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THE CANADIAN FINANCIAL SERVICES SECTOR: COMPARISON OF REPORTS AND THE POLICY FRAMEWORK ON ITS FUTURE

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THE CANADIAN FINANCIAL SERVICES SECTOR: COMPARISON OF REPORTS AND THE POLICY FRAMEWORK ON ITS FUTURE

INTRODUCTION

On 1 June 1992, the federal government proclaimed its new legislative framework for federally regulated financial institutions: banks, trust companies, insurance companies and the national organization of the credit union movement. The new legislation changed the landscape within which federally regulated financial institutions operate. New powers were introduced, changes were made to the ownership regimes, and new prudential safeguards were put in place.

On 18 December 1996, the Minister of Finance announced the mandate and composition of the Task Force on the Future of the Canadian Financial Services Sector. The Task Force was asked to advise the government on what needs to be done to ensure that the Canadian financial system remains strong and dynamic.

In September 1998, the Task Force released its final report, which contained 124 recommendations along four major themes: enhancing competition and competitiveness, improving the regulatory framework, meeting Canadians' expectations, and empowering consumers.

Two parliamentary committees -- the House of Commons Standing Committee on Finance and the Standing Senate Committee on Banking, Trade and Commerce -- scrutinized the report of the Task Force. Both committees conducted extensive public hearings and, in December 1998, issued their respective reports.

Following upon these reports, in late June 1999, the Minister of Finance released the federal government White Paper, *Reforming Canada's Financial Services Sector: A Framework for the Future*. The White Paper outlines the government's vision for the future of the financial services sector.

This paper will compare the recommendations of the Task Force on the Future of the Canadian Financial Services Sector with the response of the House of Commons Standing Committee on Finance in its report *The Future Starts Now*; the recommendations of the Standing Senate Committee on Banking, Trade and Commerce in its report *A Blueprint for Change*; and the financial services sector reform proposals made by the Government of Canada in the White Paper *Reforming Canada's Financial Services Sector, A Framework for the Future*. The comparison will focus on key areas such as structure, access to the payments system, merger review, regulation, expanded business powers, consumer protection, business practices and accountability, taxation, and accounting rules.

In each case, the analysis will give a brief summary of the recommendations of the Task Force Report, the responses of the Finance Committee and the Senate Banking Committee to the Task Force recommendations, and the proposals made in the White Paper.

STRUCTURE

A. Definition of "Widely Held"

The *Bank Act* sets out the ownership rules for banks, of which one is that Schedule I banks must be widely held. Under current rules, this means that a shareholder cannot own more than 10% of any class of shares. This policy facilitates Canadian control of banks and allows for the continued separation of financial and commercial activity. Schedule II banks, on the other hand, must be controlled by other "eligible" financial institutions. These are generally widely held Canadian or foreign-regulated entities.[1]

The Task Force recommended a continuation of the 10% rule for financial institutions with shareholder equity in excess of $5 billion. This would apply to all large federally regulated financial institutions, not just banks. Under the Task Force proposals, the Minister of Finance would have authority to authorize individual shareholdings up to 20% of any class of shares, provided that all shareholders holding more than 10% of the shares did not collectively own or control more than 45% of the equity. In certain circumstances, a shareholder

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(1) Task Force on the Future of the Canadian Financial Services Sector, *Organizational Flexibility for Financial Institutions: A Framework to Enhance Competition*, Background Paper #2, September 1998, p. 11.

could be permitted to exceed the 20% threshold temporarily, subject to an acceptable divestiture plan and an undertaking not to exercise the voting rights of the shares exceeding the 20% limit. The Task Force saw this 20% limit as a way to facilitate strategic transactions; it was not to be applied to passive investors. The Task Force also recommended that a widely held regulated financial institution incorporated in Canada should be able to own up to 100% of any other regulated financial institution, regardless of size.

The Finance Committee was of the view that control of Canadian financial institutions should remain primarily in Canada. It agreed with the 10% limitation on share ownership for large financial institutions and with the recommendation that the Minister of Finance have discretion to permit ownership up to 20% and beyond, on a temporary basis. The Committee also recommended that the government should establish parameters that would clarify the limits under which the Minister's discretion would be exercised.

The Senate Banking Committee agreed with the Task Force that the largest financial institutions should be widely held. This Committee, however, chose to distinguish between ownership and control; it recommended that no individual or group acting together should control more than 20% of the voting shares and own more than 30% of the equity of a financial institution. Among other things, the Banking Committee felt that a general 20% limit would provide added flexibility for mergers and acquisitions, allow for closer monitoring of management, and eliminate excessive use of ministerial discretion. Furthermore, a 30% limit on equity would allow non-voting shares to be used if a merger or acquisition required more than 20% to be completed.

The White Paper defines "widely held" along the lines recommended by the Senate Banking Committee. Under the White Paper's definition, an investor would be allowed to hold 20% of any class of voting shares and up to 30% of the non-voting shares of an institution that the White Paper proposes must be widely held (banks and demutualized insurance companies with equity exceeding $5 billion). This ownership rule would be subject to a "fit and proper test" which is used to assess the suitability of potential owners. This differs from the Task Force proposal for a 10% limit on portfolio investments and possible holdings of up to 20% in situations where some type of business alliance has been proposed.

B. Ownership Rules

As noted earlier, the current provisions of the *Bank Act* require that all Schedule I banks must be widely held. Trust companies, federal property and casualty insurance companies and stock life insurance companies can be closely held but must have a 35% public float of their voting shares when their equity reaches $750 million.

The Task Force recommended a single set of ownership rules for all federally regulated financial institutions. Institutions with equity in excess of $5 billion would be widely held. Medium-sized institutions with equity between $1 billion and $5 billion would be required to have 35% of their voting shares publicly traded and widely held. The smallest institutions (with equity under $1 billion), however, would be closely held and could have one owner.

The Task Force also recommended that a Schedule I bank that is subject to the 10% ownership rule, but which by virtue of its size would not be subject to the proposed widely held regime, could be recategorized into the class of financial institutions that would apply by reason of its shareholder equity. Thus, banks with equity under $5 billion could move from being widely held to being more closely held.

Both the Finance Committee and the Senate Banking Committee strongly supported a size-based ownership regime for all financial institutions.

The White Paper proposes a set of ownership rules for domestic banks along the lines set out in the Task Force report. Small banks whose equity was under $1 billion would have no ownership restrictions. Medium-sized banks, with equity between $ 1 billion and $5 billion, would be required to have 35% of voting shares publicly traded and widely held. Large banks, those with equity above $5 billion, would have to be widely held. As mentioned earlier, the White Paper uses the term "widely held" to describe the situation in which a shareholder owns no more than 20% of any class of voting shares and no more than 30% of non-voting shares.

Consistent with the Task Force recommendations, the White Paper proposes that existing banks with equity under $5 billion would be able to apply to the Minister of Finance, who would have the discretion to allow them to change their ownership structure in accordance with the proposed regime. Thus, banks with equity between $1 billion and $5 billion could be closely held, subject to a 35% public float rule, or could have no ownership restrictions if their

equity was under $5 billion. Banks that grew from one threshold level to another would have three years to change their ownership status.

The ownership regime set out in the White Paper would also apply to demutualized life insurance companies. Initially, these companies would automatically fall under the widely held rule. After the expiration of a two-year transition period, however, they could apply to the Minister of Finance to become more closely held if their equity fell within the threshold limits permitting close ownership.

Under the White Paper, trust companies, federal property and casualty insurance companies and stock life insurance companies would retain their present ownership rules, with one exception. The threshold at which the 35% public float comes into effect would be increased from $750 million to $1 billion.

The White Paper rejects the concept of a single-ownership regime based upon size for all federally regulated financial institutions. Instead, it would limit the size-based regime to banks and demutualized life insurance companies and continue the existing ownership rules (with a higher threshold for the imposition of the public float requirement) for trust companies, federal property and casualty insurance companies and stock life insurance companies.

The Task Force had proposed elaborate grandfathering rules for institutions such as Canada Trust and Great West Life that would not have conformed to the ownership regime it proposed. By limiting the ownership regime to banks and demutualized life insurance companies, however, the government has avoided the problem of grandfathering such institutions.

C. Holding Companies

Widely held financial institutions such as banks are not permitted to operate under a holding company. They are allowed to own subsidiaries but not to be one.

The Task Force recommended that federally regulated financial institutions should have the option of being organized as subsidiaries of a regulated non-operating financial holding company. The Task Force also proposed that the regulatory requirements applicable to the holding company and its unregulated subsidiaries be as non-intrusive as possible. In

addition, the holding company would be required to have a controlling interest in its principal Canadian operating financial institutions.

The Finance Committee agreed with the Task Force that the use of a financial holding company model would be beneficial to financial institutions. The Committee also recommended that the regulated holding company be subject to as little regulation as possible.

The Senate Banking Committee endorsed the concept of a regulated non-operating financial holding company that would control both bank and non-bank affiliates. This would allow for the separation of retail and non-retail banking.

The White Paper proposes to allow widely held financial institutions to organize under a regulated holding company structure. The holding company, which would be widely held, would be a lightly regulated, non-operating company whose primary role would be to raise capital and manage the affairs of its operating subsidiaries. A similar type of holding company would be available to demutualized insurance companies.

Where a holding company owned a bank, it would have to own more than 50% of the bank's shares. The remaining shares of a bank subsidiary would have to be widely held. The White Paper provides that the 20% limit on voting share ownership and the 30% limit on non-voting share ownership would be applied to the total direct and indirect cumulative ownership of the bank; thus, no one investor would be able use the holding company structure to exceed the bank ownership restrictions. The holding company would be required to have "control in fact" (a minority of shares could be held, but control could be exercised) over other subsidiaries that were primarily engaged in providing certain financial services such as credit cards, small business loans or consumer loans. There would be no control requirements, however, for subsidiaries undertaking advisory or agency activities or for businesses considered ancillary or incidental to financial services. Closely held banks would also be permitted to organize under a regulated holding company model.

The White Paper proposes to allow a wider range of permitted subsidiaries for either holding companies or parent banks so that they could better compete against mono-line companies. This proposal is in accord with the recommendations of the Task Force and the two parliamentary committees.

D. Minimum Capital Requirements

At present, federally regulated financial institutions have a minimum capital requirement of $10 million. The White Paper points out that this is required to ensure that the principal shareholders are strongly committed to the institution and that the new institution has enough capital to support its operations from the outset.(2)

The Task Force recommended that the Minister of Finance have discretion to allow new financial institutions to incorporate with less than $10 million in capital, provided that the Office of the Superintendent of Financial Institutions (OSFI) approved the business plan.

Both the Finance Committee and the Senate Banking Committee supported a reduced capital threshold.

The White Paper proposes that the minimum capital requirement to start a new bank, trust or insurance company be lowered from $10 million to $5 million.

E. Financial Co-operative Sector

The credit union/caisse populaire system in Canada is characterized by a three-tiered structure. At the local level, individual credit unions and caisses populaires are member-owned. They operate independently and are provincially regulated. Representatives from local credit unions elect the boards of directors of the provincial centrals or regional federations in Quebec. The boards of the provincial centrals, in turn, elect the directors of the Credit Union Central of Canada, while the boards of the Quebec regional federations elect directors of the Confédération des caisses populaires d'économie Desjardins du Québec.

Provincial centrals provide a number of services in support of local credit unions. They also manage the liquidity pool for their member credit unions and participate in the national liquidity pool managed by the Credit Union Central of Canada. In Quebec, Mouvement Desjardins manages liquidity support for local caisses.

The Task Force set out proposals for two legislative frameworks for the co-operative sector. The first would entail changes to the *Co-operative Credit Associations Act* to allow credit union centrals to provide wholesale financial services to other financial institutions

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(2) Department of Finance, *Reforming Canada's Financial Services Sector, A Framework for the Future*, 25 June 1999, p. 36.

and retail financial services direct to members of local credit unions. The second would provide for the creation of one or more co-operative banks.

Both the Finance Committee and the Senate Banking Committee supported the Task Force recommendations with respect to the co-operative sector.

The White Paper proposes two changes that would apply to co-operative financial institutions: allowing for the creation of a co-operative bank and restructuring the existing framework under which credit unions operate. The present three-tiered structure would be collapsed into two by eliminating provincial centrals. A new National Service Entity would be created.

F. Demutualized Life Insurance Companies

Mutual life insurance companies in Canada are in the process of demutualizing -- that is, transforming their ownership from their participating policyholders to shareholders.

The Task Force recommended that the ownership regime for demutualized life insurance companies should be determined by their size, based on shareholder equity after demutualization. The Task Force recommended that there be a three-year transition period following the demutualization of a life insurance company during which the company would have to be widely held and could not engage in mergers or acquisitions. The Minister of Finance would have flexibility to approve non-hostile mergers or acquisitions during the transition period.

Both parliamentary committees essentially agreed with the Task Force recommendations.

The White Paper sets out the government's policy for demutualized insurers. First there would be a two-year transition period following demutualization during which no one shareholder could hold more than 20% of the voting shares and 30% of the non-voting shares of the company. No mergers among or acquisitions of demutualized firms would be allowed during the transition period. Second, the ownership regime applying to banks would also apply to demutualized insurance companies after the transition period was over. All demutualized insurers with equity in excess of $5 billion would be widely held. Demutualized insurers with equity under $5 billion would retain their widely held status but would be able to apply to the

Minister of Finance to have their status changed to closely held, subject to the 35% public float rule if their equity was between $1 billion and $5 billion, or with no ownership restrictions other than fit and proper tests if their equity was under $1 billion.

G. Foreign Bank Branching

The Task Force recommended that foreign banks should be able to carry on any business in Canada except for taking retail deposits (deposits below $150,000) through branches of the bank.

Both committees endorsed the Task Force recommendations to ease the entry of foreign banks into Canada.

As a result of recent legislative changes, a foreign bank can establish either a full-service branch or a lending branch. Neither type of branch is permitted to take retail deposits under $150,000. Foreign banks wishing to take retail deposits in Canada can do so through a subsidiary.

The White Paper notes that the government's foreign entry regime for banks, including those changes made to allow foreign banks to establish branches, will be reviewed in light of the framework proposed in the White Paper. Any legislative amendments to the foreign entry regime that may be required will be made as part of the legislative package implementing the framework.

THE PAYMENTS SYSTEM

A. Access to the Payments System

Canada's payments system consists of a set of separate networks that include the cheque payments system, the credit card systems of VISA and MasterCard, the automatic teller machine, point-of-sale terminal and the debit card systems of Interac and the respective clearing systems for debt and equity instruments and for mutual funds. The Canadian Payments Association (CPA) has the mandate under the *Canadian Payments Association Act* to operate a national clearing and settlement system and plan the evolution of the national payments system.

Membership in the CPA is limited to federally and provincially regulated deposit-taking institutions. Members can be direct or indirect clearers. Direct clearers clear and settle

their own payments direct and provide clearing services and access to settlement facilities for indirect clearers. The convergence towards a single financial services marketplace raises issues about membership in the CPA for non-deposit-taking institutions such as life insurance companies, mutual fund companies and securities firms.

The Task Force recommended that financial institutions other than deposit-taking institutions should become members of the CPA upon meeting criteria related to their solvency, liquidity, regulatory and legal frameworks.

Both the Finance Committee and the Senate Banking Committee supported increased access to the payments system.

The White Paper proposes a broader access to the payments system that would allow the participation of non-deposit-taking institutions such as life insurance companies, securities dealers and money-market mutual funds. The legal foundation for life insurance companies and money-market mutual funds makes it difficult for them to be direct clearers in a way that would not impose higher risks on the system; therefore, the government proposes that they be allowed to participate only as indirect clearers.

B. Governance of the Payments System

The Task Force made a number of recommendations concerning the governance of the CPA. For example, it recommended that the Minister of Finance, rather than the Governor-in-Council, should have the power to approve new by-laws or changes to by-laws of the Association. In addition, the Task Force recommended that the Minister of Finance should have the power to review all new or revised rules of the CPA and to revoke changes contrary to the public interest. The Minister would also have the power to issue directives to the CPA.

The Finance Committee and the Senate Banking Committee agreed with the Task Force recommendations pertaining to the governance of the payments system.

The White Paper makes a number of recommendations relating to the governance of the payments system, including:

- clarifying the mandate of the CPA;
- expanding the board of the CPA from 11 to 15 members;

- enshrining the Stakeholder Advisory Council in the CPA legislation (the Council, which was established in 1996, advises the Board of the CPA on the payments system from the perspective of a number of interest groups);

- providing that the Minister of Finance would have up to 30 days within which to disapprove a new or amended CPA rule if it was contrary to the public interest;

- giving the Minister of Finance the authority to designate other payments systems for oversight;

- providing the Minister of Finance with authority to issue directives to the CPA and other designated systems to changes rules, by-laws or operating practices contrary to the public interest; and

- eliminating the requirement for OSFI to examine and report annually on the CPA activities.

These proposals suggest that the government would be relying more on the CPA to govern itself and less on regulatory oversight by institutions such as OSFI. The Minister of Finance would, however, have authority to intervene through the disapproval and directive process where the public interest warranted.

MERGER REVIEW

Canada has federal legislation dealing with mergers and acquisitions. Past mergers and acquisitions of financial institutions have received selective reviews by the Competition Bureau, OSFI and the Department of Finance. There is, however, no comprehensive merger review policy in place. There are no guidelines stating what type of mergers are to undergo public scrutiny and, if so, by what government agencies. Furthermore, there is no clear public policy governing the criteria that must be met with respect to safety and soundness and the public interest. Under the existing review process, the Minister of Finance has final decision-making authority on financial institution mergers. How the Minister makes a decision and the factors considered in the decision-making process are not a matter of public record. Only the Competition Bureau has well-established rules governing mergers and acquisitions.

The Task Force focused a number of its recommendations on the merger review process for financial institutions and as a matter of general policy recommended that there be no overall policy to prevent large financial institutions from entering into business combinations with other large institutions. With respect to the merger review process, the Task Force recommended that business combinations involving a federally regulated financial institution should be assessed by the Competition Bureau in relation to competition concerns, the Office of the Superintendent of Financial Institutions in relation to prudential concerns; and the Minister of Finance in relation to general public interest concerns.

The Minister of Finance would be required to approve all mergers except for those between two federally regulated institutions that did not require pre-notification under the *Competition Act*. A formal Public Interest Review Process would be instituted for mergers involving financial institutions where the equity of the combined entity exceeded $5 billion. The Task Force also recommended that smaller mergers be subject to this review process where this was considered in the public interest. Finally, the Task Force recommended that the Minister have legislative authority to obtain enforceable undertakings from the parties involved in the merger.

The Finance Committee agreed that there should be no general policy to prevent financial institutions from merging. The Senate Committee, while believing that there should be no general prohibition against financial institution mergers, recommended that large banks and large life insurance companies should not be able to merge. This recommendation was driven by the Committee's belief that mergers between these entities would result in too great a concentration of economic power in too few hands.

The Finance Committee also supported the Task Force recommendations pertaining to the merger review process. The Committee recommended that there be a three-part merger review process that would be transparent, efficient and co-operative and would involve the Competition Bureau, OSFI and a Public Interest Review Process. The Minister of Finance would be required to issue guidelines on how the process should work.

The Senate Committee recommended that competition policy issues, prudential issues and public interest issues (stewardship) be addressed sequentially. The stewardship accountability review would last no longer than four months and would apply to mergers between large banks or mergers between large insurance companies. The Senate Committee

went on to recommend that any public hearings held in connection with a stewardship review should be conducted by the Department of Finance.

The White Paper proposes that the government establish a formal, transparent merger review process for mergers among banks with equity in excess of $5 billion. Banks would be required to prepare a Public Interest Impact Assessment, as recommended by the Task Force. The Assessment would be considered by the House of Commons Finance Committee, which would hold public hearings into the broad public issues raised by the proposed merger. Consistent with the Task Force and parliamentary committees, the White Paper proposes that the government introduce legislation to ensure compliance by financial institutions with the terms and conditions attached to the merger. The Competition Bureau and OSFI would conduct their respective reviews of the merger concurrently with the Finance Committee hearings. Final approval of the merger would rest with the Minister of Finance.

Unlike the Task Force and the parliamentary committee reports, the White Paper speaks of a merger review process for banks, rather than a general process for all financial institutions. A merger between a large bank and a life insurance company, for example, would not be subject to the formal merger review process. Certain aspects of the process would apparently be open-ended as there would appear to be no limits on the issues that could be raised during public hearings and no defined time period within which the review process would have to take place.

REGULATION

The Task Force spent a considerable amount of time focusing on the regulatory environment within which financial institutions operate. Canada's financial system is noted not only for the high degree of its safety and soundness but also for the relative difficulty of entering the Canadian banking sector.

The Task Force made a number of recommendations on various aspects of the financial services sector regulatory environment in order to streamline the regulation of financial institutions, avoid overlap and duplication of regulation, and lighten the regulatory compliance burden.

A. Mandate of the Office of the Superintendent of Financial Institutions

As part of its mandate, OSFI is responsible for supervising financial institutions to determine if they are in sound financial condition and are complying with the law. In carrying out its mandate, OSFI is instructed to strive to protect the interests of depositors, creditors and policy holders, while at the same time "having due regard" to the fact that financial institutions must be allowed to compete effectively.

The Task Force recommended that there should be revisions to OSFI's mandate to better describe its responsibilities. In particular, it recommended that OSFI's mandate should include administration of the consumer protection provisions of legislation covering federal financial institutions and responsibility for balancing competition and innovation considerations with its current obligations in respect of safety and soundness.

The Finance Committee and the Senate Banking Committee strongly rejected any expansion of OSFI's mandate to include consumer protection and the balancing of competition and innovation with safety and soundness. Both committees felt that OFSI should continue to focus on prudential regulation.

The White Paper does not recommend that OFSI take on additional responsibilities in relation to consumer protection or competition.

B. Canada Deposit Insurance Corporation and CompCorp

The Canada Deposit Insurance Corporation (CDIC) is a government-established compensation program applying to regulated deposit-taking institutions. The Canadian Life and Health Insurance Compensation Corporation (CompCorp) is an industry-backed compensation scheme for life insurers.

The White Paper describes the functions of the CDIC and CompCorp in the following manner:

> The Canada Deposit Insurance Corporation (CDIC) insures deposits at banks, other federally incorporated deposit-taking institutions and some provincial trust companies. CDIC's board comprises several senior public servants and private sector members appointed by the Governor in Council. The Corporation has the power to inspect its members and, in some circumstances, to take control or acquire the

> assets of a member institution. As a Crown corporation, the government guarantees CDIC obligations. Since 1996, a credit enhancement fee has been applied to any new borrowings to bring CDIC's cost of debt in line with that of a private sector organization.
>
> In contrast, the Canadian Life and Health Insurance Compensation Corporation (CompCorp) is a private, non-profit corporation established by the life insurance industry to protect life insurance policyholders against the loss of benefits in the event of insolvency. Its board is composed solely of independent directors. It has no regulatory responsibilities and no power to step in over a troubled member institution. CompCorp can borrow from the private sector and from member life insurance companies, but it cannot borrow from the federal treasury.(3)

The Task Force recommended that CDIC and CompCorp be merged either as a Crown corporation or an independent organization with liquidity backup borrowing authority from the Consolidated Revenue Fund.

The Senate Banking Committee did not support the amalgamation of the CDIC and CompCorp compensation schemes. Among other things, the Committee reasoned that the principal rationale for deposit insurance was to deal with systemic risk, that is, to stop a run on a bank, should it get into financial trouble. The Committee did, however, state that, once life insurance companies were granted access to the payments system and began to offer what were essentially demand deposits, all products satisfying the clear definition of a CDIC-insured deposit should be insured by the CDIC.

The Finance Committee, on the other hand, agreed that the two plans should be merged, particularly as the products offered by life insurance companies and deposit-taking institutions converge.

In the White Paper, the government rejected the Task Force proposals to merge the compensation schemes. It did so on the basis that deposit insurance was primarily designed to protect the public by reducing systemic risk. The life insurance business, on the other hand, does not pose this kind of systemic risk. This conclusion differs from that of the Task Force, which largely viewed the compensation schemes as a means to protect the savings of consumers.

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(3) *Ibid*., p. 71.

C. CDIC and OFSI

The Task Force recommended that OSFI should have the sole responsibility for promoting standards for sound business practices. Any existing overlapping mandate of the CDIC should be repealed.

Both the Finance and the Senate Banking Committee agreed with the Task Force recommendations in this regard.

The White Paper rejected the transfer of standards bylaws from CDIC to OSFI and proposed enhanced co-ordination and information-sharing between the two bodies.

The White Paper also acknowledged that greater competition in the financial services sector increases the potential for risk. As a result, the government proposes to give the Superintendent of Financial Institutions additional supervisory powers, that would include:

- allowing the Superintendent to remove directors and senior officers from office in certain circumstances, such as instances of misconduct;
- a system of administrative money penalties for financial institutions and individuals that failed to comply with undertakings and cease and desist orders, or violated financial institution legislation and regulations; and
- measures to enhance the Superintendent's power to deal with related party transactions.[4]

D. Streamlining Regulatory Approvals

Before federal financial institutions can complete certain transactions and business undertakings they must obtain the approval of the Minister of Finance or the Superintendent of Financial Institutions.

The Task Force recommended that the Superintendent should be given authority to provide necessary approvals without the need for referral to the Minister of Finance, except where policy matters were involved. It also recommended measures to streamline regulatory approvals such as a system of notice filings, blanket approvals, fast-track approvals and advance rulings.

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(4) *Ibid*., p. 74.

The Finance Committee and the Senate Banking Committee supported the introduction of such measures.

The White Paper endorses a streamlined regulatory process. A new notice-based approval process would be introduced for many of the transactions currently requiring the approval of the Superintendent. Under this process, institutions would file a standard notice with OSFI that would be automatically approved within 30 days unless OSFI raised concerns or required further information. The White Paper also proposes to permit blanket approvals for certain types of transactions.

EXPANDED BUSINESS POWERS

The Task Force recommended that federally regulated deposit-taking institutions be allowed to sell insurance and lease light vehicles through their branches, once appropriate tied selling and privacy protection regimes were in place.

The Finance Committee did not support the Task Force recommendations in this regard. It recommended that the existing prohibition on the sale of insurance and the leasing of automobiles in the branches of deposit-taking institutions be reconsidered only after the consumer protection regime recommended by the Committee had been established, evaluated and determined to be effective.

The Senate Banking Committee, on the other hand, recommended that deposit-taking institutions should continue to be prohibited from selling property and casualty insurance in their branches, but should be able to sell life annuities to their RRSP customers immediately and retail other life insurance products after a transition period. The Committee also recommended that deposit-taking institutions be able to lease automobiles, subject to certain restrictions.

The White Paper does not propose any expansion of powers for deposit-taking institutions with respect to selling insurance or leasing vehicles. The government agreed with the Finance Committee that measures to foster competition and promote consumer protection should be given time to become fully effective before any changes to business powers are considered.

CONSUMER PROTECTION

A. Access to Financial Services

1. Basic Account

In February 1997, the major banks agreed to facilitate access to accounts and to cheque-cashing services for low-income individuals and to improve their access to basic services.

The Task Force recommended that deposit-taking institutions should make standard basic accounts available at reasonable charges but stopped short of recommending that access be legislated immediately.

The Finance Committee agreed with the Task Force recommendation to ensure access to basic banking services; however, it had some concerns with the recommendation that the federal and provincial governments should provide low-cost personal identification to anyone who requires it.

The Senate Banking Committee supported the Task Force recommendations and went on to recommend that the government should legislate access if progress is not achieved quickly.

The White Paper provides that the government will introduce legislation to require banks to open accounts and cash federal government cheques for any individual who meets certain basic identification requirements, provided there is no reason to suspect fraudulent activity. In addition, the government will introduce regulations to require banks to inform customers clearly about bank policies in relation to "hold" periods applicable to deposited cheques.

The White Paper also states that legislation will be introduced to require banks to offer a standard low-cost account, the details of which will be specified in regulation. Banks will be required to post information about this account prominently in every branch.

2. Branch Closures

Currently, a federal deposit-taking institution wishing to close a branch is obliged only to inform customers of the location to which their accounts have been transferred.

The Task Force recommended that that deposit-taking institutions be required to give four months' notice before closing a branch. Notice of the pending closure would have to be given to all customers and relevant local authorities and published in local newspapers.

The Finance Committee and the Senate Baking Committee agreed with the Task Force recommendations in this regard.

According to the White Paper, the government will require federal deposit-taking institutions to provide four months' notice of a branch closure and six months' notice of the closure of a rural branch. In addition, regulations will be introduced providing a proposed Financial Consumer Agency with the discretion to convene a consultation if a rural or inner-city branch closure appears to be taking place with insufficient consultation.

B. Financial Consumer Agency

At the present time, a number of federal government departments and agencies have oversight responsibilities in relation to the financial sector. These include OSFI, the Department of Finance, Industry Canada and the Canada Deposit Insurance Corporation. In addition to monitoring compliance with regulations and self-regulation, these departments and agencies also play a limited role in assisting consumers.

The Task Force considered the creation of a consumer protection office at the federal level, but in the end decided that, given the important role of the provinces in consumer protection, a federal office was neither required nor desirable. As a result, the Task Force recommended that OSFI take on consumer protection responsibilities as part of its mandate.

The Finance Committee recommended that, to promote consumer protection, a federal consumer protection bureau be created that would be responsible to a Financial Services Ombudsman. The Senate Banking Committee, on the other hand, made no recommendations about the creation of such an entity.

The White Paper provides for the creation of a Financial Consumer Agency (FCA) that would report to the Minister of Finance. The FCA would:

- enforce the consumer-oriented provisions of the federal financial institution statutes;
- have the authority to impose penalties on financial institutions for systematic non-compliance with consumer protection measures;

- monitor and report on industry self-regulatory initiatives;
- promote greater consumer awareness of the financial system;
- provide one-window access to consumers seeking information about financial services; and
- play a role in initiatives to improve transparency and disclosure of information about financial products.(5)

The FCA, however, would not provide a consumer redress service.

C. Canadian Financial Services Ombudsman

The banking and life insurance sectors provide consumer redress mechanisms. The Canadian Banking Ombudsman deals with banking complaints from individuals and small businesses. In 1998, the Canadian Life and Health Insurance Association introduced an Ombudservice to provide informal conciliation for consumers with complaints about life insurance companies.

The Task Force recommended the introduction of federal legislation to establish an ombudsman office to which all federally regulated financial institutions would be required to belong. The Ombudsman, who would report to Parliament through the Minister of Finance, would have a mandate to hear complaints made by individuals and small business customers.

The Finance Committee also called for a legislated financial sector ombudsman who would be given responsibility for promoting consumer protection and auditing compliance.

The Senate Banking Committee did not support a legislated model. It argued that the operation and structure of the Canadian Banking Ombudsman should be maintained as an independent office but one whose mandate would be broadened to include all financial institutions and a majority of whose directors would have to come from outside the financial services sector.

The White Paper rejected a legislated ombudsman. The government proposes to work with financial institutions to establish the Canadian Financial Services Ombudsman (CFSO). Banks would be required to join the CFSO. Other federally incorporated financial

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(5) *Ibid.*, p. 54-55.

institutions would be required to be members of a third-party dispute resolution system but could join the CFSO if they wished to do so. The CFSO would be independent of its financial institution members. The majority of the board of directors would be non-financial institution representatives. The board would appoint the Ombudsman and approve the CFSO's annual budget. The CFSO would have the power to make non-binding recommendations and would report annually to the Minister of Finance and the public. An institution that failed to comply with a recommendation could be named publicly by the Ombudsman.

BUSINESS PRACTICES AND ACCOUNTABILITY

A. Transparency and Disclosure

The Task Force noted that the level of transparency and disclosure in many financial consumer contracts and marketing documents falls short of consumers' expectations and the capabilities of the industry.

In order to rectify these deficiencies, the Task Force recommended, among other things, that the federal government, the provinces, industry and consumer groups form a multi-partite working group to review Canadian financial services contracts and marketing documents to determine whether these meet best practices with respect to their transparency and disclosure.

For the most part, the Finance Committee and the Senate Banking Committee agreed with the Task Force recommendations.

The White Paper provides that the federal government will hold discussions with the provinces and the industry on working toward enhancing transparency and disclosure of financial service sales documents and contracts. This work will include developing model contracts and best practices to serve as benchmarks for use by financial institutions. In addition, federal financial institution statutes will be amended to provide for regulation-making authority governing disclosure.

B. Personal Privacy

The Task Force strongly supported the introduction of legislation at the federal level to establish standards for the collection, use and disclosure of personal information. It also recommended that federally regulated financial institutions be required to develop legally binding privacy codes conforming with the Canadian Standards Association model. Under the scheme proposed by the Task Force, OSFI would certify acceptable codes and consumers would have recourse in respect of privacy matters to the proposed financial services sector ombudsman.

Like the Task Force, the Finance Committee supported the expeditious passage of federal privacy legislation and the establishment by the industry of legally binding codes. It did not, however, support the proposal that OFSI should have responsibility for certifying such codes.

The Senate Banking Committee also supported the development of legally binding privacy codes and the introduction of federal legislation to ensure privacy standards.

The White Paper refers to pending federal privacy legislation and notes that the proposed Canadian Financial Services Ombudsman would refer specific privacy complaints to the Privacy Commissioner and keep the Commissioner informed of general concerns about the privacy practices of financial institutions.

C. Coercive Tied Selling

"Coercive tied selling" is the practice whereby a firm uses coercion to require a customer to buy one product as a condition of purchasing another one. The White Paper expressed concern that the nature of their relationship with financial institutions makes the customers of these institutions particularly vulnerable to this practice.(6)

Since 1998, the *Bank Act* has prohibited a bank from coercing or imposing undue pressure on a customer to purchase another of its financial products as a condition for obtaining a loan.

The Task Force, suspecting that the potential for coercive tied selling would grow as more institutions became conglomerates and networking arrangements increased, made a

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(6) *Ibid*., p. 59.

number of recommendations covering the practice. One recommendation was that there should be a legislative ban on coercive tied selling by banks and other financial institutions and that section 459.1 of the *Bank Act*, which prohibits coercive tied selling in relation to loans, be amended to cover all credit products, insurance and other products specified in regulations.

The Task Force also called for financial institutions to provide customers with a written description of what constitutes coercive tied selling and advice that is not legal. Penalties for breach of the prohibition against coercive tied selling would be spelled out in legislation.

The Finance Committee requested that the government move quickly to enact the Task Force recommendations in this area.

The Senate Banking Committee supported the Task Force recommendations, but cautioned that a clear and precise definition of coercive tied selling would be required.

The White Paper provides that the scope of the present coercive tied selling provision in the *Bank Act* would be extended to prohibit a bank from coercing or imposing undue pressure on a customer to purchase a financial product from the bank as a condition of obtaining not only loans, but any other product. Furthermore, banks would be required to inform consumers that coercive tied selling is illegal, prior to entering with them into a series of financial transactions. These proposals would apply only to banks.

D. Public Accountability

The Task Force recognized that financial institutions play an important role in the communities they serve; however, it also noted that there was no commonly accepted method for such institutions to report on their community activities.

The Task Force therefore proposed that all federally regulated deposit-taking institutions and life insurance companies should be required to produce annual Community Accountability Statements informing the public of the institution's contribution to the community through activities such as:

- investment in community development;
- corporate philanthropy;
- support of community activities and partnerships with the community;

- the participation of employees in community service;
- the employment provided;
- taxes paid to all levels of government; and
- any other relevant issues.

The Finance Committee disagreed with the Task Force recommendations on the ground that a requirement to produce annual Community Accountability Statements would impose a disproportionately high cost on smaller institutions. The Committee did, however, want financial institutions to provide statistics on their investment and lending activities.

The Senate Banking Committee felt that some form of annual accounting was desirable but did not agree with the Task Force's proposal for Community Accountability Statements; like the Finance Committee, this Committee felt that such statements would be too costly for smaller institutions. The Committee also felt that the Statements might turn into a public relations exercise of questionable value and considerable expense.

The White Paper proposes a form of accountability document. Federal financial institutions with equity in excess of $1 billion would be required to publish an annual Public Accountability Statement describing their contributions to the Canadian economy and society and including:

- the national dollar amount of charitable donations and examples of philanthropic activities;

- employee volunteer activities;

- examples of funding provided to local government and voluntary agencies for community works;

- investments or partnerships in micro-credit programs;

- small-business financing initiatives such as venture capital programs, and dollar amounts of small business lending – broken down by loan size and reported by region;

- initiatives to improve access to banking services by low-income individuals, seniors and people with disabilities;

- the location of openings and closings of branches;
- the number of individuals employed; and
- taxes paid to federal, provincial and municipal governments.[7]

Financial institutions would be required to make these statements available to the public.

E. Financing Small- and Medium-Sized Business

The inadequacy of information on the financing needs (both debt and equity) of small and medium-sized enterprises (SMEs) and those in the knowledge-based industries (KBI) in Canada poses a problem for policy makers and financial institutions.

The Task Force recommended a program of comprehensive data collection, analysis and publication for SMEs and KBIs to be carried out by Statistics Canada and Industry Canada.

Both the Finance Committee and the Senate Banking Committee supported the Task Force recommendations on improving the adequacy of information on SMEs.

The White Paper accepts the thrust of the Task Force recommendations in this regard. It proposes a comprehensive program of information collection and analysis to ensure that there would be sufficient information relating to the financing needs of SMEs to enable development of effective public policy. Statistics Canada would be given the mandate to collect and publish data on the supply of debt and equity financing to SMEs. A dedicated SME Finance Group responsible for analyzing the Statistics Canada data, conducting other surveys and undertaking continuing research on SME financing issues would be established within Industry Canada. The same department would also report annually to the House Standing Committee on Industry on the state of SME financing in Canada.

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(7) *Ibid*., p. 61.

F. Financing Aboriginal Business

The Task Force acknowledged that Aboriginal enterprises face challenges in securing financing, and made recommendations towards improving access to capital by these enterprises. The National Aboriginal Financing Task Force had recommended that, subject to the consensus of First Nations communities, federal legislation should be amended to facilitate the provision of credit by financial institutions to Aboriginal individuals and institutions by allowing on-reserve personal moveable property to be used as collateral. The Task Force endorsed this recommendation.(8)

The Finance Committee supported the Task Force recommendations concerning the financing of Aboriginal businesses. The Senate Banking Committee did not comment on these recommendations.

The White Paper notes that at present there are no plans to amend the *Indian Act*; however, the government is working with financial institutions to explore ways of operating within the current constraints posed by that statute.

TAXATION

A. Capital Taxes

At the federal level, large corporations with capital in excess of $10 million pay a capital tax. A second federal capital tax is levied on the capital of regulated financial institutions in excess of $200 million. The provinces also levy capital taxes.

The Task Force was of the view that capital taxes levied on financial institutions make them less competitive and create risks to safety and soundness. It therefore recommended that the federal and provincial governments take steps to reduce the level of taxation on the financial services sector. The Task Force called for the elimination of special capital taxes on financial institutions or, where such taxes could not be eliminated, that the tax burden be shifted from capital and towards profits.

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(8) Task Force on the Future of the Canadian Financial Services Sector, *Report*, September 1998, p. 220.

The Finance Committee supported the principle of relying more on profit-sensitive taxes and less on capital taxes while the Senate Banking Committee called for the elimination of capital taxes.

The White Paper notes that capital taxes have served two policy goals; they act as a minimum tax and provide a steady source of government revenue. The federal government states it is committed to reviewing its own capital taxes and to discussing with the provinces the effects of capital taxation on the financial services sector. The government has not, however, agreed to reduce or eliminate such taxes.

B. Withholding Taxes

Withholding taxes are levied on certain financial transactions between Canadian residents and non-residents; for example, taxes are levied on interest payments to non-resident lenders. The White Paper pointed out that in certain circumstances, the withholding tax liability is exempted.

The Task Force recommended that withholding taxes should be removed from all arm's length borrowings, regardless of their term. The Finance Committee and the Senate Banking Committee agreed with the Task Force.

In the White Paper, the government makes no commitment with respect to withholding taxes other than to review the issue in the context of its treaty negotiations with other countries.

ACCOUNTING RULES

In the course of its study, the Task Force received submissions outlining concerns arising from the different accounting treatment of business combinations in Canada and the United States. The Task Force documents describe two ways of accounting for a business combination (mergers and acquisitions): the pooling of interest method and the purchase method. Under the pooling method, no goodwill is recognized when a merger or acquisition takes place. Under the purchase method, however, goodwill associated with the business

combination is valued and set up as an asset on the balance sheet of the purchaser or, where an amalgamation has taken place, on the balance sheet of the ongoing business.(9)

Canadian Generally Accepted Accounting Principles (GAAP) usually follow the purchase method of accounting for goodwill arising from a business combination, while U.S. GAAP allow for pooling of interest transactions where no goodwill is recognized.

The Task Force was of the view that the Canadian accounting rules place Canadian firms at a competitive disadvantage. It therefore urged the Canadian Institute of Chartered Accountants (CICA) to develop an interim solution to be applied until Canadian and U.S. accounting rules relating to business combinations are harmonized. The Task Force went on to state that, should the CICA be unable to find a solution, OSFI should use its power to specify accounting principles allowing Canadian companies to pursue acquisition opportunities on a competitive basis.

The Finance Committee and the Senate Banking Committee supported the Task Force position on accounting rules for business combinations.

The White Paper expresses the government's support for the harmonized accounting rules anticipated by the end of 2000 for business combinations between Canada and the United States. If there is insufficient progress toward harmonization, the White Paper provides that OSFI will consider what measures could facilitate mergers and acquisitions for financial institutions.

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(9) Task Force on the Future of the Canadian Financial Services Sector, *Competition, Competitiveness and the Public Interest*, Background Paper #1, September 1998, p. 128.