory pricing. The practice of setting a relatively low price with the intent of damaging a competitor.

Production level. The level within a financial institution at which a financial instrument is designed, adapted to the specific needs of customers, and managed.

Pyramiding of capital base. A situation in which the common stock or subordinated debt eligible to be counted as part of the capital base of a financial institution is owned by another financial institution but not deducted from the capital base of the owning institution.

Reciprocity. In trade negotiations, reciprocity implies an exchange of concessions to the mutual, equal advantage of each party. This should be distinguished from national treatment, where one country's institutions are treated in another country the same as the latter's domestic institutions.

Registered retirement savings plan (RRSP). A savings vehicle that benefits from special tax treatment. Contributions to such vehicles - up to a certain amount annually - are deductible from taxable income, and interest is not taxable on accrual.

Retail banking. The most widely known form of banking, which involves the provision of a wide range of financial services to consumers and small businesses.

Risk-related premiums. Premiums for deposit insurance that are set according to the riskiness of the insured institution; as a result, higher-risk institutions pay higher premiums.

Securitization. A process whereby car loans, mortgage loans, or operating loans are bundled together in security pools, units of which are sold to private or corporate investors.

Self-dealing. A situation that occurs when a conflict of interest results in a harmful non-arm's-length transaction for the sole advantage of the person or institution making the decision.

Self-regulation. An approach to regulation in which an association of financial institutions sets out rules and regulations by common agreement and assumes the enforcement power. The rules and regulations applying to members of the various stock exchanges are an example of self-regulation.

Short-term deferred annuities. Annuity contracts issued by life insurance companies, in which the annuity payment is deferred, thereby making the contracts very similar to term deposits.

Stabilization fund. A fund set up and administered by either a provincial government or a financial cooperative central to assist financial cooperatives in difficulty and to act as a guarantor of deposits.

Stripped bonds. Bonds in which the interest coupons have been separated from the principal.

Subordinated debt. Debt, usually in the form of bonds or debentures, that holds an order of priority in the event of a firm's failure or in the payment of interest, above shareholders' equity but below other debt.

Syndicated loans. Loans that, because of their large size, have been undertaken by a group of financial institutions called a syndicate.

Tied-selling. A transaction in which a customer is required to purchase a second service as a condition of purchasing the first.

Underwriting. The process by which securities (bonds or stocks) or insurance policies are issued.

Universal life policies. Life insurance contracts, with premiums that may be variable at the discretion of the insured and that separate the savings component from the insurance component. In effect, the insured buys a term life-insurance policy and a mutual-fund-like instrument at the same time. Once the premiums for the face value of the policy, based on the company's current rates, have been deducted from the premium payments made by the insured, the balance is invested in (or any deficit is made up out of) the savings component, on which interest accrues at current rates.

Wholesale deposits. Deposits that are placed with a financial institution by deposit brokers or by large institutions. The financial institution pays a commission to the brokers who obtain deposits for them.

Widely held corporation. A firm whose shares are distributed among a large number of investors, with no single shareholder having a controlling interest.

Workout procedures. The revision to the terms of a non-performing loan, including the extension of the maturity date and the granting of additional credit, in order to assist the borrower during a difficult period and to reduce the loss to the lender by as great an amount as possible.

Notes

CHAPTER 1

1 It is only recently that mortgage-backed securities, which have been in existence in the United States for some time, were introduced in Canada.

2 Department of Finance, *The Regulation of Canadian Financial Institutions: Proposals for Discussion* (Ottawa: Supply and Services Canada, April 1985), known as the Green Paper.

3 W. R. Wyman, Chairman, *Final Report of the Working Committee on the Canada Deposit Insurance Corporation (CDIC)* (Ottawa: Supply and Services Canada, April 24, 1985).

4 D. Blenkarn, Chairman, *Canadian Financial Institutions*, Report of the House of Commons Standing Committee on Finance, Trade and Economic Affairs, November 1985.

5 Senate of Canada, *Deposit Insurance*, Tenth Report of the Standing Committee on Banking, Trade and Commerce, December 1985.

6 Ontario Task Force on Financial Institutions (J. S. Dupré, Chairman), *Final Report*, December 1985.

7 Senate of Canada, *Towards a More Competitive Financial Environment*, Sixteenth Report of the Standing Committee on Banking, Trade and Commerce, May 1986.

8 The Honourable Willard Z. Estey, Commissioner, *Report of the Inquiry into the Collapse of the CCB and Northland Bank* (Ottawa: Supply and Services Canada, 1986).

9 See A. Ryba, "The role and efficiency of the financial sector: From theory to reality," a background paper prepared for the Economic Council of Canada, 1986.

10 At the time of writing, the number of Schedule A banks was down to 10, following the completion of mergers in early 1986.

"Total assets" include those booked in Canada, as well as abroad. The relative importance of groups of institutions is slightly different when only the assets booked in Canada are considered. Schedule A banks accounted for about 43 per cent of the domestic assets of financial institutions at the end of 1985; Schedule B banks, 4.0 per cent; trust companies, 9 per cent; life insurance companies, 10 per cent; local credit unions, 6.5 per cent; property and casualty insurance companies, less than 3 per cent; and investment dealers, less than 2 per cent.

11 The role of government in providing financial services has been discussed in a previous Council report, *Intervention and Efficiency: A Study of Government Credit and Credit Guarantees to the Private Sector* (Ottawa: Supply and Services Canada, 1982).

12 The 1980 revision to the *Bank Act*, a product of the 1970s, encouraged further competition by lowering reserve requirements for banks, allowing the entry of foreign banks on a limited basis, permitting the incorporation of new banks through letters patent, and establishing the Canadian Payments Association – a clearing facility of which all deposit-taking institutions could become members.

13 The marginal tax rate on personal real income declined from an average of 30.2 per cent in the 1960-70 period to 15.6 per cent in the 1970-80 period; see Economic Council of Canada, *Steering the Course*, 21st Annual Review (Ottawa: Supply and Services Canada, 1984).

14 Economic Council of Canada, *Strengthening Growth: Options and Constraints*, 22nd Annual Review (Ottawa: Supply and Services Canada, 1985), Chapter 5.

15 In 1983, Bank of America acquired Charles Schwab and Company, the largest discount brokerage firm in the United States. In 1982, Security Pacific purchased Kahn and Company, a Memphis-based discount brokerage firm. In 1981, Prudential acquired Bache Halsey Stuart Shields. In a single week in 1981, Dean Witter Reynolds, one of the largest securities firms, and Coldwell Banker, the largest real estate broker, were acquired by Sears Roebuck to add to its already-owned Allstate Insurance and Allstate Savings and Loans. This was followed by the opening of Sears financial centres in many of its stores.

16 With whole-life policies that included a saving component, companies were realizing most of their returns on the spread between what was being paid to the policyholder and the earnings from the investment of the saving component. Because of developments in the savings market in the wake of high and volatile interest rates and because of the greater sophistication of individual investors, long-term fixed contracts were no longer a satisfactory savings vehicle. Life insurance companies had to separate the saving from the insurance component in their new universal life policies, and, in the process, their main source of income suffered a serious decline. They also reacted to the loss of their traditional line of business by offering short-term deferred annuities.

17 Recently, the Toronto-Dominion Green Line Service heralded the entry of banks into discount brokerage; the Royal Bank is currently offering a similar service. Also, the Royal Bank is now offering, to customers who obtain a loan for the purchase of a new car, insurance covering the difference between the car's replacement value and the amount paid by insurance companies in the event of a total loss by accident in the first year. This may, however, be viewed as an extension of the offering of insurance services tied to the lending activity of banks. Indeed, banks have been offering life insurance in connection with personal and mortgage loans.

18 For more information on financial holding companies, see A. Ryba and M. Scinocca, "Financial holding companies," a background paper for the Economic Council of Canada, 1986.

19 The Banque Populaire merged with the Provincial Bank of Canada in 1970; the Unity Bank was amalgamated with the Provincial Bank in 1977; and the Provincial Bank and Bank Canadian National merged in 1979.

20 Financial innovation may take place to lower the cost of regulation or to lower the cost of business; see Yoshio Suzuki, "Financial innovation in Japan," 1985.

21 Manufacturers Life Capital Corporation, a subsidiary of ManuLife, issued nine million such shares for a total value of $225 million. The proceeds were used to purchase first preferred shares of Manufacturers Life Property Corporation, another ManuLife subsidiary. The latter applied the proceeds to the acquisition of a real estate portfolio from ManuLife for an aggregate cost of about $378 million. The balance of the acquisition cost was provided by the issuance of common shares and subordinated indebtedness of Manufacturers Life Property to Manufacturers Life Insurance and the assumption of existing mortgages.

22 This section is largely based on Ryba, "Role and efficiency of the financial sector."

23 From a private perspective, efficiency is attained when a private decision-making process leads to the allocational and operational efficiency of the financial sector. "Allocational efficiency" requires that the financial system collect and channel funds in accordance with expected risk/return combinations. "Operational efficiency" requires that the four roles be performed at minimal cost. For a financial system to be efficient from the point of view of society, it should provide means of payment that are commensurate with the needs of the economy, as well as access to all its services for all Canadians. See Ryba, "Role and efficiency of the financial sector."

Chapter 2

1 The central bank's role in the regulation of the money supply transcends the financial system. This has more to do with the global regulation of economic activity and is not considered here.

2 Parliament has indirect powers to regulate some aspects of securities transactions - through the Criminal Code, for example.

3 For a detailed discussion of the "regulation of trade and commerce" and the "peace, order and good government of Canada" powers, see P. Anisman and P. W. Hogg, "Constitutional aspects of federal securities legislation," in *Proposals for a Securities Market Law for Canada*, vol. 3 (Ottawa: Consumer and Corporate Affairs Canada, 1979), pp. 157-161, 177-186.

4 W. Moull, E. Waitzer, and J. Ziegel, "The changing regulatory environment for Canadian financial institutions: Constitutional aspects and federal-provincial relations," in *Canadian Financial Institutions: Changing the Regulatory Environment*, ed. J. Ziegel, L. Waverman, and D. Conklin, (Toronto: Ontario Economic Council, 1985), p. 113.

5 Inevitably, Canada's securities-trading system has become more automated. Because automation involves the implementation of sophisticated communication networks between provinces, it is appropriate to conclude that this would undoubtedly constitute an interprovincial undertaking within federal jurisdiction, under section 92(10). For a detailed discussion of "works and undertakings," see Anisman and Hogg, "Constitutional aspects," pp. 171-76.

6 Anisman and Hogg, "Constitutional aspects," p. 144.

7 Moull, Waitzer, and Ziegel, "The changing regulatory environment," p. 105.

8 P. W. Hogg, *Constitutional Law of Canada* (Toronto: Carswell Company Limited, 1977), p. 531.

9 *Re Bergethaler Waisenamt*, ([1949] 1 D.L.R. 769).

10 Hogg, *Constitutional Law*, p. 532.

11 From *Attorney-General for Alberta v. Attorney-General for Canada* [1947], A.C. 503 (M.2), at 517.

12 Hogg, *Constitutional Law*, p. 528.

13 Hogg, *Constitutional Law*, p. 530.

14 Schedule A banks are widely held domestic institutions. Schedule B banks are closely held institutions. Until 1986, there was only one domestic Schedule B bank (now merged with a foreign-bank subsidiary); the others were all foreign subsidiaries.

15 Office of the Inspector General of Banks, "Submission to the Commission of Inquiry on Certain Banking Operations" (prepared by Campbell, Godfrey & Lewtas), December 1985, pp. 41-43, passim.

16 The provisions of those sections are too numerous to discuss; for more information, see the brief overview in OIGB, "Submission," pp. 43-45.

17 OIGB, "Submission," p. 4.

18 It is, of course, for the courts to decide whether a manager really showed enough expertise or provided for an adequate rate of return on an investment.

19 Legislative authority to regulate the securities markets lies within provincial jurisdiction under section 92(13) of the *Constitution Act*, which relates to "property and civil rights." This has been interpreted by the courts as the authority to regulate securities markets. For example, "in 1932 the Privy Council upheld the Alberta Security Fraud Prevention Act of 1930 as a valid exercise of provincial jurisdiction intended to protect local investors from fraudulent practices and the case, now the leading decision in the field, has been broadly read so that in most instances in which a question concerning the validity of a Securities Act has arisen, the provincial legislation has been upheld"; see Anisman and Hogg, "Constitutional aspects," p. 144. More recently, in 1982, the Supreme Court of Canada stated that "it is well established that the provinces have the power, as a matter of property and civil rights, to regulate the trade in corporate securities in the province"; see M. J. Dymond, "Jurisdictional aspects of Ontario's regulation of financial institutions,"

a staff paper prepared for the Ontario Task Force on Financial Institutions, Toronto, May 1985.

20 P. Anisman, "The regulation of the securities market and the harmonization of provincial laws," in *Harmonization of Business Law in Canada*, vol. 56, Studies of the Royal Commission on the Economic Union and Development Prospects in Canada (Ottawa: Supply and Services Canada, 1986), p. 119.

21 Any company planning a public issue of debt or equity has to provide a certain amount of information on its finances and its operations, as well as the intended use of the funds to be raised by the issue, in a document called a "prospectus."

22 Dominion Bureau of Statistics, *Canada Year Book* (Ottawa: King's Printer, 1925), pp. 711-12.

23 This is true for any trust manager, including a trust company.

24 Ontario Task Force, *Final Report*, p. 43.

25 Dymond, "Jurisdictional aspects," p. 41. Dymond illustrates the problems created by the presence of different provincial regulatory regimes in the trust industry.

26 Anisman, "Regulation of the securities market," p. 127.

27 Anisman, "Regulation of the securities market," p. 81.

CHAPTER 3

1 Economists assess the degree of competition by looking at the number of firms in a market, their pricing behaviour, and their profitability. A competitive situation is said to exist when the revenues of firms are just enough to cover all costs, including the cost of capital and of management - the so-called "zero-profit" situation. Because of the difficulty in determining whether prices are above their competitive level and whether profits are abnormally high, analysis has often focused on market concentration and on factors that contribute to competitive behaviour, such as freedom of entry.

2 The Cadillac Fairview Corporation Limited, "A brief on the Green Paper: The regulation of Canadian financial institutions," Ottawa, August 1985, pp. 12 and 13.

3 Ontario Task Force, *Final Report*, p. 57.

4 G. Lermer, "Regulation of conflicts of interest and self-dealing in the Canadian financial services market," a background paper prepared for the Economic Council of Canada, 1986, p. 67.

5 In a study by the Department of Consumer and Corporate Affairs, the degree of concentration is determined by the number of companies that account for 80 per cent of the output or employment of an industry. The degree of concentration is "very high" when that number is four or fewer; "high" with five to eight; "relatively high," with nine to 20 companies; "relatively low," with 21 to 50 companies; and "low," with more than 50 companies.

6 Five groups of institutions were considered in our analysis - namely, chartered banks (Schedule A and Schedule B), trust and mortgage loan companies, life insurance companies, and financial cooperatives. The other institutions are not involved to any large extent in the deposit, mortgage, or business-loan market for which the concentration analysis was performed. Several different calculations were made. The first took into account obvious ownership links that would bring together the mortgage-loan subsidiaries of banks and trust companies with their parent - for example, the Montreal Trust Company and the Montreal Trust Corporation. A second calculation took into account the ownership links between companies on the basis of the "Calura book" (Statistics Canada, *Intercorporate Ownership*, Cat. 61-517, 1985). A distinction was made between "obvious ownership links" and "full ownership links," as information on the latter was not available for 1967. A third calculation considered as one unit the various companies that belong to a holding group; for example, Royal Trust and London Life were put together with Trilon. All these calculations took into account the total assets and the domestic assets of the institutions, for 1979 and 1984. Calculations were also done adding the estate, trust, and agency (ETA) business to the trust companies. For more detail, see A. Mayrand, "Diversification, concentration et concurrence au sein de l'industrie des services financiers," a background paper prepared for the Economic Council of Canada, 1986. This paper also provides other measures of concentration.

7 These calculations, and all the others reported in the following pages, take into account full ownership links and holding groups.

8 The "Herfindahl index" (the sum of the squares of each firm size, expressed as a ratio of total industry size) is a more sophisticated measure of concentration. It takes into account both the number of firms in an industry and their relative size. Had it been used instead of the "inverse index" (the number of companies required to account for 80 per cent of the value of the industry) or the "industry concentration ratio" (the percentage of the value of the industry accounted for by the four largest companies), the results would have been largely similar: in 1967, the Herfindahl index was 6.93; in 1979, it was 9.07; and in 1984, it was 8.07, showing that concentration of assets increased between 1967 and 1979 and declined thereafter.

9 Trusteed pension plans are also lenders on mortgage markets but they have not been included in the analysis. In 1984, they globally accounted for only 2.2 per cent of mortgage loans outstanding, and it is very unlikely that they would rank among the 20 to 30 largest mortgage lenders.

10 G. D. Quirin and W. R. Waters, "Competition, economic efficiency and profitability in the Canadian property and casualty insurance industry," a study prepared for the Insurance Bureau of Canada, January 1982.

11 Considering only some ownership links, the four largest companies in the mortgage market were Sun Life, London Life, Canada Permanent Mortgage, and Manufacturers Life in 1967; the Royal Bank; the Royal Trust; the Canada Trust and the Canadian Imperial Bank of Commerce (CIBC) in 1979; and the Royal Bank, the CIBC, the Bank of Montreal, and the Royal Trust in 1984. Taking into account full ownership links, the four largest companies were: in 1979, the Royal Bank, the Royal Trust, the Canada Trust, and the CIBC; and in 1984, the

Royal Bank, the CIBC, the Bank of Montreal, and the Royal Trust.

12 See the Glossary for a definition of "contestable market." An exposition of the theory of contestable markets can be found in W. G. Baumol "Contestable markets: An uprising in the theory of industry structure," *American Economic Review* (March 1982).

13 The Hongkong Bank of Canada is an exception, with 17 branches across the country, including those in Red Deer and Grande Prairie in Alberta, and in Nanaimo, Prince George, and Kamloops in British Columbia. The Banque Nationale de Paris also has branches in smaller cities - namely, Sherbrooke, Trois-Rivières, and Quebec City.

14 Although financial institutions pay interest on deposits, the difference between the rate paid on deposits and what is received on risk-free investments can be thought of as revenue received in exchange for liquidity and other services provided by the deposit-taking institution to its deposit customers.

15 The discussion of diversification is based largely on Mayrand, "Diversification, concentration et concurrence."

16 A distinction should be made between a financial holding company and a financial holding group; see Glossary. See, also, Ryba and Scinocca, "Financial holding companies."

17 Eaton Financial Services have recently been acquired by the Laurentian Group. The comments in this chapter are based on observations made prior to that transaction.

18 Studienkommission 'Grundsatzfragen der Kreditwirtschaft,' "Basic banking questions: A summary" [of the report of the West German commission of enquiry into banking], Bonn, May 1979.

19 Some individual counsellors even had rates of return of between 12 and 27 per cent. The figures on investment counsellors were provided by Pension Finance Associates of Toronto. For more information on performance and, in particular, the operation of investment counselling firms, see M. Scinocca, "Investment counsellors: A specialized group that has found a niche," a background paper prepared for the Economic Council of Canada, 1986.

20 Royal Commission on Corporate Concentration (Robert B. Bryce, Chairman), *Report* (Ottawa: Supply and Services Canada, 1978), pp. 116 and 118.

21 Economic Council of Canada, *Efficiency and Regulation: A Study of Deposit Institutions* (Ottawa: Supply and Services Canada, 1976).

Chapter 4

1 Only coins and bank notes are legal tender - i.e., they cannot be refused by law for the purchase of goods and services and for the liberation of debt. But they constitute only a small proportion of the total means of payments available. Although cheques and bank transfers of funds are often viewed as means of payment, it is really the underlying deposits that are the means of payment; the cheque is just a method of utilizing the means of payment, like a wallet is used to carry cash.

2 E. Hannah, C. Horner, and T. Smee, "The causes of insolvency: An analysis of Canadian and American incidents of insolvency," a background paper prepared for the Ontario Task Force on Financial Institutions, January 1986.

3 See H. H. Binhammer, "Depository institutions: Risk and insolvencies," a background paper prepared for the Economic Council of Canada, 1985, pp. 5-6.

4 See D. Albert, "Institutions financières et insolvabilité : facteurs explicatifs," a background paper prepared for the Economic Council of Canada, 1986.

5 Estey, *Report*, p. 182.

6 Hannah, Horner, and Smee, "Causes of insolvency."

7 Mayrand, "Diversification, concentration et concurrence."

8 See Binhammer, "Depository institutions," p. 20.

9 Hannah, Horner, and Smee, "Causes of insolvency."

10 Simply stated, the "duration" of an asset is defined as a weighted average of the number of times in the future when interest and principal payments are to be received. This measure was introduced because of the problems associated with different price movements for assets or liabilities bearing different interest rates. For this reason, the matching of assets and liabilities according to their respective maturities was inappropriate. In reconciling assets with liabilities of the same duration - that is, with a "zero duration gap" - an institution protects its net worth against changes in interest rates. The gap measure can also be used to facilitate the control of interest-rate risk. The gap is the difference between rate-sensitive assets and rate-sensitive liabilities, expressed either in dollar terms or as a percentage of total earning assets. But uncertainty remains with respect to the capacity to restructure assets and liabilities to achieve fully and simultaneously a zero gap or a zero duration level in order to secure a full immunization. The fact that financial instruments are not readily convertible to achieve a planned immunization strategy is part of this weakness. To overcome this, financial institutions can use financial futures, or options, to hedge interest-rate risk. Options are contracts between two parties to sell (or to buy) a financial instrument at some future date at a price agreed upon now but paid in the future, at time of delivery. Options can immunize an institution from interest-rate changes by offsetting a potential loss (gain) of net interest income or net worth with a potential gain (loss) from options trading. All these measures, in turn, can be used and are, indeed, widely used by managers to develop appropriate asset/liability strategies, thereby ensuring the stability of the institution. See, also, Binhammer, "Depository institutions."

11 Estey, *Report*, p. 181.

12 The capital base of a financial institution consists of the paid-up capital stock plus contributed surplus and reserves (usually referred to as shareholders' equity), plus subordinated debt, in some instances.

13 Hannah, Horner, and Smee, "Causes of insolvency."

14 James A. Morrison, *Report of the Special Examination of Crown Trust Company, Greymac Trust Company, Seaway Trust Company, Greymac Mortgage Corporation and Seaway Mortgage Corporation*, to the Honourable Robert G. Elgie, M.D., Minister of Consumer and Commercial Relations, Province of Ontario, June 1983, p. 239.

15 Lermer, "Regulation of conflicts of interest," p. 63.

16 Estey, *Report*, p. 262.

17 See Lermer, "Regulation of conflicts of interest."

18 Theoretically, at least, a solvent institution should be able to cope with a massive withdrawal by selling off some of its assets. But, in reality, assets cannot be sold off fast enough to match the withdrawal of deposits, and information on the soundness of the institution may not be available, or available in suitable form, to convince depositors to leave their money with the institution - hence the role of deposit insurance.

19 The insurer may also allow insured depositors to gain immediate access to their funds in another institution.

20 Credit-union stabilization funds have generally been able to rehabilitate member institutions facing financial difficulties, and members have always recovered all their funds.

21 Under this system, the examiner of a member dealer is required to report operating losses in excess of net free capital should that occur during two successive months.

22 OIGB, "Submission."

23 Estey, *Report*, p. 251.

24 Binhammer, "Depository institutions," p. 48; Recommendation 14 of the Estey Commission reinforces this.

Chapter 5

1 Binhammer, "Depository institutions."

2 Studienkommission, "Basic banking questions."

3 Studienkommission, "Basic banking questions," p. 2.

4 Lermer, "Regulation of conflicts of interest," p. 29.

5 See, for example, Department of Finance, *Regulation of Canadian Financial Institutions* [the Green Paper], pp. 33 and 36-37.

6 A mortgage loan secured by an overvalued piece of property, if granted to an independent party, is just a bad loan.

7 For example, after Genstar purchased Canada Permanent in 1981, a number of related-party transactions took place between these two companies. The Permanent had selectively purchased from Genstar or its affiliates mortgages on serviced residential properties sold to Genstar by third parties. The aggregate value of these loans from 1982 to the end of 1985 was approximately $43 million. The decisions to purchase them were made by The Permanent in accordance with its customary review procedures, and Genstar agreed in the sales contract to repurchase any mortgage that went into default. Canada Permanent Realty Ltd. (now called Sutter Hill Developments), a wholly owned subsidiary of Canada Permanent, purchased the fully operational Lime Ridge Mall Shopping Centre in Hamilton from Genstar for $72 million. This property was sold shortly thereafter to a third party, with a capital gain of about $5.4 million. Genstar had leased equipment from Canadian Dominion Leasing Corporation (a Bank of Montreal subsidiary) for a number of years. After acquiring The Permanent, Genstar felt that its new subsidiary should get involved in this activity. Unable to enter directly into the domain of financial leasing, The Permanent lent $63 million to Canadian Dominion Leasing Corporation, and this amount was applied to the purchase of heavy construction equipment to be leased to Genstar. The loan made by The Permanent was guaranteed by the Bank of Montreal. All of these non-arm's-length transactions appear to have been beneficial to The Permanent.

8 The potential loss to minority shareholders as a result of self-dealing is illustrated by the controversy over a recent Trilon stock issue from which the Great Lakes Group, a distant Trilon affiliate, is alleged to have benefited. See *The Globe and Mail*, Toronto, 12 April 1986, p. B-2.

9 C. E. Corrigan, "Are banks special? A summary," in Federal Reserve Bank of Minneapolis, *Annual Report*, 1982.

Chapter 6

1 This chapter focuses on the needs of individuals and businesses, and leaves governments aside. Government financing was considered in the Council's 21st Annual Review, *Steering the Course*.

2 The figures for individuals also include unincorporated businesses; as a consequence, mortgage financing may include some financing of unincorporated businesses, secured by real estate.

3 The Toronto Stock Exchange, *Canadian Shareowners: Their Profile and Attitudes* (Toronto: TSE, April 1984).

4 Canadian Bankers' Association, *Bank Facts*, 1986.

5 Canadian Life and Health Insurance Association, *Canadian Life Insurance Facts*, 1985.

6 The TSE, *Canadian Shareowners*.

7 The Canadian Association of Financial Planners does publish a code of ethics that sets out the planner's obligations to his or her clients, but the association has little power to enforce its code. Furthermore, not all financial planners belong to the association.

8 In West Germany, a substantial number of "universal" banks provide for most, if not all, of the needs of savers and investors; in particular, they engage in underwriting and securities dealing. Individuals seldom deal with one institution for one type of service and with a second institution for other services. Thus, once a bank has secured the business of an individual, it has little incentive to direct him to instruments other than its own. As a result, stock markets are less developed there, and West Germans invest less in equities than their North American counterparts. By contrast, Canadian banks, trust companies, life insurance companies, credit unions, and investment dealers compete for savings dollars in a number of distinct

markets. Investment dealers contribute to the development of the securities market by bidding the savings dollar away from deposits and mutual funds.

9 Economic Council, *Steering the Course*.

10 These problems were discussed in the Council's previous report, *Intervention and Efficiency*, Chapter 3.

11 Another explanation may be the lack of a strong explicit demand for equity financing. But there is definitely a "pent-up" or "option" demand for it; see Ryba, "Role and efficiency of the financial sector."

12 The distance travelled to obtain the services of a retail banking outlet is an important aspect of how well the population is served and, particularly, of the choices that are available to customers.

In Newfoundland, most of the branches are located around the perimeter of the island, where the majority of the population lives. Most residents in the southeast corner are within 30 kilometres of a branch, while residents of other sections of the perimeter may have from 40 to 60 kilometres to travel. Residents of the interior may have to travel up to 80 kilometres or more. Retail outlets are well scattered over Prince Edward Island and Nova Scotia, so that almost all residents are within 20 to 30 kilometres of an outlet. Distances are a bit greater in north-central New Brunswick, but not excessive. In the southern parts of Ontario and the Montreal-Québec axis, most residents are within 15 to 20 kilometres of a retail outlet; however, in the sparsely populated northern regions, isolated residents may have to travel several hundred kilometres. Local concentrations of population, however, usually have a branch of one of the institutions.

In the Prairie region, southern Manitoba, Saskatchewan, and Alberta have branches fairly regularly spaced but farther apart than in southern Ontario; a distance of 80 kilometres between branches is not uncommon. In the northern regions, branches may be several hundred kilometres apart. In British Columbia, the majority of the branches are concentrated in the southwestern corner of the province. Branches may be several hundred kilometres apart in the northern region, and even in the more southeastern regions the distances between branches can be greater.

13 For more details on the role played by financial cooperatives and on their historical development, see D. Albert, "Les coopératives financières au Canada," a background paper prepared for the Economic Council of Canada, 1986.

14 Although the branches of trust companies in smaller localities do not usually have a trust officer on staff, arrangements can be made, through the retail-banking branch of the company, for a trust officer to visit the branch or to meet with the customer at some other place. Most smaller communities do not have branches of trust companies, however.

15 Contingency funds are considered here in the role of protecting consumers - not as contributing to confidence in the system, which was considered in Chapter 4.

16 These are: the British Columbia Credit Union Reserve Board; the Alberta Credit Union Stabilization Corporation; the Saskatchewan Mutual Aid Board; the Manitoba Credit Union Stabilization Fund; the New Brunswick Credit Union Stabilization Fund; the Nova Scotia Credit Union Stabilization Fund; the Prince Edward Island Stabilization Fund; the Corporation de fonds de sécurité de la Confédération Desjardins; and the Ontario Stabilization Fund Corporation.

17 Wyman, *Final Report*. The Estey Commission recommended further study on the matter.

List of Tables and Figures

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Figures

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