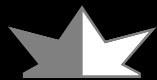

Task Force on the
Future of the
Canadian Financial
Services Sector

September 1998

change challenge opportunity

Organizational Flexibility for Financial Institutions: A Framework to Enhance Competition

Background
Paper #2

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Chapter 1

Introduction

This background paper deals with the questions of who can own regulated financial institutions, how the institutions can organize themselves, and what business powers they are allowed to exercise.

The financial services sector in Canada, as in other countries, has traditionally faced more restrictions on how it can organize and conduct its activities than most other types of business. Until recently the Canadian regulatory environment was characterized by the "four pillars" view of financial services. Each "pillar" – the banks, trusts, insurers and securities dealers – was regulated differently, with the result that various ownership rules, diverse corporate structures and differentiated business powers developed based on the type of institution.

Historically, regulated financial institutions were custodians of other people's money, taken either as deposits to be returned at some time in the future or as premiums for insurance to be paid at some time in the future under defined circumstances. Most of the regulatory restrictions flow from the public policy goal of ensuring that the institutions remain viable so that their "promises to pay" can be honoured. That is certainly the case with respect to ownership policy and, in particular, the long-standing tension in Canada over the benefits of wide ownership versus commercially controlled financial institutions. It is also largely true with respect to allowable organizational forms for carrying on business, although it should be recognized that the traditional division of responsibility for financial institutions between the federal and provincial governments has also contributed to the policies that require some activities to be undertaken in subsidiaries, rather than in-house. The history of the powers that financial institutions are able to exercise is more complicated, with current policy having been determined by a combination of prudential, federal/provincial and competitive concerns.

As described elsewhere,[1] the functions performed by financial institutions around the world are changing in response to more sophisticated consumer demands, the enabling power of technology and globalization. New competitors are offering new products, and many of these competitors are unregulated or less tightly regulated than banks, trust companies and insurance companies.

[1] See *Competition, Competitiveness and the Public Interest*, Task Force Background Paper #1.

To date, the Canadian financial system has generally been able to adjust well to these changes in the marketplace. Since market forces drive the evolution of the industry, a rigid regulatory framework necessarily lags behind fast-paced change. As a result of the comprehensive restructuring of legislation and regulatory oversight that has occurred from the mid-1980s to the present time, our institutions have been able to expand their range of activities and, through the use of subsidiaries, have achieved considerable organizational flexibility. Since greater flexibility and increased powers led to more competition, consumers have generally benefited from a greater range of products and services at competitive prices.[2] As markets evolve at an accelerating pace, it is important that the legislative framework in Canada continue to provide the required flexibility rather than impede developments that would benefit consumers.

The recent history of financial sector regulation in Canada is reflective of the broad forces of change affecting the industry. The 1992 federal legislation was a watershed in several respects. For the first time, all the federal legislation was reviewed concurrently. This reflected the changing nature of the sector, with different institutions increasingly competing with each other in non-traditional areas. In a world where competition is increasingly based on the function performed or the product and service provided rather than the type of institution, it is more important than ever to consider the financial sector as a single marketplace. The logical corollary is that each type of institution must have the flexibility and business powers to compete across the broad spectrum so that consumers, not regulatory restrictions, determine the providers of choice.

The 1992 legislation and the period that has followed clearly illustrate how policy makers have reacted to the increasing pace of change in the industry. Prior to 1992, the Bank Act was subject to decennial review and other financial legislation was reviewed sporadically. Even the 10-year provision in the Bank Act did not always ensure timely review. Consider the contrast since 1992: there was an interim legislative amendment in 1995 to deal with issues that were important enough, in the view of the Government, not to wait until 1997, and all the federal acts were reviewed and amended as scheduled in 1997. The federal legislation has a 2002 sunset clause, and it is expected that there will be legislation to deal with foreign bank entry and demutualization issues in the near future.

[2] For an overview of how well Canadians are served by the financial services sector, see McKinsey and Company, *The Changing Landscape for Canadian Financial Services*, Research Paper Prepared for the Task Force on the Future of the Canadian Financial Services Sector, (Ottawa, September, 1998), Ch. 6.

Although federally incorporated financial institutions, with few exceptions, were permitted by the 1992 legislation to perform all financial activities directly or through subsidiaries, there are still some remaining restrictions on ownership, structure and business powers. Key restrictions that the Task Force has addressed are summarized in Exhibit 1.1.

Exhibit 1.1
Key Restrictions Addressed by the Task Force

	Bank					
	Schedule I	Schedule II	Trust	Credit union centrals[1]	Mutual insurance co.	Stock insurance co.
Ownership	10 percent rule 10-year transition for start-up	35 percent public float for companies with more than $750 million in shareholders' equity	35 percent public float for companies with more than $750 million in shareholders' equity		Must be widely held after demutualization	35 percent public float for companies with more than $750 million in shareholders' equity
Organizational Structure	Lack of a holding company option				Lack of a holding company option	
Business powers	Retailing insurance in branches Light vehicle leasing	Retailing insurance in branches Light vehicle leasing	Retailing insurance in branches	Dealing with retail customers Providing wholesale services outside the credit union system	Light vehicle leasing In-house payment system access	Light vehicle leasing In-house payment system access

[1] This refers only to the restrictions in the federal Cooperative Credit Associations Act. Provincial centrals, which may elect to be regulated pursuant to the federal act, are also bound by their provincial acts of incorporation, which may have different restrictions. More detail is provided in Chapter 5.

A key question for the Task Force is whether further changes in ownership policy, organization and powers are now appropriate. Will allowing greater flexibility in ownership policy reduce barriers to the entry of new institutions without unduly compromising safety and soundness? Can more flexible organizational forms provide a basis for nuanced regulation rather than a "one-size-fits-all approach," and can this help level the playing field between regulated and unregulated institutions and thus increase competition in the marketplace? Would the elimination of remaining restrictions on business powers benefit consumers? These are the issues that are addressed in this background paper.

The following three chapters of the paper discuss ownership policy, organizational flexibility and business powers, respectively. Each chapter reviews the current situation in Canada, recent significant policy events that have shaped the current situation, and the state of policy and practice in other major countries. A reconsideration of current policy and conclusions of the Task Force are then set out as a basis for presenting the proposals of the Task Force. Some specialized issues relating to cooperative financial institutions are examined in Chapter 5, while Chapter 6 contains brief concluding remarks.

Chapter 2

Ownership Policy

The current variations in the ownership regimes for federally incorporated financial services firms reflect a compromise between competing policy objectives. The 1992 legislation clearly recognized that convergence in the financial sector was blurring the traditional "pillars" view of the industry. Despite the provision of similar business powers to banks, trusts and insurance companies, the ownership regimes for the various types of institution generally continued to reflect the history of each pillar. As a result, current ownership policy reflects historical concern about domestic control and prudential soundness of the largest firms in the industry, overlaid on the practical constraints of accommodating existing ownership arrangements.

This chapter summarizes the current situation and recent evolution of the federal ownership regime, drawing some conclusions about how sometimes conflicting policy objectives have been addressed. After a brief overview of international approaches to ownership policy, the conclusions of the Task Force are developed.

The focus here is on the federal ownership regime. Aside from those institutions that are widely held by definition (cooperatives and mutuals), provincial legislation generally accommodates closely held financial institutions. This may have contributed to the disparate federal regime. Given its exclusive jurisdiction, the federal government could impose a common ownership regime for banks. For trusts and insurance companies, however, federal policies had to be sensitive to the fact that companies considering the federal ownership regime undesirable could choose to continue under a provincial charter.

The Current Regime

The various ownership restrictions are summarized in Exhibit 2.1. No individual can acquire more than 10 percent of any class of shares in a federally incorporated financial institution without the approval of the Minister of Finance. The Bank Act is even more restrictive in that it requires banks to be widely held or, in the case of Schedule II banks, controlled by other "eligible" financial institutions, which are generally widely-held Canadian or foreign-regulated entities.[3] "Widely held" in the context of the current Bank Act refers to the provision that no shareholder can have more than 10 percent of any class of

[3] See sections 370, 374, 375 and 518 of the Bank Act for more detail.

shares of a Schedule I bank.[4] A Canadian bank may also have Schedule II status for 10 years after incorporation, providing a transition period before it would become subject to the widely-held requirements of Schedule I.

Trusts and insurance companies have not been required to be widely held, although four of the largest life insurance companies have chosen to organize themselves as mutual companies. Since a mutual is owned by its policy holders, by definition it does not have a controlling shareholder. A mutual company can become a stock company through the process of demutualization. The 1992 federal legislation requires that large mutual companies (those with more than $7.5 billion in assets) would have to be widely held upon demutualization.

Exhibit 2.1
Current Ownership Regime for Federal Financial Institutions

Bank	Insurance company	Trust company
Schedule I • 10 percent rule • 10-year transition for new banks **Schedule II** • 35 percent public float of voting shares required if shareholders' equity exceeds $750 million • Minister may exempt banks owned by widely held Canadian financial institutions or foreign banks from the public float requirement	**Stock companies** • 35 percent public float of voting shares required if shareholders' equity exceeds $750 million **Mutual companies** • wide ownership by definition • large (more than $7.5 billion in assets) companies must be widely held following demutualization	• 35 percent public float of voting shares required if shareholders' equity exceeds $750 million

Large federally incorporated trust and insurance companies are subject to a public shareholding requirement. This requirement applies when shareholders' equity exceeds $750 million, with companies having five years after passing the threshold to come into compliance.[5] Shares with 35 percent of the voting rights of all voting shares outstanding must be held by persons with no "significant interest" (more than 10 percent) in any class of shares issued by the company, and these shares must be traded on a Canadian stock exchange.

[4] As used in this paper, "widely held" generally refers to the current 10 percent ownership rule for Schedule I banks and the Task Force proposals for a modified ownership rule that continues to ensure that the largest financial institutions do not have a controlling shareholder or shareholder group.

[5] Trust and Loan Companies Act, section 379; Insurance Companies Act, section 411. The provision also applies to Schedule II banks, although the Minister may grant an exemption under the Bank Act, section 381.

Although the current regime prohibits the acquisition of a significant interest (more than 10 percent) in a Schedule I bank, all other types of financial institution may have significant or controlling shareholders. The provisions of the federal legislation give the Minister broad discretion to determine whether a proposed shareholder is "fit and proper" to own more than 10 percent of a regulated institution.[6]

Historical Context

The ownership restrictions on each type of financial institution reflect the different history of each pillar. For insurance companies, the landscape of the sector was established in the 1950s when, with government encouragement, the largest stock life insurance companies became mutual companies to provide protection against foreign takeover. From the 1950s onward, the mutual status of a number of the largest life insurance companies (Canada Life, Manulife, Mutual, Sun Life and, prior to their merger and liquidation respectively, North American Life and Confederation Life) ensured that a significant core of the insurance sector was domestically controlled and widely held. The 1992 legislation entrenched wide ownership of the large mutuals by requiring that they be widely held if they were to demutualize.

In what we now tend to view as a single deposit-taking sector, there are important historical differences in the development of banks and trusts. Trust companies began as fiduciary businesses and over time became more and more bank-like as they gained a wider range of business and investment powers. Even before the 1992 legislation removed most of the remaining business power distinctions between banks and trusts, ownership of a trust company, which was not constrained by a widely-held rule, was a way for a commercial enterprise to own a bank in all but name. The emergence of larger trust companies as part of non-financial conglomerates and the failure of a significant number of trust companies in the 1980s contributed to an increasing focus on the presumed prudential advantage of wide ownership of financial institutions.[7]

Banks in Canada had been subject to wide ownership restrictions since the introduction of the 10/25 ownership rule in 1967. A single shareholder was allowed to own no more than 10 percent of any class of shares, and total foreign shareholdings were restricted to 25 percent in Schedule I banks. This restriction was introduced explicitly to prevent the takeover of a Schedule I bank by a U.S. bank. The 25 percent limit on foreign ownership was eliminated for United States residents pursuant to the 1989 Canada-U.S. Free Trade Agreement

[6] See the Insurance Companies Act, sections 407 and 420; Bank Act, sections 372 and 390 (for Schedule II banks); Trust and Loan Companies Act sections 375 and 388.

[7] Eleven trust companies failed between 1981 and 1985. See *The Regulation of Canadian Financial Institutions: Proposals for Discussion*, Department of Finance, 1985, p. 11.

(FTA). While foreign owners were permitted to incorporate new federal trust, loan and insurance companies, there was a limit of 25 percent on foreign shareholdings for existing companies. U.S. residents were exempted from these provisions pursuant to the FTA, and this preference was extended to Mexican residents in the context of the North American Free Trade Agreement (NAFTA) effective January 1994. In January 1995, as a consequence of the Uruguay Round of trade negotiations, Canada committed to extending the exemption from the foreign shareholding limits for all federally incorporated financial institutions to all members of the World Trade Organization (WTO). Any shareholding of more than 10 percent in a federally incorporated financial institution requires the approval of the Minister of Finance, and the prohibition on a shareholder having more than 10 percent of any class of shares in a Schedule I bank remains in place. This 10 percent restriction, which applies equally to Canadian and foreign shareholders, effectively ensures the upstream separation of banking and commercial interests.

All financial institutions attract regulation because of the role they play as repositories of people's savings, but historically banks have been singled out for special attention. Banks have been the major holders of liquidity (deposits payable at par on demand) and the main providers of the payments services (cheques and, increasingly, electronic payments) that underlie virtually every business transaction. Loss of confidence in the value of liquid deposits and failure of the payments system would have serious repercussions throughout the economy. As a result, banks have been the subjects of more focussed public policy concern than the rest of the financial services sector. One consequence of this greater concern has been the provision to banks of a safety net including deposit insurance and access to liquidity support from the central bank (see Exhibit 2.2).

Being widely held ensures that a bank is not subject to the pressures of a controlling shareholder. Experience clearly demonstrates that being widely held does not ensure safety and soundness, but the debates in Canada since 1985 have demonstrated a prudential preference on the part of regulators and policy makers that large banks be widely held. The view is largely based on the concern that a controlling shareholder, for reasons of self-interest, might cause investment decisions to be made that are not in the best interests of the depositors. A specific concern is that depositors' funds, raised on the strength of deposit insurance, would be directed to fund the commercial enterprises of the institution's owner. This could ultimately affect the solvency of the institution, and could also result in distortions in credit allocation in the economy.

Exhibit 2.2

What is the Safety Net?

Liquidity support from the central bank, deposit insurance, and the potential for other government support in time of crisis are the three elements of the safety net for deposit-taking institutions (DTIs). The policy intent is to maintain confidence in the financial system. However, DTIs may benefit because the safety net provides their creditors with confidence that they are less likely to fail in the event of a financial crisis than are unregulated entities.

Is the Safety Net a Cost or a Benefit?

The safety net benefits are not cost-free to the institutions. Costs borne by institutions are ultimately paid by consumers. In addition to the explicit costs of deposit-insurance, financial institutions bear the costs of regulation. Regulatory costs and the value of the safety-net subsidy are both difficult to quantify. A significant body of research, which focuses primarily on the United States, offers no clear conclusion on whether the value of the subsidy is more than offset by the costs of regulation.[1] Submissions to the Task Force by regulated institutions have stressed the costs of regulation, which they view as impeding their ability to compete against unregulated entities. Submissions by unregulated players have stressed the advantages that large banks derive from regulation.

Does the Safety Net Create Unfair Competition?

If there is a net subsidy, and it can be transferred to other parts of a financial group, companies affiliated with a deposit-taking institution would have a cost-of-capital advantage over other competitors. The subsidy could be transferred directly through related party transactions that saw low-cost funds raised on the strength of deposit insurance moved from the DTI to an affiliated company. The subsidy might also be transferred from the regulated entity to other related entities if the market perceives that the risk of an entire group is lessened by the supposed reluctance of the government to see the bank part of the conglomerate fail.

Restrictions on related party transactions can address the funding of other parts of the conglomerate with depositors' funds. The market perception that some institutions are too big to fail is more difficult to address. Regulators specifically avoid affirming that institutions are too big to fail. To the extent that creditors have doubts that an institution would be rescued, or believe that the unregulated parts of a conglomerate could be allowed to fail even if the regulated DTI was rescued, expansion of the safety net will be minimal as creditors will still demand the premium for the risk of failure.

[1] For recent summaries of the research in this area, see Myron L. Kwast and S. Wayne Passmore, *The Subsidy Provided by the Federal Safety Net: Theory, Measurement and Containment*, (Washington D.C.: Board of Governors of the Federal Reserve System, December 1997) and Gary Whalen, *The Competitiveness Implications of Safety Net-Related Subsidies*, Economics Working Paper 97-9 (Washington D.C.: Office of the Comptroller of the Currency, May 1997).

In April 1985, the federal government released its Green Paper[8] containing policy options for discussion. This was followed in 1986 by policy proposals in the Blue Paper.[9] The key ownership provisions of these two papers are summarized in Exhibit 2.3. Both sets of proposals reflected the difficulty in achieving the appropriate balance between conflicting objectives. Many would view wide ownership ensuring no commercial links as the ideal ownership regime for financial services firms. However, a prohibition on commercial links constitutes a barrier to the entry of new competitors. Further, any new ownership regime does not start with a clean slate: divergent ownership structures exist and need to be accommodated in any new approach.

While the structures and ownership restrictions discussed in 1985 and 1986 were not adopted as originally proposed, there are a number of important principles that can, in retrospect, be distilled from the debates of the 1980s:

- the desirability from a prudential and Canadian-control standpoint to have the largest financial institutions widely held;
- the recognition that commercial owners can be an important source of competition in the financial sector; and
- reconciliation of these conflicting objectives by means of a size-based ownership regime, ensuring that the largest institutions are widely held, allowing some institutions to be closely held, and providing a middle range where there can still be a controlling shareholder.

The ownership debates from 1985 and 1986 continued as draft trust legislation was introduced (but not passed) in 1987 and a White Paper was released in fall 1990.[10] The regime which ultimately emerged ensured that the core of the financial sector would be Canadian-controlled by continuing the widely-held regime for banks, and requiring that large demutualized insurance companies would also have to be widely held.

Despite some discomfort on the part of regulators, existing closely held financial institutions were not required to meet the same widely-held regime as Schedule I banks. Instead, a compromise modelled on the Blue Paper proposals was introduced to require institutions (other than Schedule I banks and mutual insurance companies) with more than $750 million in shareholders' equity to have 35 percent of voting shares widely held and listed on a stock exchange. This was intended to ensure that directors would be accountable to minority shareholders and subject to the governance requirements for publicly traded firms in determining that their stewardship decisions were in the best interests of the institution

[8] *The Regulation of Canadian Financial Institutions: Proposals for Discussion* Department of Finance, 1985.

[9] *New Directions for the Financial Sector*, Department of Finance, 1986.

[10] *Reform of Federal Financial Institutions: Legislative Proposals*, Department of Finance, 1990.

and all shareholders, rather than those of the controlling shareholder alone. It also imposed market discipline since public companies are required to disclose all material facts and are subject to scrutiny by analysts and rating agencies.

Exhibit 2.3
Green and Blue Paper Ownership Proposals

Institution type	Green Paper	Blue Paper
Banks: • Schedule A	• widely held – 10/25 rule	• widely held – 10/25 rule
• Schedule B	• owned by a foreign bank • domestic banks within 10 years of start-up may be closely held	• owned by a foreign bank • domestic banks within 10 years of start-up may be closely held • at least 35 percent public shareholdings within five years of reaching $750 million in capital • shareholders with more than 10 percent may not participate in new issues, so that over time no shareholder would have more than 10 percent
• Schedule C	• may be closely held by a financial holding company • if not controlled by a financial holding company, subject to the 10/25 regime applicable to Schedule A banks	
Trust and insurance companies	• may be closely held, but must be held by a Financial Holding Company if there is a shareholder owning more than 10 percent of the trust or insurance company as well as another financial institution operating under different legislation • no restriction on new entrants but existing domestically owned institutions would be subject to a limit of not more than a 10 percent holding by any one foreign shareholder, and a total of 25 percent in foreign shareholdings	• new incorporations limited to applicants with no significant commercial interests • commercial interests not permitted to acquire or increase significant ownership positions (10 percent or more) in companies with more than $50 million in capital • 35 percent public float for firms with more than $50 million in capital if commercially linked, $750 million threshold if no commercial link
Holding Company	• can be closely held • holding company owning existing Canadian financial institutions is subject to a limit of not more than a 10 percent holding by any one foreign shareholder, and a total of 25 percent in foreign shareholdings • Foreign-controlled holding company could not own a Schedule A or C bank • no restrictions for new entrants	• ownership requirements for each type of financial institution can be met at the institution or holding company level • a widely held holding company could own a bank • 35 percent public float requirement if the holding company held only non-bank institutions

Where regulated institutions were held by unregulated entities, the concerns of the supervisor about access to the parent and the ability to obtain an overview of the business of the entire financial conglomerate were met in practice by obtaining undertakings from both the holding company and the regulated subsidiaries. This is viewed as less satisfactory than dealing with a widely held entity or a regulated parent, with practical experience being mixed.

In some cases, the regulator has had satisfactory access to information and the controlling shareholder has, in fact, been viewed as a source of managerial and capital strength for the financial institution subsidiary. In the case of a number of failing firms, regulators have found their ability to obtain an accurate view of the financial condition of the entire financial conglomerate to be inadequate. Also, the unsatisfactory experience in reaching restructuring agreements with troubled trust companies in the early 1990s led to amendment of the Canada Deposit Insurance Corporation Act in 1992 to permit the Corporation, in limited circumstances, to seize control of and restructure failing deposit-taking institutions (DTIs). Even with this enhanced power, dealing with a controlling shareholder by means of undertakings is a compromise. If there are to be closely held institutions, the regulator would clearly prefer to have the right of access to information, and the ability to take remedial action when required, ensured by statute without having to rely on negotiated undertakings.

Consideration of the current regime and its recent evolution has prompted the Task Force to explore a number of specific ownership issues. First, given the convergence in the financial sector, which will continue to blur the distinctions between types of institution, is it appropriate to consider a single ownership regime for all financial institutions? A second question is how greater flexibility might be provided while retaining the benefits of a wide-ownership regime. A third area to explore is whether the size-based regime that currently applies to insurance and trust companies and Schedule II banks might be further refined and more broadly applied. The following brief review of international experience provides some further insights that contribute to the conclusions drawn by the Task Force.

International Experience

In reviewing the approach taken in other countries, it is important to note that there are often significant differences between what is described in law and what is observable in practice. For example, as illustrated in Exhibit 2.4, while many countries do not have written ownership restrictions, most require formal or informal government approval of ownership changes. This power has often been used to ensure that institutions, particularly major institutions, are widely held and domestically controlled.

Exhibit 2.4

Ownership Restrictions in Selected Countries[1]

Country	Life insurance		Banking	
	Legislative restrictions	**Practical impact**	**Legislative restrictions**	**Practical impact**
Australia	Supervisor may prohibit shareholdings of greater than 15 percent	The two large life insurers that make up 2 of the "6 pillars" have recently demutualized and are now widely held.	Individual shareholdings limited to 15 percent	4 largest are widely held stock companies
France	Shareholders acquiring more than 5 percent must notify the supervisor; approval of the supervisor is required to hold more than 10 percent	Of the 6 largest, 2 are controlled by mutual holding companies, one is a widely held stock company and 3 are government-controlled.	Unrestricted, complies with EC Second Banking Directive which requires shareholders with more than 10 percent to meet a "fit and proper" test	Of the 8 largest, 4 are cooperative, 3 are widely held stock companies and one is state-owned.
Germany	Supervisor may prohibit shareholdings of greater than 10 percent	Largest (Allianz AG) is controlled by a holding company. There are complex cross-ownership agreements with Munich Reinsurance and the 3 largest banks in Germany, but there is no controlling shareholder.	Unrestricted, complies with EC Second Banking Directive which requires shareholders with more than 10 percent to meet a "fit and proper" test	Shareholdings exceeding 10 percent are not uncommon, but 7 of 8 largest do not have a controlling shareholder, while one is controlled by a province.
Netherlands	Complies with EU Directive 92/96 which requires any person acquiring more than 10 percent of the shares to notify the supervisor	Largest 4 are controlled by holding companies.	No explicit restrictions, but a declaration of non-objection from the Minster or Central Bank is required for a holding of more than 5 percent	Of 5 largest, one is a cooperative, one is a widely held stock company, one is government-owned, and 2 are controlled by holding companies

Exhibit 2.4 **(continued)**

Country	Life insurance		Banking	
	Legislative restrictions	**Practical impact**	**Legislative restrictions**	**Practical impact**
United Kingdom	Supervisor can prohibit anyone from owning more than 10 percent on "fit and proper" grounds	Of 5 largest, 2 are mutuals, 3 are widely held stock companies	A firm has to apply to the regulator to become a shareholder controller and receive non-objection.	7 of 8 largest are widely held stock companies, one is controlled by a holding company that is itself widely held
United States	Varies by state	4 of 5 largest are mutual, one is not-for-profit	The Change in Bank Control Act (CBCA) of 1978 requires that the appropriate federal regulator approve any acquisition of more than 10 percent of the shares of a bank holding company or federally insured bank (includes state charters with FDIC insurance).	10 largest are widely held stock companies

[1] Canadian restrictions are summarized earlier in this chapter in "The Current Regime."

Sources: Robert A. Eisenbeis, "Banks and Insurance Activities," in Saunders and Walter, eds., Universal Banking (New York: New York University, 1996); James R. Barth, Daniel E. Nolle and Tara N. Rice, "Commercial Banking Structure, Regulation and Performance: An International Comparison," Washington: Office of the Comptroller of the Currency, Economic Working Paper 97-6, March 1997; The Conference Board of Canada; regulatory authorities in various countries.

Almost all of the largest banks and insurance companies around the world are widely held despite the lack of formal requirements that this be the case. The U.S. and the U.K. situations illustrate how the practical impact of banking and insurance ownership restrictions can be quite different from what would be suggested simply by a reading of legislation.

U.S. federal legislation has maintained a long-standing legal prohibition on the linking of banking and commerce, but in recent practice a commercial entity can easily provide banking functions by acquiring a federal thrift licence[11] or a state banking charter. The largest U.S. banks are widely held, but numerous smaller banks and near-banks are closely held and/or are part of an unregulated commercial conglomerate. Insurance companies and securities firms also frequently own a thrift or state-chartered bank, so banking and insurance as well as banking and securities dealing can be conducted within the same conglomerate despite the legal restrictions on banks and bank holding companies.

Individual thrifts and thrift-holding companies may be closely held by commercial firms or by financial services firms such as insurance companies or investment dealers. Large commercial firms that have owned or currently own thrifts are:

- Ford Motor Company, the second-largest auto manufacturer in the United States (Ford also engages in vehicle financing through its financing subsidiary);
- Sears Roebuck and Company, one of the world's largest retailers;
- ITT Corporation, a leading hotel, gaming, entertainment and information company;
- Weyerhaeuser Company, the world's largest private owner of softwood timber and producer of wood and paper products;
- Temple Inland Inc., which has major interests in paper, packaging, building products and financial services; and
- Pulte Corporation, one of the largest U.S. builders of single-family homes, also engaged in mortgage banking.

It appears that these thrifts were purchased because they offered some synergy between the thrift customers and the customers of the commercial firm. Examples include offering the firm's products to the thrift's customers or allowing thrift customers to conduct financial transactions through the firm's existing distribution systems, such as grocery stores.[12]

[11] A federal savings bank or "thrift" is a near-bank depository institution. The distinguishing feature of a thrift is that it must maintain a specific amount of assets in defined thrift investments, primarily housing loans and consumer credit. Because of this restriction, thrifts, unlike banks, are not major providers of commercial credit. However, a thrift that is part of a holding company or commercial structure can be affiliated with an unregulated finance company that provides bank-like commercial credit.

[12] Office of Thrift Supervision, *Holding Companies in the Thrift Industry* Background Paper (Washington, D.C.: Department of the Treasury, April 1997).

Regulation in the U.K. has evolved significantly in the last 20 years, with the most recent changes focussing more on the role and powers of regulatory authorities than the ownership structure and powers of financial institutions. The most significant development has been the creation of the Financial Services Authority (FSA), which combines in one body the prudential and market conduct functions of nine agencies dealing with deposit-taking, life insurance, securities and investment management.[13]

There are no explicit ownership restrictions for U.K. banks and insurance companies. The FSA must approve any "shareholder-controller" of a bank. In considering whether a prospective shareholder meets the "fit and proper" criterion, the FSA will consider, among other things, "the likely degree of influence the person will bring to bear on the conduct of the institution's affairs and whether the financial position, reputation or conduct of the person is likely to damage the institution through contagion."[14] While in principle banks may be owned by commercial firms, such ownership arrangements are not widespread[15] and the largest U.K. banks are widely held (see Exhibit 2.4). This is generally thought to be a function of concern by the regulator about potential conflicts of interest, contagion and expansion of the safety net if commercial entities have substantial shareholdings in major banks.[16] There is evidently less concern about these risks for smaller retail-focussed banks, as evidenced by the approval of bank ownership by leading supermarket chains such as Sainsburys and Tesco.

In addition to being widely held, the largest banks in the U.K. are domestically headquartered. As with commercial ownership, there is no explicit restriction on foreign ownership but it would appear that the Bank of England, as well as the Office of Fair Trade and the Monopolies and Merger Commission, have historically used discretion to discourage foreign takeover of large clearing banks. The proposed 1982 acquisition of the Royal Bank of Scotland by the Hongkong and Shanghai Banking Corporation was rejected on "national interest grounds." However, the same bank's 1992 acquisition of a larger U.K. bank, Midland Bank, was approved. A significant difference in the two cases is that in 1992 the actual acquirer was HSBC Holdings plc, the U.K.-based holding company parent of Hongkong and Shanghai Banking Corporation. HSBC

[13] For more detail, see "Report to the Chancellor on the Reform of the Financial Regulatory System," (Securities and Investments Board, July 1997) and the eight subsequent discussion papers issued by the FSA.

[14] Maximilian J.B. Hall, *Banking Regulation and Supervision: A Comparative Study of the U.K, U.S.A. and Japan* (Aldershot, Hants: Elgar Publishing, 1993) p. 40.

[15] United States General Accounting Office, *Bank Regulatory Structure: The United Kingdom*, December 1994, p. 11.

[16] Hall, *Banking Regulation,* p. 41.

Holdings plc had been established in 1990 to facilitate regulatory consent to a major U.K. acquisition by making the ultimate parent of the banking group a U.K.-domiciled company.

Reconsidering Current Policy

A number of issues should be considered in assessing whether the ownership policy that now exists is appropriate for the financial services sector Canada should have in the future. Wide ownership can assure the maintenance of Canadian-controlled and -headquartered financial institutions, and can contribute to prudential objectives. However, wide ownership can constrain competition by imposing barriers to entry on certain types of potential players in the financial services sector.

Most public comment on ownership policy has centred on the so-called "10 percent rule," which precludes any shareholder from owning more than 10 percent of any class of shares of a Schedule I bank. In the many submissions that were received by the Task Force, very few supported removing the 10 percent rule. Some argued that the rule unduly constrained share values and business strategies by restricting Canadian banks in the use of their shares as currency in acquisitions of other institutions, particularly foreign banks. Research conducted for the Task Force found no "direct evidence of gross undervaluation or of seriously inflated capital costs" for Canadian banks because of the existence of the 10 percent rule.[17] While the 10 percent rule might constrain business acquisitions, executives who met with the Task Force suggested that it was not as important a deterrent as the accounting treatment of goodwill in an acquisition, the low value of the Canadian dollar, or the very high price-earnings multiples on U.S. banks arising from the rapid pace of consolidation triggered by the removal of the remaining barriers to U.S. interstate banking.

Several of the banks urged that if the 10 percent rule were to be retained, it should be clearly seen to be a principle based on the national interest and not a privilege or protection for bank management.

Ownership issues go far beyond the 10 percent rule for banks. As noted earlier, the 1992 legislation required that, should the large Canadian mutual life insurance companies choose to demutualize, they would have to be widely held. All of these companies have recently announced their intention to demutualize and

[17] Gerald Garvey and Ron Giammarino, *Ownership Restrictions and the Value of Canadian Bank Stocks*, Research Paper Prepared for the Task Force on the Future of the Financial Services Sector, (Ottawa, September 1998). Garvey and Giammarino conclude that there may be a takeover premium that potential target bank shareholders do not enjoy because of the 10 percent rule. For industrial companies traded on the Toronto Stock Exchange (TSE), this premium could be as large as 10 percent. The authors find that, on average, controlling shareholders do not have a substantial effect on firm value; however, they identify specific instances where a significant shareholder can have a positive effect.

the issue of their future ownership structure is squarely on the agenda of the Task Force. The Task Force has concluded that the national interest would best be served by a fundamental re-examination of the current ownership regimes for all federal financial institutions. There is a continuing need to balance entrepreneurship and competition in the financial services sector with the long-standing goals of safety and soundness and Canadian control.

A Single Ownership Regime

The vision that the Task Force has for the financial sector[18] features a continuing convergence of the businesses of competing financial institutions, driven by innovation and consumer preferences and facilitated by regulatory change. As this convergence continues, banks will continue to become less special by doing more and more business that is not based on intermediation of savings or providing payment services. At the same time, other institutions – trust companies, credit unions and insurance companies in particular – will increasingly be providing the same kinds of intermediation and payments services traditionally provided by banks as well as competing more vigorously with them in other markets. As institutions continue to converge in the functions they perform, any reasons that might have existed to discriminate between them on the basis of ownership requirements become less and less compelling.

There is no logical reason to apply different ownership regimes to regulated financial institutions merely because one is incorporated under the Bank Act and another, for example, under the Insurance Companies Act or the Trust and Loan Companies Act. In an era in which the blurring of the distinctions between financial institutions continues unabated, measured by the business activities that they in fact carry on, the Task Force believes that there should be a single ownership regime.

This is a logical consequence of the evolution of the financial services business. Canadian financial conglomerates with their roots in the life insurance business increasingly have activities that extend far beyond that business into aspects of wealth management. If the proposals of the Task Force are accepted,[19] life insurance companies will also be empowered to deliver payment services. As they enter the payments system, it will become important that the same prudential considerations related to commercial links and ownership are applicable. There is no rational basis for maintaining distinctions in the ownership regime.

With respect to whether such institutions should be widely held or not, the Task Force is of the view that wide ownership serves two important objectives that are worth preserving. The first is significant Canadian control of our

[18] The vision is set out in the final report of the Task Force.

[19] These are developed in Chapter 4 of this paper.

financial services sector.[20] The second is the separation of commercial and financial interests. Since 1992, financial institutions have been subject to much more stringent and rigorous related-party transaction rules, introduced in large measure because of failures of trust and loan companies that were owned by commercial interests in the late 1980s and early 1990s. In principle, these related-party transactions make it less necessary to insist on the strict separation of commercial and financial interests. However, these provisions, introduced in 1992, have not yet been seriously tested since the economy and financial institutions have performed quite well since the last round of legislative changes. The Task Force is also aware that very few other major industrialized countries have historically allowed commercial ownership of banks, and particularly large banks (even though this restriction is becoming more relaxed in the United States and United Kingdom for smaller banks).

The Task Force believes that both Canadian control considerations and prudential factors suggest that large, regulated financial institutions should be widely held. While the Task Force is well aware that widely held institutions are not immune from failure, it has been struck by the fact that the vast majority of large financial conglomerates around the world are widely held. In addition, wide ownership will facilitate the objective that large financial conglomerates – whether led by banks, insurers or trust companies – will continue to be based in Canada well into the next century.

The Task Force therefore proposes that the current disparate ownership regimes for federal financial institutions be replaced by a regime that is consistent across sectors and is based on the size of institution, measured by shareholders' equity. The current requirement for any "significant interest" (holding of more than 10 percent of any class of shares) in a federally incorporated financial institution to be approved by the Minister would be retained. The largest financial institutions, those with shareholders' equity in excess of $5 billion, will have to be widely held[21]. Smaller financial institutions, including smaller banks, will not have to be widely held. Institutions with less than $1 billion in shareholders' equity can be wholly owned by any individual or group, subject only to the Minister approving them as "fit and proper" owners. Institutions with more than $1 billion (but less than $5 billion) in shareholders' equity will be required to have at least 35 percent of their voting common shares widely held and publicly traded. The key elements of this approach are outlined in Exhibit 2.5 and discussed in the following sections.

[20] The concept of Canadian control and reasons why the Task Force believes Canadian control is important are set out in *Competition, Competitiveness and the Public Interest*, Task Force Background Paper #1.

[21] Shareholders' equity for the purpose of this ownership policy is defined to include loans granted to the company by the principal shareholder or related partners.

Exhibit 2.5

Proposed Ownership Regime for Federal Financial Institutions

Bank	Insurance company	Trust company
Widely held • current Schedule I banks • any with shareholders' equity exceeding $5 billion	**Widely held** • same as banks	**Widely held** • same as banks
Controlling shareholder permitted • no ownership restrictions except "fit and proper" test if shareholders' equity is less than $1 billion • 35 percent public float of widely held voting common shares if more than $1 billion in shareholders' equity • must become widely held if shareholders' equity exceeds $5 billion • current Schedule I banks with less than $5 billion in shareholders' equity can, with two thirds majority shareholder approval, request permission from the Minister to have applied the ownership restrictions appropriate to their size as measured by shareholders' equity	**Controlling shareholder permitted** • same as banks	**Controlling shareholder permitted** • same as banks
Cooperative bank • member-owned • widely held by definition • demutualization regime parallels insurance demutualization	**Mutual insurance company** **Cooperative insurance company** • policy holder – owned (mutual) • member-owned (cooperative) • widely held by definition • demutualization permitted pursuant to regulations	**Cooperative trust company** • member-owned • widely held by definition • demutualization regime parallels insurance demutualization
Controlled by a foreign financial institution • normal size-based rules apply • Minister would have the ability to exempt subsidiaries from the requirement to have a 35 percent public float	**Controlled by a foreign financial institution** • same as banks	**Controlled by a foreign financial institution** • same as banks

Definition of "Widely Held"

In reconsidering the definition of "widely held," the Task Force was guided by the desire to both facilitate alliances and enhance the governance of financial institutions.

The financial services industry around the world is rapidly restructuring. Some of the restructuring may take the form of mergers or other business consolidations that, in a Canadian context, are the subject of comment elsewhere.[22] However, other important restructuring opportunities will also exist, some of which may be unavailable to Canadian institutions because of the present definition.

More flexibility is required to enable companies in the Canadian financial sector to restructure as the sector in the rest of the world goes about the same process. However, for the reasons noted earlier in this paper, it would not be in the national interest to abandon the widely-held rule entirely or to replace it with one dependent entirely upon Ministerial discretion. Some clear but more flexible framework is required.

Such a framework should be designed to facilitate the ability of financial and non-financial companies, wherever incorporated and located, to enter into mutually beneficial relationships with regulated Canadian financial institutions (including a more substantial ownership position than 10 percent) without compromising the Canadian-control and prudential objectives.

To provide this more flexible framework, the Task Force proposes that "widely held" be defined as follows:

- No shareholder would be allowed to own, directly or indirectly, more than 10 percent of any class of shares in a widely held institution without the approval of the Minister of Finance.
- The Minister of Finance would have discretion to permit ownership positions of up to 20 percent, including all direct and indirect holdings, so long as all shareholders allowed by the Minister to own more than 10 percent do not collectively own or control more than 45 percent of any class of shares.
- Any two or more persons acting in concert pursuant to any formal or informal agreement or understanding would be deemed a single shareholder for the purposes of determining the allowable ownership stake in a financial institution.
- The Minister could also permit a shareholder to temporarily exceed the 20 percent limit, subject to an acceptable divestiture plan to be executed within a fixed time period, in order to facilitate transactions considered to be in the public interest. No shareholder would be able to vote more than

[22] See *Competition, Competitiveness and the Public Interest*, Task Force Background Paper #1.

20 percent of the shares, even if the minister has permitted a shareholder to temporarily exceed the 20 percent limit.

Details would have to be finalized, but the following are the key elements of a workable regime:

- Anyone contemplating obtaining more than a 10 percent ownership position would apply in advance to the Minister for approval.
- The Minister would have unfettered discretion, similar to that outlined in section 27 of the Bank Act relating to the incorporation of a bank. In addition to the general requirement that the shareholder meet a "fit and proper" test, the Minister would be likely to want to consider whether the shareholding above 10 percent would facilitate a business alliance or acquisition, improve corporate governance, or otherwise benefit Canada and Canadians. An approval to facilitate an alliance or business combination would generally be expected to provide greater benefit to Canada and Canadians than an increased shareholding by a passive investor.
- Once approval is provided, the applicant would have a period of time fixed by the Minister to acquire shares. At the end of the fixed period the shareholder would not be permitted to further increase the ownership position even if the actual percentage of shares acquired fell short of the level approved by the Minister. For example, if a shareholder had received approval to hold 20 percent but only attained 15 percent, a further approval would be required for the shareholder to increase holdings above 15 percent. This would prevent an entity from acquiring and holding a valuable approval without using it.
- The Ministerial approval would apply only to the shareholder to whom it was granted. A shareholder with more than a 10 percent holding could sell any or all of the ownership position without the prior approval of the Minister provided that such a sale would not result in any other shareholder(s) having more than 10 percent ownership. Thus, a 20 percent shareholder could sell a 5 percent share to four purchasers, but could not sell 15 percent to one purchaser unless the Minister approved an application from that purchaser.

The proposed 20 percent threshold will accommodate significant transactions which are in the interest of the financial institution and its stakeholders (including its shareholders, employees and customers) and of Canada, but which are presently constrained by the 10 percent rule. For example, as distribution channels and the scope of business activities carried on by Canadian financial conglomerates continue to expand, beneficial business alliances may be available, but only if the alliance participant is able to obtain a significant, though not necessarily a controlling, share interest in the financial institution.

Such business alliances could be of many forms. In an era of globalization, cross-border investments between financial institutions are increasingly common.

The relationships they offer can provide a means for Canadian financial institutions to obtain long-term linkages with institutions based outside Canada, with the resulting potential for enhanced efficiency and for innovative products and delivery channels. For example, the foreign institution may, either itself or through its activities or alliances in other parts of the world, provide a platform for the Canadian domestic institution to offer improved services to its Canadian customers doing business abroad. To take another example, companies historically not active in the financial sector may be interested, in a joint venture context, to expand their businesses to include financial products. Consumer products distribution companies (such as supermarkets) and information technology companies, for instance, are already pursuing business strategies through which they will become active participants, in one way or another, in the financial services business.

As noted, some third parties may be willing to forge such an alliance only if they are able to obtain a substantial investment in the alliance partner. Others may be willing to participate only if equity accounting is available to permit the alliance partner to include the annual earnings of the investee financial institution in its own financial statements. While a 20 percent shareholding would not guarantee that treatment, it would enhance the possibility of equity accounting and the business relationships that might flow from it. An increase of permitted shareholdings to 20 percent, subject to Ministerial review, would permit Canadian domestic financial institutions to build alliances with these new market participants. In doing so, they could become stronger institutions, thereby enhancing competition in the market as well as the safety and soundness of the Canadian financial system.

The 20 percent threshold will also facilitate acquisitions by Canadian financial institutions in which the use of shares as acquisition currency is constrained by the present widely held rule. Assume, for example, that a Canadian bank is considering the acquisition of a financial institution based in the United States, with a large controlling shareholder. The 10 percent rule prevents the bank from issuing its shares to accomplish the acquisition if the controlling shareholder of the target company would, after the transaction, hold more than 10 percent of the shares of the Canadian bank. The increase in the permitted shareholdings from 10 percent to the proposed 20 percent will, in itself, substantially increase the scale of acquisitions that may be undertaken in the future.

An additional important feature of the ownership regime is the Task Force proposal that shareholdings could, for a temporary period, exceed the new 20 percent threshold. This would be permitted only in circumstances in which the Minister concluded that the excess was required to facilitate a transaction (such as the acquisition by a Canadian financial institution of another business)

in the public interest. This provision is intended to address the concern expressed to the Task Force that any widely held rule, whatever the chosen threshold, may constrain a Canadian institution wishing to acquire, through a share exchange, a target company controlled by a large shareholder.

The discretion for the Minister to approve transactions that would create a shareholding in excess of 20 percent is intended to permit larger commercial transactions considered to be of benefit to Canada. The Minister would be permitted to exercise the discretion only if the party receiving the incremental shares undertook to dispose of them in a time frame and on a basis negotiated with the Minister. The Minister should have the authority to negotiate binding undertakings to achieve this result. In addition, a single shareholder would be limited by an enforceable undertaking to exercise the vote of no more than 20 percent of the shares during the period in which holdings exceeded this level.

Another benefit of permitting shareholdings of up to 20 percent in widely held institutions is the potential to enhance the governance of Canada's largest financial institutions. The ability of financial institutions to survive and prosper by pursuing successful strategies, along with the resulting safety and soundness of the financial system, is increasingly dependent upon effective governance within the institutions themselves. External regulation by governmental authorities such as the Office of the Superintendent of Financial Institutions (OSFI) and the Canada Deposit Insurance Corporation (CDIC) cannot be relied upon as the only bulwark. Instead, solid corporate governance is, and must be, the first point of reliance. The Task Force expects that knowledgeable investors permitted an ownership stake of more than 10 percent will enhance corporate governance by bringing a sophisticated knowledge of the industry and its evolving best practices to the table, thereby strengthening Canadian institutions.

It is true that more concentrated ownership makes it easier for shareholders to influence management. There is no authoritative or precise calculation of what level of ownership defines the best trade-off between improving corporate governance through larger permitted shareholdings and the risk that a shareholder may exercise control in practice and possibly influence management to act in the interests of the shareholder at the expense of depositors and policy holders. The proposed change to allow a 20 percent shareholding, with the further proviso that no three shareholders can control more than 45 percent, reflects a judgment that this would provide a more appropriate balance than the current regime.

The Task Force is proposing that shareholdings beyond 10 percent not be generally available for passive investments in which the investor adds no value beyond its investment in the ongoing business.

The Task Force suggests that the Minister issue guidelines to identify the circumstances in which the Minister would be prepared to consider an application to exercise the discretion. Those guidelines would outline the factors considered by the Minister as likely to give rise to public interest benefits from the increased share ownership (such as enhancing domestic competition, fostering innovation, facilitating restructuring or acquisitions, providing access to foreign markets, or providing Canadian businesses active outside Canada with improved access to high-quality financial products from Canadian financial institutions at reasonable cost). The guidelines should also outline the process by which an investor proposing an excess shareholding would seek and obtain approval.

A widely held, regulated financial institution that is incorporated in Canada should be able to hold up to 100 percent of the shares of another regulated financial institution, regardless of size.

This new ownership regime will mean that large Canadian institutions continue to be widely held, albeit with the potential for shareholders with somewhat larger interests than is presently the case. It will maintain the benefits of Canadian control and the prudential assurances which flow from wide ownership. At the same time, it will facilitate business alliances, innovation, domestic competition and growth of successful Canadian institutions at home and abroad.

Encouraging Other Competitors

Those, then, will be the rules for Canada's largest financial institutions. What of the smaller companies? As noted above, it is proposed that financial institutions with equity of less than $1 billion may be owned by any individual or group, without ownership restrictions except the "fit and proper person" test. Institutions would be expected to meet progressively more stringent widely-held requirements as their shareholders' equity grows. An investor starting a new venture would have the ability to maintain the fruits of the risk investment, and the flexibility and other benefits of close ownership, for a very long time. This change should be of particular importance in the banking business. Under the present rules, the 10 percent rule is now enforced in full after 10 years of a bank's business life, whatever may be its size at that time.

Institutions with shareholders' equity of between $1 and $5 billion would be required to have a public float of voting common shares that amounts to at least 35 percent of all such common shares. The Minister should have the right to approve the terms and conditions of any such shares. Once an institution has reached the $1 billion shareholders' equity threshold, the Task Force believes that its size and significance in the Canadian financial services sector will justify such a widely-held public float of not less than 35 percent of the company's voting common shares.

This requirement is similar but not identical to the current regime for insurance and trust companies and Schedule II banks. It differs in that the threshold will be $1 billion rather than $750 million and that the public float requirement must be satisfied by the listing of common shares rather than voting shares of some other class. Like the current approach, this new proposal is designed to ensure the benefits of wide market ownership, including transparency, independent directors, and the discipline of investor and market analyst scrutiny, based upon timely and meaningful disclosure of the company's business and affairs. Mid-sized companies in this category present substantially greater prudential risks than smaller institutions but, the Task Force believes, are of such a size that the benefits of fostering competition through permitting a continued control block of shares outweigh the prudential considerations. At the $5 billion threshold level, these considerations justify the full application of the widely-held rule.

Institutions reaching the $1 billion and $5 billion thresholds would have a reasonable time period to comply with the 35 percent and widely-held requirements respectively. This window is meant to ensure that companies can choose what they view as a favourable time to issue new shares or sell all or part of a control block.

This ownership regime is designed to encourage new entrants. With some notable exceptions such as First Nations Bank, in recent years there have been few new financial institutions started from scratch in Canada. There should in the future be more potential for new entrants to participate successfully by pursuing a specialized product or a carefully designed target market, employing state-of-the-art technology and the most modern of product development and marketing methods. The change of the ownership rules will enable niche investors to pursue long-term strategies within a closely held corporation on a long-term basis. Accordingly, it should create incremental business opportunities. It is an important part of the strategy recommended by the Task Force to enhance competition.

Safety and Soundness

From a prudential point of view, the greatest concern must be with the largest institutions, because their failure could create serious systemic risk issues. The revised widely-held rules will apply to those companies. However, ownership rules and other regulatory principles should not be designed with the objective that no institution of any size could ever fail. Scope must be left for entrepreneurship and risk-taking, and for the attendant hazards of business failure so long as systemic risks are managed.

In addition, and of great importance, the Task Force believes that it should be possible, through the existing related-party rules and other ring-fencing practices as might be thought appropriate, to minimize the likelihood for improper conduct and resulting business failure in all institutions. However, the public

cannot expect regulation to guarantee business success. The rules should facilitate, not frustrate, entry. The Task Force is persuaded that the new regime constitutes a more appropriate balance between the competing goals of competition and of safety and soundness.

Specific Considerations

While these would be the rules of general application, there are specific issues that will have to be resolved in implementing the new policy.

Common Ownership of Financial Institutions

Where a single owner, or group of related owners, has effective control[23] of more than one regulated financial institution, the combined shareholders' equity of all such regulated financial institutions should be aggregated for purposes of applying the appropriate ownership regime. In effect, institutions in which a single owner or group of related owners has effective control should be deemed to be a single financial institution for purposes of the ownership policy.

Where the size of the combined shareholders' equity of the institution, defined as above, exceeds $1 billion or $5 billion, the relevant ownership rules should be complied with. The owner should be required to bring the ownership of the effectively controlled institutions, as a group, into conformity with the policy by either:

i) diluting the ownership position in one or more of the institutions so that the remaining group complies with the ownership policy; for example,
   - if the combined shareholders' equity of the institutions in which there is effective control exceeds $1 billion, the owner may divest to 65 percent in each of the institutions or divest to a non-controlling interest in one or more institutions so that the combined shareholders' equity of the remaining controlled institutions conforms with the ownership policy;
   - If the combined shareholders' equity of the institutions in which there is effective control exceeds $5 billion, the owner may divest to a non-controlling position in one or more of the institutions so that the combined shareholders' equity of the remaining controlled institutions conforms with the ownership policy; or

ii) restructuring his holdings to create a regulated holding company or operating financial institution parent that controls the entities in which case the ownership rules may be complied with according to options described above under i) or at the level of ownership of the regulated holding company or operating financial institution parent.

[23] To be determined by OSFI in the circumstances. For example, a 40 percent holding in an institution under $5 billion in shareholders'equity could be deemed to be effective control depending on how the balance of the shares are held.

Non-conforming Ownership

Exhibit 2.6 presents a list of major Canadian financial institutions and recent estimates of their shareholders' equity. These estimates illustrate how institutions would fit in the proposed ownership regime. Actual calculations would have to be confirmed by OSFI. These estimates make it apparent that some institutions currently have share structures and ownership patterns that do not fully comply with the regime proposed by the Task Force for institutions of their size. It would be unreasonable to require those institutions, as a condition of continued participation in the Canadian market, to reshape themselves. Accordingly, it is proposed that in such cases, which are expected to be few in number, the present ownership structures would be grandfathered in terms to be resolved in the enabling legislation. The objective of the grandfathering policy should be to ensure that the present economic value of those institutions and their shareholders is not lessened by the new policy but that, in the long term, steps would be taken so that the institutions would be onside.

The Task Force proposes that a company with ownership currently not conforming to the new rules be permitted to continue business without altering its ownership structures, subject only to OSFI being satisfied on an ongoing basis with the quality and substance of the undertakings provided by the controlling shareholder in respect of prudential issues. An institution with shareholders' equity in excess of $1 billion and with a controlling shareholder at the time the new regime is introduced would not be compelled to dilute its ownership block, even if it is then or should subsequently grow to a size that would otherwise require it to be widely held ($5 billion in shareholders' equity). A controlling shareholder wishing to sell its control would have the following options:

1) Subject to Ministerial approval based on the "fit and proper" test, the owners of non-conforming control blocks would be permitted to sell to a single purchaser or group of purchasers even if the transaction did not bring the institution into compliance with (*a*) the 35 percent float requirement if it has $1 to $5 billion in shareholders' equity, or (*b*) the widely-held requirement if shareholders' equity exceeds $5 billion. Any subsequent disposition of the control block would be in accordance with one of the mechanisms in paragraph 2 below.
2) In addition to option 1, the controlling shareholder, or a purchaser pursuant to the single transaction exemption contemplated in option 1, could dispose of the control block in any of the following ways:
   - Share issue to dilute the control block.
   - Sale to multiple purchasers, which would result in compliance with the applicable ownership principles. As with any other transaction, Ministerial approval would be required for any shareholder to own more than 10 percent of the shares.

Exhibit 2.6

Publicly traded financial institutions[1]	Total assets ($ billions)	Total equity ($ billions)	Market cap. ($ billions)
Royal Bank[2] Oct. 31, 1997	244.8	10.4	23.2
CIBC[2] Oct. 31, 1997	238.0	10.2	17.07
Bank of Nova Scotia[2] Oct. 31, 1997	195.2	9.4	15.2
Bank of Montreal[2] Oct. 31, 1997	207.8	8.9	15.9
Toronto-Dominion Bank[2] Oct. 31, 1997	163.9	7.3	15.34
Great-West Lifeco. Inc.[3] Dec. 31, 1997	75.5	5.2	7.18
National Bank[2] Oct. 31, 1997	66.2	2.8	3.43
CT Financial Dec. 31, 1997	46.2	2.7	6.4
Laurentian Bank[2] Oct. 31, 1997	13.4	0.56	0.47
Canadian Western Bank[2] Oct. 31, 1997	2.0	0.13	0.19
Mutuals, cooperatives and subsidiaries	**Total assets ($ billions)**	**Total equity ($ billions)**	**Market cap. ($ billions)**
Sun Life Dec. 31, 1997	80.1	5.7	N/A
ManuLife Dec. 31, 1997	79.7	5.1	N/A
Canada Life (includes estimate for Crown Life) Dec. 31, 1997	46.2	3.2	N/A
Mutual Life (includes estimate for MetLife Canada) Dec. 31, 1997	31.3	3.1	N/A
Hongkong Bank of Canada Oct. 31, 1997	23.9	0.67	N/A
Maritime Life Assur. Co. Dec. 31, 1997	5.5	0.25	N/A
Imperial Life Assur. Co. Dec. 31, 1997	5.0	0.39	N/A
Co-operators Group Dec. 31, 1996	3.7	0.46	N/A
Royal Insurance Canada Dec. 31, 1996	2.7	0.64	N/A
Wawanesa Insurance Dec. 31, 1997	2.5	0.86	N/A
Aetna Life Ins. Co. Dec. 31, 1996	2.3	0.15	N/A
Canadian General Insurance Group Ltd.[4] Dec. 31, 1996	2.0	0.51	N/A
AXA Canada Dec. 31, 1996	1.8	0.38	N/A

[1] Great-West Lifeco. Inc. and CT Financial are publicly traded owners of financial institutions, but are not themselves regulated financial institutions.

[2] Schedule I banks.

[3] The equity for Great-West Lifeco Inc. is before consolidation adjustments to reflect $2 billion minority and other interests of policy holders and preferred shareholders, which are minority interests of the Great-West Life Assurance Company and its subsidiaries. See Annual Report, p. 51.

[4] Canadian General Insurance Group Ltd. was purchased by General Accident PLC of Britain at the end of 1997. The resulting entity is the largest Canadian property and casualty (P&C) insurer. 1997 Financial data was not available at the time of writing.

Notes: Life insurance company assets include segregated funds. Equity includes share capital, retained earnings and surplus. It excludes subordinated debt. Equity estimated by Task Force staff from annual reports, OSFI Web site data and other public sources to illustrate how institutions would fit in the proposed regime. ING Canada is Canada's fourth-largest P&C insurer, but does not make its financial statements available on a group basis.

- Sale to a foreign or domestic widely held financial institution which is approved by the Minister on the basis that it is a “fit and proper” owner (and without any requirement for the purchaser to provide the undertaking described in option 1).
- Sale to a purchaser that has provided a divestiture plan acceptable to the Minister to achieve compliance with the ownership regime.

As a result of these transition provisions, owners of existing control blocks would have a number of ways to maximize the value of their shares in the long term, including the important option of selling to widely held financial institutions which are not Canadian controlled.

Smaller Banks

The special circumstances of the smaller existing Schedule I banks will also have to be considered. There are three such institutions which are currently subject to the 10 percent rule but do not have shareholders’ equity in excess of $5 billion, namely the Canadian Western Bank, the Laurentian Bank and the National Bank. The Task Force proposes that these institutions would, in the first instance, become subject to the new widely-held regime (i.e., shareholdings could be increased to the 20 percent limit with Ministerial approval). However, the Task Force also recognizes that these institutions may consider that their business interests would best be served by reverting to the ownership rule that would otherwise apply to them by reason of their size. This would, for example, permit such institutions to pursue business strategies, including alliances with prospective partners, of a different nature and scope than would be the case if they remained widely held.

These somewhat smaller Canadian institutions are promising platforms upon which to build stronger and even more competitive financial service businesses, firmly rooted in Canada. As a result, it is critical that they should have the greatest available flexibility as they consider how and when to reshape themselves. The ownership proposals of the Task Force would, for example, permit one of these institutions to develop a cross-ownership relationship with a commercial entity or foreign institution, or to take advantage of the proposed holding company regime (see Chapter 3) to form an alliance with other mid-sized players in the Canadian financial services sector. Accordingly, it is proposed that these institutions have the right to be recategorized out of the widely-held class of financial institutions and into the category (with the resulting ownership rules) which would apply by reason of their share capitalization.

The recategorization would require the approval of the board of directors of the financial institution, confirmed by a special resolution of its shareholders and the approval of the Minister. The rules relating to the exercise of the recategorization right will have to be carefully designed so that the decision to

exercise the right cannot be forced on the institution by transactions proposed to the bank by a third party and which the board of directors of the bank would be obligated to pursue by reason of otherwise applicable legal principles. The concern of the Task Force in this regard arises from a scenario in which a third party might make a takeover bid for a small bank, conditional upon recategorization. This could, in legal theory, force a restructuring and a business re-alignment upon the bank against its corporate will – something which could not be imposed if the institution were to remain within the widely-held regime. One option to avoid such a scenario might be legislation which provides that the institution in question should remain widely held for a specified time period from the date of the recategorization, unless the Minister otherwise determines.

Cooperative and Mutual Ownership

Canada stands almost alone among developed countries in terms of the relatively small market share of second-tier institutions competing with the largest deposit-taking institutions. Institutions such as state-run postal savings offices, cooperative banks and regional banks are important counterweights to large institutions in highly concentrated banking markets in countries such as the Netherlands and Switzerland. While government cannot mandate the creation of a thriving middle tier in Canada, it is important that regulatory barriers to the growth of alternatives to the largest institutions be removed. To this end, the Task Force views it as vitally important to ensure that the cooperative sector, rooted as it is in community participation, has every opportunity to grow and prosper.

In the framework that the Task Force has recommended, financial institutions owned in a mutual or cooperative form are deemed to comply fully with the ownership rules. Concern was raised with the Task Force that the present regime may not fully accommodate cooperative ownership.[24] Since it is evident that these ownership forms fully meet the intent of wide ownership, there should be no suggestion in the policy that mutual or cooperative enterprises would be obliged, by reason of their size, to float their shares on the public market. The Task Force proposes that the necessary amendments be made to clarify that cooperative ownership complies with the widely-held provisions of the ownership regime.

[24] The concern raised by The Co-operators Group Limited is that section 411 of the Insurance Companies Act requires that any company upon reaching $750 million in shareholders' equity, subject to a transition period, must "have, and continue to have, voting shares that carry at least 35 percent of the voting rights attached to all of the outstanding voting shares of the company and that are (a) shares of one or more classes of shares that are listed and posted for trading on a recognized stock exchange in Canada; and (b) beneficially owned by persons (i) who have no significant interest in any class of voting shares in the company."

A federal cooperative bank charter could enhance competition in three ways. It could provide a vehicle for stronger central organizations to better meet the needs of consumers, both by providing services to local credit unions and caisses populaires, and by providing some services directly to individual consumers (see Exhibit 2.7). Second, it might provide a vehicle for credit unions and caisses populaires to provide services across provincial boundaries. Some existing provincially chartered institutions, subject to compliance with provincial legislation, might apply for continuance as federally chartered cooperative banks. Third, the cooperative bank option provides another ownership structure for potential new entry into the banking business at a community level. Both the Mouvement Desjardins and Credit Union Central of Canada (CUCC) have suggested that the Task Force recommend the establishment of cooperative banks.

Therefore, the Task Force proposes that a new category of federal financial institution, distinguished by a cooperative form of ownership, be provided for in the federal legislation. Under this provision, credit unions, caisse populaires and credit union centrals, with the permission of their province of incorporation, could apply to be continued as banks or trust companies. In addition, new institutions could be formed based on the cooperative principle of one member, one vote. Membership in cooperative financial institutions would be open to other cooperatives as well as to individual members.

While the large mutual life companies have indicated their intention to become stock companies, there continue to be many smaller (mostly provincially incorporated) mutually owned life and general insurance companies. Mutual ownership would continue to be a permitted ownership structure for federal insurance companies.

Demutualizing Life Insurance Companies

Mutual insurance companies around the world are converting to stock companies to better position themselves to participate in the global restructuring of the financial services sector. The mutual ownership form precludes voting common shares. Among the benefits that arise from demutualization are the following:

- Policy holders can realize on the value of the company through shareholdings.
- There is greater flexibility in the type, timing and cost of capital.
- Common shares can be used as acquisition currency.
- The ability to provide options and share purchase plans can assist in attracting and keeping highly skilled employees.
- The market discipline of being publicly traded may lead to greater innovation and efficiency.

Exhibit 2.7
Competitive Small Institutions

In the United States, there are thousands of small independent deposit-taking institutions that are able to compete effectively with larger institutions despite handicaps arising from their small size and limited market area. On their own, these small institutions would have difficulty in obtaining the necessary economies of scale to be able to offer and support retail products that are competitive with the banking conglomerates. In Canada, smaller trust companies and banks as well as the credit union movement face similar issues.

The credit union movement has a long history of banding together to provide services centrally. Specialized institutions and associations have also developed to provide systems and products to banks. A U.S. example is the Bankers' Bank based in Madison, Wisconsin, which offers services to over 800 banks and thrift companies in the Mid-west. The profits of the bank are distributed to its shareholders, who are also customers of the Bankers' Bank. A potential customer is not required to join as a shareholder. The Bank offers specific services to its customer banks including support for retail products such as credit cards and mortgages, as well as internal banking services such as auditing, compliance reviews, operations consulting, and account verifications. There are approximately 17 institutions in the United States that offer similar services to the small deposit-taking institutions.

Within Canada, such collaborative types of services could be facilitated through the proposal to allow formation of cooperative banks. The credit union system may find the cooperative bank option a more efficient way to deliver services to credit unions than is currently possible. The viability of other small deposit-taking institutions in Canada would also be enhanced if such banking service providers were to develop.

The four large Canadian mutual life companies (Mutual Life, Sun Life, Manulife and Canada Life) have announced their intention to demutualize.[25] These companies pose special ownership issues. The current regime requires that large life insurance companies be widely held. The Task Force proposes that the ownership of demutualized companies be based upon their size, consistent with the ownership regime for all other federally incorporated financial institutions. An additional issue that requires consideration is whether there is a need for a transition period for newly demutualized companies, within which they would continue to be widely held, regardless of size.

[25] The 1992 legislation provided for the demutualization of insurance companies. Section 237 of the Insurance Companies Act provides that the Minister may approve a proposal to convert a mutual company in accordance with the regulations. The Mutual Company Conversion Regulations, which came into force on April 20, 1993, apply only to companies with less than $7.5 billion in total assets in Canada for the 1991 fiscal year. Regulations for the demutualization of large companies have not yet been promulgated. The industry has been working extensively with the Department of Finance in developing the new regulations and a consultation paper was released on August 27, 1998.

The question of a transition period has been raised because of the view that a newly demutualized life insurance company, without special legislative protection, might find itself the subject of unwanted takeover activity in the period immediately following demutualization. Such activity may not be in the best interests of the institution or of Canada and Canadians. The Task Force believes that the demutualizing insurance companies provide an important platform to enhance competition in the Canadian financial marketplace. The Task Force agrees that, following listing of the shares of the company, it will require some time to attain full market recognition and value. Finally, the Task Force also agrees that it may take some time for newly demutualized companies, and their management teams, to fully adjust to the reality of life as listed public corporations, with the attendant aggressive scrutiny and market expectations created by value-conscious investors and market analysts. For all these reasons, demutualizing insurance companies should be provided with a breathing period to facilitate their restructuring.

The Task Force has considered and rejected the suggestion that the transition should be a period in which all business combinations involving mutual insurance companies would be prohibited. The rapid pace of change currently in evidence provides an opportunity not only for the insurance companies but for other mid-sized and second-tier institutions in Canada to restructure and forge new alliances to better compete with the largest institutions in Canada and abroad. To exclude the demutualized companies from this process by requiring a business standstill would be a disservice to Canadian consumers as well as to the shareholders and employees of the companies themselves. The Task Force is also well aware that without a transition period these companies could simply be swallowed up by other large institutions. The challenge, then, is to provide a mechanism that would prevent unwanted takeovers while still facilitating restructuring of the sector.

Approval of the Minister is required for any change in ownership of a federal financial institution. The views of the Task Force on the appropriate process, including provision for public input for transactions involving the largest financial institutions, are detailed elsewhere.[26] The Task Force proposes that there should be transition guidelines to be applicable for a three-year period following the demutualization of a life insurance company. The basic principle behind the guidelines would be that a newly demutualized company should not be subjected to a hostile takeover bid or amalgamation proposal in a period while it is still adjusting to the reality of the public market environment. While

[26] See *Competition, Competitiveness and the Public Interest*, Task Force Background Paper #1, Chapter 7.

hostile transactions should be precluded, the guidelines should not be so inflexible that newly demutualized companies are denied the opportunities to enter into strategic alliances that may bring more effective competition to the Canadian financial services sector.

Large demutualized companies (that is, those with shareholders' equity in excess of $5 billion) will have to remain widely held during the transition period and beyond, by virtue of their size. Smaller demutualized companies would not, under the general ownership rules, have to be widely held. The transition guidelines should provide:

- that the smaller demutualizing companies should also be widely held for the three-year transition period, and
- in the normal course, the Minister of Finance should not approve any proposal for merger or acquisition of any newly demutualized company.

Newly demutualized companies, may, however, find it desirable to form strategic alliances with other providers earlier, rather than later. The Task Force proposes that where a demutualized company proposes, and its board approves, a transaction that might violate the transition guidelines, the Minister be prepared to approve it if it is clearly demonstrated that it would be in the public interest and that it is desirable to proceed before the transition period has expired.

Flexibility for the Future

The Task Force has assessed whether the ownership regime outlined above has sufficient flexibility to attain the desired national objectives in the years ahead in all possible circumstances. This is a time of rapid change in the financial services business. It is simply not possible to foresee all scenarios. While the Task Force believes that the ownership framework outlined above will achieve the policy goals for which it is designed, the Task Force is also of the opinion that the Minister of Finance should be afforded maximum flexibility to facilitate other major changes in the restructuring of Canada's financial services sector, if further steps become desirable.

It is possible to imagine many circumstances in which such flexibility could be used by the Minister to achieve important national policy interests. For example, a major Canadian financial institution could face financial difficulties that gave rise to serious questions as to its continuing safety and soundness. One option would be the combination, by merger or takeover, of that institution with another large Canadian financial institution. That, however, would increase still further the concentration in Canada's financial sector and could be detrimental to Canadian consumers in terms of competitive choice. In such a circumstance, the Minister should have the statutory authority to look

beyond Canadian financial institutions to find a "white knight," weighing the various objectives of the ownership policy and the need for a competitive marketplace.

Another scenario is that a medium-sized Canadian financial institution might be unable, for reasons of capital or other business constraints, to pursue an expansion of its business in Canada even though it might add a vitally important competitive force to Canada's financial services market. That institution might be an attractive candidate for acquisition or significant investment by a widely held financial institution based outside Canada that is interested in expanding its operations in Canada. The acquisition or investment could be offside the new rules.

In either of these cases, the Minister would obviously want to know whether it would be possible to craft a transaction to maintain the benefits otherwise attributed to Canadian control, while pursuing the objectives of safety and soundness and of enhanced competition. There would seem to be every reason for the legislation to contain a mechanism permitting such transactions if the Minister obtains satisfactory assurances on such questions.

As a result, the Task Force proposes that there be a provision to permit the acquisition of a widely held Canadian financial institution by a foreign purchaser. Such an acquisition would require a more stringent approval process than that proposed by the Task Force for other acquisitions or mergers. If the Competition Bureau had no competition concerns, the transaction could proceed provided that: *(a)* the buyer was a widely held, regulated financial institution approved by OSFI; *(b)* the acquisition was approved by the Governor-in-Council on the recommendation of the Minister of Finance (based upon a decision by the Minister that the acquisition would be in the public interest by enhancing the safety and soundness of the Canadian financial services system or by enhancing competition within the sector); and *(c)* enforceable undertakings were provided to the Minister by the acquiring shareholder to ensure that the transaction provided its intended benefits to Canada.

Because the Task Force expects this power to be exercised only in exceptional cases, it proposes that the transaction be approved by the Governor-in-Council rather than in some other fashion. It is important that the exception not become the rule. On the other hand, the enhanced flexibility available in the system through this exception is, in the opinion of the Task Force, of considerable value.

Summary

These, then, would be the new ownership rules for the financial services sector. The Task Force is of the view that they would, through their broader scope, open the possibility for business transactions that can enhance the strength and competitiveness of Canadian financial institutions to the clear benefit of Canada and Canadians. A core component of the financial sector will remain Canadian-controlled, and the largest institutions will have the prudential benefit of being widely-held. A more flexible definition of "widely held" will provide increased flexibility for alliances and acquisitions, and will enhance corporate governance. Transition rules for existing small banks and demutualizing insurance companies will provide flexibility to facilitate the development of more competitive institutions New ownership options, including closely held smaller banks and cooperative banks, will increase the potential for competition from new and existing players. The Task Force expects that Canadians will benefit from increased competition without jeopardy to the essential safety and soundness of the financial sector.

Chapter 3

Permitted Corporate Structures

Changing Markets and Functional Regulation

As financial markets have changed, institutions have broadened the range of products and services they offer beyond what have traditionally been regarded as their core functions. Insurance companies provide investment choices to consumers through products such as deferred annuities, which are very similar to Guaranteed Investment Certificates sold by banks. They also sell segregated funds, which are very similar to mutual funds, and, through bank or trust subsidiaries, they have the power to offer deposit accounts, chequing services and personal loans. Banks, directly and through subsidiaries, now provide mutual funds, insurance, credit cards and a host of other products that years ago would not have been considered the business of banking.[27]

The changing financial markets have also led to the emergence of new participants that compete with traditional financial institutions in select product lines. Independent mutual fund companies are dominant in the mutual fund market, accounting for about two thirds of assets under management.[28] Asset-based lenders, such as Newcourt Credit Group, have emerged as significant competitors in certain commercial credit markets. Such asset-based lenders, because they do not take deposits from individuals, are not regulated institutions. Mutual funds fall under the jurisdiction of provincial securities commissions. Mutual fund companies are regulated, but because market risks are assumed by the investors, regulators focus only on market conduct and not on safety and soundness.

[27] For example, until 1954 banks were unable to provide residential mortgages, and between 1954 and 1967 were restricted to National Housing Act (NHA) insured mortgages. The 1967 Bank Act permitted banks to provide conventional mortgage financing. The Porter Commission noted with approval the "vigorous and imaginative way" that established institutions introduced innovations, despite the fact that "old-time bankers would surely shudder at the very thought of instalment loans and NHA mortgages in bank portfolios." *Report of the Royal Commission on Banking and Finance* (Ottawa: Queen's Printer, 1964), p. 2.

[28] The mutual fund affiliates of regulated financial institutions account for about 35 percent of mutual fund assets, with banks and trusts having 30.2 percent, life insurers 3.8, and credit unions and caisses populaires about 0.7 percent as at June 1998. Source: The Investment Funds Institute of Canada.

There is a growing dichotomy between activities that are not regulated or less regulated when carried on in some institutions, and more regulated when carried on in others. As markets become more competitive, the cost burden of regulation on the same activities in some institutions and not in competing institutions can affect competition in the marketplace. This has led to a desire to explore whether the type and degree of regulation should be related more to function than to institution.

A further consideration behind this desire is the belief that organizational structure should be determined by business decisions rather than regulatory considerations, except where specific organizational restrictions are essential to meet public policy objectives.

In principle, it would be desirable for similar functions to be regulated similarly, even when carried out by different institutions. In practice, this is an ideal which is difficult to attain in the real world. At the end of the day, it is institutions that fail, not functions. Regulation must continue to be based on institutions.

The question remains, however, whether it is possible to move closer to the ideal through allowing more flexible organizational structures. Are there structures that would allow different functions to be performed by separate legal entities within a corporate group, with these functions being regulated differently (or not at all) depending on the nature of the function? If new organizational structures can lead to more nuanced regulation of financial groups, without compromising basic principles of prudential regulation, there could be important benefits to the institutions and to the promotion of competition in the economy.

This question is examined in more detail in this chapter. Subsequent sections:

- review the permitted organizational structures now in place;
- discuss the concept of a holding company for regulated financial institutions;
- present some information on structures permitted in other countries; and
- discuss ways in which flexibility might be increased in Canada.

Permitted Organizational Structures

Currently two forms of organizational structure are allowed for regulated financial institutions: the "unregulated holding company" and the "financial institution parent model."

The Unregulated Holding Company

The current regime does not allow holding companies for Schedule I banks or mutual insurance companies because the law requires these companies to be widely held. There is currently no wide-ownership requirement for trust

companies or stock insurance companies and these institutions can be, and often are, owned by holding companies. Such companies are not regarded as financial institutions and are not regulated.

An unregulated holding company poses three major types of problems for regulators. First, the regulator needs to be assured that the capital in the regulated institution is true equity capital and not debt. If the equity investment by the holding company in the financial institution is borrowed by the holding company, the regulated institution is not as strong as it appears. Because debt raised by the parent is likely to require contractual payments that can be met only from the income of the regulated subsidiary, there is likely to be pressure from the parent for the regulated subsidiary to continue dividends or management fee payments to the parent even when the financial institution is in difficulty.

Second, such holding companies are not prevented from holding entities that the financial institution itself would not be allowed to hold, such as other unregulated financial institutions or even commercial enterprises. Related-party transaction rules may not be a sufficient or effective tool for the regulator to monitor and control transactions between the regulated entity and unregulated or commercial entities owned by the same investor. Experience indicates that in times of distress, regulators learn about transactions only after the fact. Thus, the risks to the regulated entity may not be adequately assessed or contained when its parent is unregulated.

Third, even though such holding companies cannot own a bank in Canada, they can own banks in other countries. Royal Trustco, an unregulated holding company, owned regulated trust companies in Canada, regulated banks in the United Kingdom, Hong Kong and Switzerland, and a U.S. thrift (savings and loan). The former Superintendent of Financial Institutions reports, "The regulators in these different countries did not understand or like this ownership structure and could not maintain meaningful relations with Canadian regulators. There was no ability of the OSFI to communicate with these regulators in a meaningful way since it did not supervise Royal Trustco. The results were, to put it mildly, unfortunate."[29]

In practice, OSFI obtains undertakings from the owners of financial institutions held by unregulated holding companies. These provide OSFI with reasonable assurance that it can discharge its responsibilities with regard to the safety and soundness of the Canadian-regulated financial institution.

[29] Michael Mackenzie, "The Case for Regulating Financial Holding Companies, February 1998." Submission to the Task Force, May 1998.

The Financial Institution Parent Model

The financial institution parent model, after the amendments to the 1992 financial institutions' authorizing legislation that broke down the traditional four pillars, allows any regulated financial institution to own any other regulated financial institution as a subsidiary. Thus a bank can now own insurance companies, trust companies and investment dealers, and any of these other companies can also own a bank, so long as it is itself a widely held financial institution. This is similar to a holding company model except that the holding company is the operating financial institution.

The financial institution parent, in this model, may make substantial investments (i.e., more than 10 percent) only in entities that are designated by statute. The main reason for controlling permitted downstream investments is to maintain the separation of financial services from trade and commerce. This separation is enshrined in the federal financial institution legislation in the stricture that federally incorporated financial institutions shall not "deal in goods, wares or merchandise or engage in any trade or other business."[30]

The entities in which a financial institution may have a substantial investment[31] generally are expected to carry on financially related activities as defined by the legislation. Approval by the Minister is required specifically when such designated entities are :

- a financial institution,
- an information services corporation,
- a specialized financing corporation,
- an ancillary corporation,[32] or
- a corporation which carries on one or more activities, and one of the activities includes an activity undertaken by any of the above noted entities.

Approval by the Minister is also required for substantial investments in certain entities in which there is less than majority control. They are:

- a factoring corporation,
- a financial leasing corporation, and
- a financial holding corporation.

[30] Bank Act, s. 410(2); Trust and Loan Companies Act, s. 410(2); Insurance Companies Act, s. 441(3).

[31] Following passage of Bill C-82 in 1997, OSFI now has broader scope to approve investments of more than 10 percent that do not result in control (holdings of more than 50 percent) of the designated entity by the financial institution.

[32] An ancillary business corporation, generally, is an entity which carries on a business closely related or ancillary to the business of a regulated financial institution or a subsidiary of a regulated financial institution that is itself regulated.

The current regime does provide a certain amount of flexibility.[33] OSFI does not supervise all the subsidiaries of banks, trust companies and insurance companies, although it reserves the right to do so. In addition, it supervises some subsidiaries more lightly than it does others or the parent company itself. In some cases, such as securities subsidiaries, other regulators fulfil the primary regulatory function.[34]

Issues

There are tensions within the current regime and they are best described by discussing two issues that ultimately must be balanced in a way that favours the broader public interest.

The first issue is whether the range of companies in which a regulated financial institution can hold an interest (a "designated entity") is broad enough. The Government has signalled its intention to allow foreign branches to operate in Canada to serve wholesale customers, without being members of CDIC and with a lighter form of regulation applying than if they entered as subsidiaries. This would put foreign bank branches somewhat closer than Canadian banks to the regime that unregulated finance companies and asset-backed lenders have. It is also the case that an unregulated holding company owning a trust or insurance company could establish a wholesale financing subsidiary that would be unregulated.

Should a Canadian bank be able to set up a separate company to carry on a wholesale financing business under the current regime and have that entity regulated less rigorously than the same activity would be if it were carried on in the bank? Some submissions to the Task Force have suggested that this option should be available.[35] It is not clear under current law whether this could be done, but it does appear that even if it could the Bank for International Settlements (BIS) capital rules would require that regulatory capital be held against the assets of the wholesale financing entity on the same basis as would be required if the activity were carried on in-house. Indeed one of the rigidities of the current regime is that when the holding company is an operating bank, regulatory capital for the consolidated enterprise must be calculated according to the BIS capital rules for banks. Similarly, if the holding company is an operating insurance company, the Minimum Continuing Capital and Surplus Requirements (MCCSR) must be met on a consolidated basis. In this event there may be no business advantage to segregating such lending activities in separate companies.

[33] More detail on the list of permitted investments and various approvals required is provided in Exhibit 3.2 at the end of this chapter.

[34] The agreement on the respective roles of OSFI and provincial governments in supervising bank-owned securities dealers is set out in the Hockin-Kwinter Accord of 1987.

[35] See, for example, "Seeing Beyond: CIBC's Technical Recommendations," Submission to the Task Force, October 1997, p. 39.

The second issue is whether it is possible or desirable from a public policy perspective to move closer to a functional regulation model using a parent-subsidiary structure.

There are two main rationales for prudential regulation: to protect small depositors or policy holders, and to prevent systemic risk. In principle, one ought to be able to consider a bank that takes retail deposits and is tightly regulated separately from all kinds of subsidiaries it may have, which can be less regulated or regulated not at all. Even if subsidiaries fail, depositors would not be at risk and there would be no systemic impacts. In practice, the situation is not so clear-cut. The regulator must be assured on four counts.

First, there must be assurance that the designated entities are ring-fenced. That is, there must be control over transactions between the bank and the entities, to prevent those entities from directly weakening the bank. The current law contains very strict related-party transaction provisions that attempt to satisfy this concern.

Second, there must be assurance that there is no contagion effect between the bank and the designated entities. That is, if a designated entity gets into trouble, will there be a general loss of confidence in the group, including the bank, and a run on the bank that could precipitate its failure? The contagion effect could create systemic problems, but even if it did not it would increase the risk to the deposit insurer. This is a much more difficult issue on which to provide comfort since it depends ultimately on public expectations and perceptions.

Third, there must be assurance that the so-called benefits of the safety net are not transmitted to the designated entities. The benefits of the safety net consist of deposit insurance, lender-of-last-resort facilities, and a possible perception that some banks are "too big to fail." As detailed in Chapter 2, there is a heated debate among academics and practitioners as to whether the benefits of the safety net offset the costs of regulation. Some claim that there are net costs to being regulated, rather than net benefits. To the extent that benefits exist, it is important that they be contained within the bank and not spread to less regulated or unregulated designated entities, as such expansion would distort competition in the market.

Finally, the regulator must be concerned about risk to reputation. The holding company in the current model continues to be an operating financial institution. To the extent that designated entities held by an operating bank were to fail, even with adequate firewalls and no contagion, what would that do to the reputation of the bank, particularly if it has international activities involving foreign regulators relying on the Canadian supervisor to warrant the integrity of the parent institution? There are no clear or easy answers.

To the extent that it is possible to use a functional approach to regulation, nuancing of regulation is possible within the existing organizational framework. However, this regulatory flexibility is ultimately limited because the parent is itself an operating financial institution.

A Holding Company Approach

In its June 1997 Discussion Paper, the Task Force asked whether "a holding company model, as a permissible option for regulated financial institutions, [would] be feasible and desirable."[36] In response, a number of financial institutions expressed the view that an optional holding company could offer business advantages. This section reviews the business case that has been made for a holding company and considers some of the advantages that a holding company might provide over the current financial institution as parent model.

The Business Case for a Holding Company Model

There are four main arguments advanced as to why a holding company could offer valuable flexibility.

The first is that organizing activities in separate legal entities could provide greater flexibility for raising capital and bringing in strategic business partners. For example, if a bank wished to bring in a joint venture partner in credit cards or custody, it would be possible to set up a separate legal entity and to issue equity out of that entity and not the bank itself. This flexibility is likely to become increasingly important. It is available now in the financial institution parent model and, indeed, CIBC has entered into a joint venture with Mellon Bank with respect to custody.[37] While this is a valid argument, it is not clear that a holding company model would provide any greater flexibility than does the current regime.

The second argument is that a holding company model could allow more nuanced regulation. The case is advanced that a wholesale finance institution held as a designated entity of a holding company would not have to be regulated in the same way as such an institution held as a designated entity of an operating bank.

[36] Discussion Paper, p. 25.

[37] CIBC Mellon Global Securities Services Company is 50 percent owned by CIBC and 50 percent owned by Mellon Bank. It is a multi-purpose corporation as defined in the Bank Act, s. 469(1)(n), providing both information services and general services. CIBC also purchased a 50 percent interest in RM Trust (now CIBC Mellon Trust) to provide the trustee services that are ancillary to the global custody business. CIBC could not complete the 50 percent acquisition of RM Trust until the Bill C-82 amendments permitted OSFI to approve the holding of a non-controlling interest in another financial institution by a federally incorporated financial institution.

The third argument, which is advanced in particular by insurance companies, is that as they continue to expand their operations to foreign countries they will increasingly be required by foreign governments to establish joint ventures with local partners. If these joint ventures are held by the parent and directly regulated by OSFI as part of its responsibility for the Canadian operation, they will face a regulatory burden that many competitors from other countries do not face. The insurance companies argue that this would put them at a competitive disadvantage when expanding internationally. If, however, they can put an international joint venture under a holding company, with appropriate firewalls, they argue that OSFI could legitimately be less concerned about the safety and soundness of the foreign operation since its impact on Canadian policy holders would be limited.

Finally, it has been argued that as the financial system continues to be restructured, a holding company provides a vehicle for facilitating the coming together of medium-sized financial institutions in different pillars to form a conglomerate that can benefit from economies of scale and scope. For example, there may be medium-sized insurance companies, banks, mutual fund companies, trust companies and perhaps other financial institutions that would be willing to work together in a conglomerate with common ownership, each keeping its own distinctive identity and management culture. A holding company that would allow each institution to swap its own shares for shares of the holding company could facilitate such combinations and provide opportunities for enhanced competition.

Advantages of a Holding Company Model

In the view of the Task Force, the fourth argument advanced above, that is, the use of the holding company as a facilitative vehicle to form conglomerates, presents an unambiguous advantage of a holding company structure.

Whether the other arguments will, in reality, be advantages will depend upon how the holding company structure is regulated. At one extreme, a holding company could be allowed and regulated in precisely the same way as the financial institution parent model. If so, then the business case advantages foreseen for the holding company structure would probably disappear.

The issue of what might constitute an appropriate regulatory regime for a holding company structure is discussed in the concluding section of this chapter. At this point, it is useful to consider what lessons might be learned from international experience.

International Experience

Virtually all developed countries have regulatory regimes that are flexible enough in practice, despite some apparent legal barriers, to permit the undertaking of a wide range of regulated and unregulated financial activities within the same financial conglomerate (see Exhibit 3.1). Even the United States, in practice, permits virtually unrestricted business powers in financial services despite what might be inferred from a strict reading of legislation such as the Glass-Steagall Act and the Bank Holding Company Act.

A holding company structure is permitted in many countries. Even where permitted, however, there are many countries where the holding company structure is not widely used. There are three possible reasons why this is the case. One might be that there are business reasons for conglomerates to use in-house powers or subsidiary structures even when a holding company option is available. A second reason, which relates to ownership restrictions, is that the desire of regulators to have widely held institutions means that holding company ownership of a large bank would not be approved on "fit and proper" grounds unless the holding company itself is widely held. The third reason could be that the regulatory approach to dealing with holding companies is so stringent that any commercial advantage of the structure is outweighed by additional regulatory requirements.

It is instructive to focus further on the United States, the United Kingdom and Australia. The United States has a legacy of restrictive legislation and a unique holding company regime. The history of the United Kingdom is in sharp contrast, with very few legislated restrictions. Australia has just concluded a major review of its financial services sector.

The United States

Despite the lack of comprehensive legislative reform in the United States, the culmination of a number of more focussed amendments, court cases and liberal interpretations by regulators together have effectively responded to market demand for convergence in the financial sector. The result has been a proliferation of organizational structures.

Exhibit 3.1
International Organizational Forms

Permissible Corporate Organizational Form in which Banks may Conduct Selected Activities

		Securities activities[1]			Insurance activities[2]		
Country	**Bank holding company permitted**	**Directly in the bank**	**Bank subsidiary**	**Bank holding company**	**Directly in the bank**	**Bank subsidiary**	**Bank holding company subsidiary**
Australia	Yes	No[3]	Yes	Yes	No	Yes	Yes
Belgium	Yes	Yes	Yes	Yes	Yes[4]	Yes	Yes
Canada	No	No	Yes	No	No	Yes	No
France	Yes	Yes	Yes	Yes	Yes[4]	Yes	Yes
Germany	Yes, but infrequently used	Yes	Yes	Yes	Yes[4]	Yes	Yes
Netherlands	Yes, widely used	Yes	Yes	Yes	Yes[4]	Yes	Yes
Switzerland	Yes, but infrequently used	Yes	Yes	Yes	Yes	Yes	Yes
United Kingdom	Yes, but infrequently used	Yes	Yes	Yes	Yes	Yes	Yes
United States:							
National Bank	Yes	Yes[5]	Yes[5]	Yes[7]	Yes[8]	Yes[8]	Yes[10]
State Bank	Yes	Yes[6]	Yes[6]	Yes[7]	Yes[9]	Yes[9]	Yes[10]

Permissible Corporate Organizational Form in which Insurance Companies may Conduct Selected Activities

		Securities activities[1]			Banking activities		
Country	**Insurance holding company permitted**	**In-house**	**Insurance co. subsidiary**	**Insurance holding company subsidiary**	**In-house**	**Insurance co. subsidiary**	**Insurance holding company subsidiary**
Australia	Yes[11]	No	Yes	Yes	No	Yes[12]	Yes
Belgium	Yes	No	Yes	Yes	No	Yes	Yes
Canada	Yes[13]	No	Yes	Yes[13]	No	Yes	Yes[13]
France	Yes	No	Yes	Yes	No	Yes[14]	Yes
Germany	Yes	No	No	Yes[15]	No	No	Yes[15]

Exhibit 3.1 (continued)

Country	Insurance holding company permitted	Securities activities[1]			Insurance activities[2]		
		In-house	Insurance co. subsidiary	Insurance holding company subsidiary	In-house	Insurance co. subsidiary	Insurance holding company subsidiary
Netherlands	Yes	No	Yes	Yes	No	Yes	Yes
Switzerland	Yes	No	Yes	Yes	No	Yes	Yes
United Kingdom	Yes	No	Yes	Yes	No	Yes	Yes
United States	Yes[16]	No	Yes	Yes	No	Yes[17]	Yes[17]

Notes

1 Securities activities include underwriting, dealing and brokering all kinds of securities, and all aspects of the mutual fund business.

2 Insurance activities include underwriting and selling insurance products/services as principal and as agent.

3 Banks can engage in all securities activities, except stockbroking, in-house.

4 Distribution only, underwriting must be done in a subsidiary.

5 National banks are not permitted to underwrite or deal in securities, except for government obligations or other designated securities. National banks may engage in brokering all types of securities and investment products.

6 The permissibility of state bank securities activities varies from state to state. Under the Federal Deposit Insurance Act, state banks may not engage as principals in any type of activity that is not permissible for a national bank unless the Federal Deposit Insurance Corporation (FDIC) determines that the activity does not pose a significant risk to the insurance fund and the state bank is in compliance with the applicable capital standards.

7 In addition to brokerage activities, and subject to specific approval, a Section 20 bank holding company subsidiary may underwrite bank-ineligible securities to the extent that no more than 25 percent of the subsidiary's revenue is derived from this bank-ineligible activity.

8 Underwriting is generally prohibited. National banks in towns with a population of less than 5,000 are permitted to sell insurance. They can serve a nationwide clientele from the small town location. Other national banks are limited to selling credit-related insurance.

9 State regulations vary, but 38 states permit banks to distribute insurance.

10 Underwriting is generally prohibited.

11 Currently in the legislation. Was a Wallis Report recommendation.

12 Must be widely held. However, the institutions may apply to the Treasurer to be exempt from the widely-held requirement.

13 Stock insurance companies can be controlled by unregulated holding companies.

14 Certain quantitative limits apply to these investments.

15 Holding companies are allowed to own large shares of banks or securities houses, theoretically even 100 percent. However, the official regulations require that the insurance company prove to the federal insurance supervisory office that it is not trying to gain influence on a bank or securities house's business. In practice, however, there are examples of Allfinanz-type arrangements, initiated by insurance companies, that have received regulatory approval to cross-market insurance with bank or securities products.

16 Varies by state, but holding companies are generally permitted.

17 Insurance companies or insurance holding companies can own federal savings banks. State bank ownership is permitted in some states.

Sources: Bank powers section revised and expanded from James R. Barth, Daniel E. Nolle and Tara Rice, *Commercial Banking Structure, Regulation, and Performance: An International Comparison*, Economic Working Paper 97-6 (Washington D.C., Office of the Comptroller of the Currency, March 1997). Insurance section compiled through contact with appropriate regulatory authorities.

Until recently, U.S. banks were subject to significant branching restrictions designed to limit concentration and protect small state banks.[38] One of the results of these historical branching restrictions was the emergence of the bank holding company, a form of corporate structure unique to the United States. Unlike other jurisdictions, where a holding company structure has commonly been used to combine a range of financial services businesses in one entity, the U.S. approach was adopted to achieve branching through a holding company structure, which permitted the common ownership and management of multiple banks.

Bank holding companies are regulated by the Federal Reserve and, pursuant to the Bank Holding Company Act of 1956, are restricted to owning banks and corporations engaged in non-bank activities closely related to banking. National banks, which are supervised by the Office of the Comptroller of the Currency (OCC), are permitted to use a financial institution parent model. There is an ongoing debate between the Federal Reserve and the OCC about the merits of their respective approaches. As might be expected, the Federal Reserve maintains that contagion is better controlled in a holding company structure, while the OCC argues that the bank parent model provides the same prudential safeguards.[39]

The lists of activities ancillary to the business of banking and non-bank activities permissible for banks and bank holding companies have been expanded almost continually by the Federal Reserve and the OCC. Similarly, progressively more liberal interpretations of the restrictions on dealing in securities by bank holding companies have in practice eliminated the separation of commercial banking and securities that continues to exist in law. A so-called section 20 subsidiary of a bank holding company is permitted to deal in securities. Originally, this business was limited to "exempt" government securities. In 1989 the Federal Reserve permitted section 20 subsidiaries to earn up to 10 percent of their revenue from underwriting or dealing in non-exempt

[38] The McFadden Act of 1927 prohibited interstate branching by national banks, with the Federal Reserve Act placing similar restrictions on state-chartered member banks. State legislation varied, with unit banking (no branches at all) required in some states, such as Illinois. Other states had more permissive legislation, which permitted not only intra-state branching but also interstate branching on a reciprocal basis with other permissive states. The Riegle-Neil Act of 1994 permitted interstate branching, effective in 1997, except in states that expressly opt out of the Act's provisions. Virtually all states have now removed or significantly liberalized branching restrictions. Thus, U.S. banks are now largely freed from restrictions on interstate expansion either through bank holding companies or branching. See Allen N. Berger, Anil K. Kashyap and Joseph M. Scalise, "The Transformation of the U.S. Banking Industry: What a Long Strange Trip It's Been," *Brookings Papers on Economic Activity*, 2:1995.

[39] For examples, see Gary Whalen, *Bank Organizational Form and the Risks of Expanded Activities*, Economic Working Paper 97-1, Office of the Comptroller of the Currency, January 1997; S. Chase, "Insulating Banks from Risks Run by Nonbank Affiliates" *Proceedings From a Conference on Bank Structure and Competition*, Federal Reserve Bank of Chicago, 1988; J.H. Boyd and S.L. Graham, "Risk, regulation and bank holding company expansion into non-banking," *Federal Reserve Bank of Minneapolis Quarterly Review*, spring 1986.

securities. While the Glass-Steagall Act has not been repealed or substantially amended, the 1996 decision of the Federal Reserve to increase from 10 to 25 percent the proportion of revenues that a section 20 subsidiary can earn from underwriting and dealing in non-exempt securities is generally viewed as having removed the restriction in practice.

The permissibility of holding companies that control insurance companies depends on the legislation in individual states. The National Association of Insurance Commissioners (NAIC) has had an Insurance Holding Company System Regulatory Act model code since 1966. This legislative model requires regulatory approval for any merger or acquisition of control of an insurance company, and also stipulates that the regulator must be provided with details on the identity and relationship of every member of "the insurance holding company system." It further obligates any insurance company or owner of an insurance company that is part of the holding company system to provide complete and accurate information as required. Thus, the regulatory approach to insurance holding companies is built on ensuring that the owners of insurance companies are "fit and proper" and that information about the entire conglomerate is provided to the regulator. There are generally no capital requirements for the holding company, although the adequacy of the capital of the holding company and the entire group will be considered when control of an insurance company is acquired.

As of July 1997, all states except New York and Wisconsin had legislation that was based on or similar to the NAIC model code.[40] There is, however, considerable variation as even the model code contains optional approaches to such key issues as the business powers of holding company subsidiaries. The model code can be drafted to restrict insurance holding companies to insurance-related subsidiaries, much in the same way as bank holding companies are restricted to owning banks and corporations engaged in non-bank activities closely related to banking. In practice, many large and small U.S. insurers are able to offer a full range of financial services, through either their own subsidiaries or companies affiliated via holding companies. With 50 jurisdictions to choose from, U.S. companies that find the restrictions of one state too binding are generally able to develop a legal structure that permits them to achieve their business objectives.

The United Kingdom

Regulation in the United Kingdom has evolved significantly in the last 20 years, with the most recent changes focussing more on the role and powers of

[40] *Model 440-1 Insurance Holding Company System Regulatory Act*, National Association of Insurance Commissioners, July 1997.

regulatory authorities than the structure and powers of financial institutions.[41] Regulation of U.K. financial institutions has long been conducted on a relatively informal, non-transparent basis. The first Banking Act was proclaimed in 1979: prior to this date there was no government authority to grant or refuse permission to carry on banking in the United Kingdom, and no formal supervisory role.

The United Kingdom generally provides broad business powers for its financial institutions. There are no formal ownership restrictions for banks, making a holding company structure available subject to the holding company being deemed a "fit and proper" owner. However, bank ownership by a holding company is not widespread. More typically, a U.K. bank is structured in a manner similar to a bank in Canada, operating as a financial institution parent with operating subsidiaries in financial and non-financial businesses. While U.K. insurers are restricted to the business of insurance, widespread use of holding companies has permitted insurers to engage in a broad range of businesses.

A notable exception to the absence of a holding company parent among the large clearing banks is the Midland Bank, which is controlled by subsidiaries of HSBC Holdings plc. Although there is no formal holding company regime in the United Kingdom, HSBC Holdings plc is considered to be a regulated holding company, with the Financial Service Authority (FSA) receiving information on the group as a whole and setting capital adequacy requirements for the group. HSBC Holdings plc is widely held (no shareholder has more than 5 percent). The holding company structure facilitated the acquisition of Midland by the Hongkong and Shanghai banking group since, as was noted in Chapter 2, the ultimate parent of Midland Bank, HSBC Holdings plc, is a U.K.-domiciled company.

There is no legislative provision to regulate holding companies that control U.K. insurance companies and banks. Moral suasion, enforced if necessary by the denial of "fit and proper" approval of shareholders, has generally been used to ensure that the regulator has the necessary access to the holding company and information about the financial condition of the group.

Australia

The Wallis Inquiry considered the role of conglomerates in the Australian context. In Australia, the predominant structure is the financial institution parent model. The Inquiry noted the growing role of conglomerates and concluded that changes in the market were such that traditional practice was not sufficient ground for restricting the corporate form of conglomerates. The Inquiry recommended that

[41] For an overview of the Financial Service Authority, which combines the prudential and market conduct functions of nine agencies dealing with deposit-taking, life insurance, securities and investment management, see "Report to the Chancellor on the Reform of the Financial Regulatory System," Securities and Investments Board, July 1997. Eight consultation papers have been released (to June 1998) as part of the process of amalgamating the nine agencies.

non-operating holding companies be permitted subject to certain requirements relating to capital, management, adequacy of firewalls, reporting of intra-group activities, and independent board representation on subsidiary entities.[42]

Increasing Organizational Flexibility

The Task Force is persuaded by the arguments advanced that increased organizational flexibility is desirable and attainable without unduly compromising safety and soundness. Three areas where such flexibility should be sought are discussed below.

The Minority Investment Regulations, which have been the subject of continual debate and review since their introduction, are one area where additional flexibility may be provided. As noted in Chapter 5 of this paper, Credit Union Central of Canada has made some specific requests and, notwithstanding the increased flexibility provided in Bill C-82, there have been other requests to remove or reduce the current restrictions.[43] The Task Force recognizes that there are important safety and soundness considerations, and encourages industry and the regulators to explore the scope for further flexibility in minority investments, subject to necessary prudential constraints.

Another area for policy makers to explore is the list of permitted designated entities of financial institutions. Government should consider whether the list is broad enough to allow operating financial institutions to restructure their activities in a way that might be beneficial from a business or regulatory perspective. The issue here is not necessarily to add new functions to the list of designated entities but to consider whether existing functions now carried on in the regulated parent should be added to the list. In a submission to the Task Force, OSFI notes that if a bank holding company were permitted, the holding company might want to have substantial investments in entities that are not currently permitted for banks, such as credit card companies. OSFI goes on to note that level playing field concerns dictate that the nature of activities a holding company could carry out through unregulated subsidiaries should not extend beyond what is permitted for banks or bank subsidiaries.[44] The Task Force believes, especially in contemplation of a holding company regime, that it is necessary to revisit the list of permitted subsidiaries of financial institutions. It may be possible to provide greater flexibility to undertake activities in a subsidiary of a financial institution without compromising safety and soundness.

[42] Financial System Inquiry Final Report, Commonwealth of Australia, 1997, pp. 344-47.

[43] For example, CIBC has argued that all downstream ownership restrictions should be removed, with firewalls and related-party transactions providing any necessary prudential safeguards. See "Seeing Beyond: CIBC Technical Recommendations," p. 41.

[44] OSFI, *A Proposal Regarding A Bank Holding Company Model,* submission to the Task Force, June 18, 1998, p. 14.

A further means of providing flexibility is a holding company structure. The Task Force proposes that an optional holding company regime be established for financial institutions. The Task Force is persuaded that the potential advantages of such a regime in some situations are real, even with no change in regulatory behaviour. However, the Task Force also believes that regulation in a holding company structure can be more nuanced with no serious risk to safety and soundness. In its submission to the Task Force, OSFI observes that it may be possible to provide greater flexibility in a holding company structure.[45] Further, the Task Force expects that, over time, as markets become more comfortable with financial holding companies and with the legitimate expectations one should have about the regulation of such entities, scope can be created for even lighter-handed regulation of some activities, which would provide significant benefits to competition and to Canadian consumers.

The balance of this section sets out some considerations that should guide the approach to providing a holding company regime for financial institutions. It also discusses the situation of currently existing unregulated holding companies.

Regulation of Financial Holding Companies

The Task Force believes that it is essential for financial holding companies to be regulated entities. By financial holding company, the Task Force means those non-operating companies that hold shares in regulated financial institutions and other permitted companies.

There are many ways to accomplish such regulation, but the preferable route is through the enactment of a separate statute, a Financial Holding Companies Act, that would set out the requirements of the holding company and the relationship between the holding company and the regulator. Some have suggested that amendments to the Bank Act and Insurance Act could provide a holding company regime for banks and demutualizing insurance companies respectively. However, using a separate statute would facilitate making the same holding company regime available to all federally incorporated financial institutions. This approach is consistent with the view of the Task Force that there should be a common ownership regime.

The nature of the regulatory regime that would apply to the holding company will have to be worked out in detail with the regulator. The Task Force believes, however, that the following principles should guide the discussion.

[45] OSFI, *A Proposal,* pp. 12-14.

Ownership and Canadian Control

The ownership requirements to be applied to a regulated holding company should be consistent with the ownership requirements for federally incorporated financial institutions. Thus, if the sum of the combined shareholders' equity of the regulated financial institutions in which the holding company has effective control exceeds $5 billion, the holding company would have to be widely held. If the combined shareholders' equity is less than $1 billion the holding company could be closely held. In cases where the combined shareholders' equity of the regulated financial institutions in which the holding company has effective control is between $1 billion and $5 billion, the requirement for 35 percent of the voting common shares to be widely held and publicly traded could be satisfied at the level of the regulated institutions or the holding company.

It is expected that the holding company would be a non-operating, passive company. The holding company would have to have a controlling interest in at least one principal operating company (regulated financial institution). For financial institutions controlled but not wholly owned by the holding company, the balance of the voting common shares would be subject to the requirement for Ministerial approval to own more than 10 percent.

The holding company would also be expected to meet the other prescribed indicia of Canadian control which are applicable to the regulated financial institutions it controls.

Capitalization

The supervisor must have the capacity to ensure that the holding company is adequately capitalized. This entails the ability to understand the quality of the capital in the holding company in order to avoid double gearing, whereby debt raised in the holding company is downstreamed to a regulated financial institution as equity. The holding company must have the capacity to serve as a source of strength for the group. Financial institution subsidiaries and other designated entities would continue to be supervised and would have to meet the appropriate capital requirements on a stand-alone basis. Greater flexibility would be provided, however, if lending activities carried on outside the regulated financial institution did not have to conform with BIS or MCCSR capital rules on a consolidated basis.

In cases where the holding company is not widely held, the supervisor must have the right to obtain undertakings ordinarily sought from the holding company from the ultimate owner of the enterprise.

Permitted Designated Entities

The permitted investments of the holding company should mirror those of operating regulated financial institutions. It would be inappropriate to bias organizational choice by permitting an institution to spin off functions in one model that it could not spin off in another. This is why, as noted earlier, it is particularly important to review the list of permitted designated entities to see whether it is as broad as it should be. Any increase in the list of permitted designated entities should stop short of allowing the holding company to hold commercial entities.

Any reorganization of a regulated financial institution to move activities carried on either in a designated entity or in-house to a holding company affiliate, should require the approval of the Superintendent. It is open to question, however, whether permitted entities that now must be controlled when owned by an operating financial institution would have to be controlled when owned by a holding company. The Task Force believes that this is an area where a holding company structure could offer more flexibility with no adverse impact on the safety of the regulated institution.

Related-Party Transactions

Regulated financial institutions in a holding company structure would continue to be subject to the provisions in their respective governing statutes concerning transactions with a related party. The related-party rules in the current financial institution parent regime constitute a model that can be adapted to provide the appropriate firewalls in a holding company structure. Details need to be developed to ensure that the restrictions do not unnecessarily restrict legitimate business transactions, but as a general rule the holding company should be considered a related party of its financial institution designated entities.

Information

The supervisor should have full access to information on, and the records of, the holding company and its unregulated designated entities. The supervisor should also have the right to examine unregulated designated entities, in exceptional circumstances, when there is reason to believe it is desirable to assess the impact of the activities of these entities on the financial stability of the group. Consolidated and unconsolidated financial statements for the holding company should be filed with the supervisor on a regular basis.

Compliance

The supervisor must have the ability to issue compliance notices to the holding company as well as to the regulated financial institutions with respect to the above matters, including notices concerning appropriate accounting and asset valuation practices.

Public Perception

It is critically important for the market to recognize that not all entities within a holding company are supervised to the same standard; that, from time to time, some may fail; and that failure of an unregulated or lightly regulated affiliate should not compromise the position of the regulated deposit-taking institution or insurance company. Achieving this recognition will not be easy, and it will take time and effort. To the extent that this can be accomplished, supervisors will be able to lighten the regulatory burden with greater confidence that contagion can be contained.

As a step in this direction, it will be important that appropriate disclosure rules be established. The rules should ensure that anyone dealing with unregulated entities in such groups is informed that the entities are not regulated financial institutions or subsidiaries of regulated financial institutions; that securities issued by these entities are not deposits and are not insured or guaranteed by government-sponsored protection programs; and that the entities and their liabilities are not guaranteed by regulated financial institutions in the group. There should also be restrictions on the use of the name "bank" within the group.

Existing Unregulated Holding Companies

As indicated above, the current regime allows for unregulated financial holding companies but these holding companies are not allowed to own banks or mutual insurance companies.

The Task Force prefers that all financial holding companies that hold federally incorporated financial institutions be regulated under the proposed Financial Holding Companies Act. The Task Force is reluctant, however, to impose organizational change on existing situations that appear to be working well. It therefore proposes that existing financial holding companies that control federally incorporated financial institutions may continue to be unregulated, subject to their reconfirming with OSFI that the undertakings already given will be continued and are appropriate.

There should be one exception to this general grandfathering. Canada has been playing an active role in international bodies concerned with the effective regulation of global conglomerates. As a member of the Basle Committee on Banking Supervision under the auspices of the BIS, Canada participated in the development of *Core Principles for Effective Banking Supervision.*[46] The heads

[46] *Core Principles for Banking Supervision*, Basle Committee on Banking Supervision, September 1997. Available on Internet at www.bis.org/publ/index.htm.

of state of the Group of Seven (G-7) countries, meeting at Birmingham, England, agreed on May 15, 1998, that all countries should adopt and implement these principles.[47]

Principle 23, which deals with cross-border banking, states:

> Banking supervisors must practise global consolidated supervision over their internationally active banking organizations, adequately monitoring and applying appropriate prudential norms to all aspects of the business conducted by these banking organizations worldwide, primarily at their foreign branches, joint ventures and subsidiaries.[48]

A working group reporting to the Committee on Banking Supervision had earlier identified, as a problem in cross-border banking, the issue of "parallel-owned banks," where a bank in one jurisdiction has the same ownership as a bank in another jurisdiction, but one is not a subsidiary of the other. The working group commented:

> Such 'sister' institutions are not subject to consolidated supervision but at the same time an inter-relationship exists and it could well be that funds are switched from one to the other if a problem arises. The working group recommends that home or host supervisors be vigilant to ensure that operations of this type become subject to consolidated supervision, if necessary by enforcing a change in group structure.[49]

For these reasons, the Task Force proposes that grandfathered holding companies controlling a bank in Canada as well as foreign banks be regulated under the proposed Financial Holding Companies Act. This situation does not currently exist, but with the adoption of the proposal that small banks may be closely held, it is possible that the currently unregulated holding company owners of financial institutions might wish to either apply to continue their trust companies as banks or incorporate a new bank. In either case, to meet Canada's international obligations, the Task Force is of the view that these holding companies should then become subject to the proposed Financial Holding Companies Act if they also control banks in other countries.

[47] Statement of the G-7 Chairman, May 15, 1998, p. 3.

[48] *Core Principles for Banking Supervision,* Basle Committee on Banking Supervision, September, 1997.

[49] *The Supervision of Cross Border Banking.* Report of a Working Group consisting of members of the Basle Committee on Banking Supervision and the Offshore Group of Banking Supervisors. Basle, October, 1996, p. 20. Available at www.bis.org/publ/index.htm.

Exhibit 3.2

Permitted Substantial Investments for a Federally Regulated Financial Institution (FRFI)

#	Designated entity	Nature of activities	Minister's approval required to undertake activity	Majority control required	Activity can be done 1. in-house 2. subsidiary only 3. either
1	Investment counselling and portfolio management corporation	Advising others how to invest their funds, or managing the funds of others through discretionary authority	No	No	3. either
2	Mutual fund corporation	Limited to investing the corporation's own funds	No	No	3. either, except for actual securities transactions
3	Mutual fund distribution corporation	Principal activities: selling units, shares or other interests in a mutual fund	No	No	3. either, except for actual securities transactions
4	Real property brokerage corporation	Primarily engaged in acting as a real estate agent and providing consulting and appraisal services	No	No	May depend on provincial laws on real estate licensing 2. subsidiary only for banks
5	Real property corporation[1]	Primarily engaged in holding, managing and otherwise dealing with real property	No	No	3. either
6	Service corporation	Primarily engaged in providing administrative services to the FRFI and entities in which the FRFI has a substantial investment	No	No	3. either
7	Real property holding vehicle	Primarily engaged in holding, managing or otherwise dealing with real property	No	No	3. either
8	Financial holding corporation	Limited to holding substantial investments in entities that the FRFI may hold	No[3]	Yes[2]	3. either
9	Factoring corporation	Limited to buying accounts receivable from an entity and collecting the amounts owed	No[3]	Yes[2]	3. either

Exhibit 3.2 (continued)

#	Designated entity	Nature of activities	Minister's approval required to undertake activity	Majority control required	Activity can be done 1. in-house 2. subsidiary only 3. either
10	Financial leasing corporation[1]	Limited to the financial leasing of personal property and prescribed related activities	No[3]	Yes[2]	3. either
11	Ancillary business corporation	Activities ancillary to the business activities of the FRFI or of a financial institution that is a subsidiary of the FRFI	Yes	No	Depends on activity
12	Information services corporation	Primarily engaged in collecting, manipulating and transmitting information that is primarily financial or economic, relates to the business of a designated entity, or that the Minister has specified; providing advisory services related to information management systems; designing, developing and marketing computer software; developing and marketing customer computer equipment designed for the provision of financial services	Yes	No	3. either
13	Substantially similar activities corporation or entity	Activities are substantially similar to those of another designated entity in which the FRFI may have a substantial investment	Yes	Depends on activity	Depends on activity
14	Dual or multi-purpose corporation	A financial institution engaged in activities of more than one designated entity referred to above (other than those of a financial institution)	Depends on combination	Depends on combination	Depends on activity
15	Specialized financing corporation (i.e., investment or "merchant banking")[1]	Primarily engaged, under prescribed terms and conditions, in making investments, providing specialized business management, and providing financing or advisory services	Yes	Yes[2]	3. either
16	Financial institution	Canadian and foreign bank; trust company; loan company; insurance company; cooperative credit association; entity primarily engaged in securities (dealer or broker)	Yes	Yes[2]	2. subsidiary only

[1] Not a permitted substantial investment for a property and casualty insurance company.
[2] Control will not be required in certain limited circumstances set forth in the Minority Investments Regulations.
[3] Ministerial approval will be required if less than control is acquired pursuant to the Minority Investments Regulations.

Note: In 1987 there were 132 subsidiaries of banks; in 1996 there were 408. Source: *Meeting the Challenge*, submission from the Insurance Bureau of Canada, Oct. 1997, p. 27.

Chapter 4

Business Powers

The major debate over business powers centres on the distribution of insurance and light vehicle leasing. The 1992 legislation provides generally similar business powers for all federally incorporated financial institutions, although there is some difference among institutions in what can be done in-house and what must be undertaken in a subsidiary. However, there is an outright prohibition on the distribution of most types of insurance through branches of federally incorporated deposit-taking institutions, and federal financial institutions are not able to lease light vehicles.

A third business power concern arises from rules governing access to the payments system, which limit direct participation to regulated deposit-taking institutions. For insurance companies, access to the payments system could be considered more of a structural issue because, even prior to 1992, a number of the larger insurance companies could access the payments system through their trust company subsidiaries. Thus, for the insurance sector, the issue is not that they cannot access the system but rather that access is not an in-house power. However, access to the payments system is addressed because, as more fully discussed later in this chapter, the Task Force proposes that entities other than regulated deposit-taking institutions have this business power.

This chapter will examine the three major issues in turn. Following an overview of the current regime in Canada and some international context, it presents the reasons for reconsidering the current approach, offers evidence and develops the conclusions of the Task Force.

Providing Payments Services

Deposit-taking institutions play a unique role in the payments system by offering accounts through which their customers can make payments for goods and services. Customers at other institutions must first convert their claims into accounts at deposit-taking institutions in order to make payments. Life insurance companies, investment dealers and mutual fund companies have all argued that they should be able to participate in the retail payments system on the same basis as deposit-taking institutions.

The current concern of these institutions about their participation in the payments system reflects several forces.

First, the ranges of financial services offered by different financial institutions increasingly overlap. Major banks now have insurance and mutual fund subsidiaries and offer mutual funds, and some insurance products, through branches. Similarly, consumers increasingly view products such as money market funds, segregated funds and other balances at life insurers and securities dealers as close substitutes for savings products of deposit-taking financial institutions. The ability to offer payments services is an important product characteristic, and the closer competition between products of competing institutions makes differences in the ability to offer payments services more critical than in the past.[50]

Second, and equally important, the adoption of new computer-based technology by financial institutions has already altered the relationship between institutions and their customers and the way in which institutions compete. Many financial institutions now seek to broaden their relationships with consumers by providing many product lines rather than competing only in a traditional, narrow range of products. Even specialized institutions recognize the need to offer a range of choices and options with their specialized functions in order to retain and attract customers.

Finally, future developments in electronic payments, even though their exact directions may not be known, seem certain to transform much of the financial sector. Many of these developments can be expected to build out from the platform of the existing payments system.[51] Institutions now outside the current system fear that they will be left behind and become uncompetitive unless they can participate in these developments on an equal footing.

The Current Payments Regime

The Canadian 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 (ATM) and debit card networks of Interac, and the separate clearing systems for debt and equities, and for mutual funds.[52] At the centre of the system is the Canadian Payments Association

[50] This point is made in several submissions to the Task Force. See, for example, Submission by AGF Managment Limited, Mackenzie Financial Corporation and Trimark Investment Management Limited, July 27, 1998.

[51] Three generations of new services – credit cards, automatic banking machines and point-of-sale terminals – all built upon the existing payments system.

[52] A comprehensive description of the Canadian payments system and its components can be found in *The Payments System in Canada: An Overview of Concepts and Structures*, Background Paper for discussion by the Payments System Advisory Committee prepared by the staff of the Bank of Canada and the Department of Finance, February 1997.

(CPA), which has the mandate under the Canadian Payments Association Act (the CPA Act) to operate a national clearing and settlement system. Members use this system to settle claims arising from their customers' cheque payments and receipts, and to discharge their net claims from transactions in the other networks.

At March 31, 1998, the CPA had 142 members, all of which are regulated deposit-taking institutions including chartered banks, trust and loan companies, government savings institutions, credit union centrals and the Caisse centrale Desjardins. Members must meet the following requirements:

> Members of the CPA must be federally or provincially regulated deposit-taking institutions. Moreover... the deposit-taking institution must be either a member of CDIC or an equivalent provincial deposit insurance agency, or a credit union central registered under the Canadian Cooperative Associations Act and a member of the Credit Union Central of Canada.[53]

In addition to the mandate to operate the national clearing system, the CPA Act charges the Association with planning the evolution of the payments system. However, with the exception of the development of the Large Value Transaction System, the role of the CPA in planning the evolution of the payments system has generally been limited to the development of technical standards for electronic networks. Most new means of payment, such as the Interac shared Automated Teller Machine Network, have been developed by subsets of CPA members outside the auspices of the CPA.

Historical Development

Expanded participation in the payments system has been raised as a policy issue a number of times in the past. From its beginning at the turn of the century, the Canadian Bankers Association (CBA) had the power to operate clearing-houses that eventually evolved into the present cheque clearing and settlement system. Until 1980, direct participation in the payments system was limited to the chartered banks as members of the CBA. Other financial institutions, such as trust companies and credit unions, were required to negotiate arrangements with chartered banks in order to offer chequing services to their customers.

In 1964 the Porter Commission proposed, as part of its thrust toward reducing differences among deposit-taking institutions, that the payments system be opened to the participation of non-bank financial institutions, including trust companies and credit unions/caisses populaires. To achieve this, the CBA's right

[53] *Access to Payments Networks in the Canadian Payments Systems*, Background Paper for Discussion by the Payments System Advisory Committee, prepared by the staff of the Bank of Canada and the Canadian Payments Association, July 1997, p. 11.

to operate the clearing system would be repealed and an association of clearing institutions formed to manage the system.[54] While these proposals did not become part of the 1967 Bank Act, they were subsequently carried out in the 1980 reforms that established the Canadian Payments Association to take over the clearing and settlement system.

The question of participation in the payments system again became an issue in the recent case brought by the Director of Investigation and Research against the Interac Association and its members. Life insurers and independent investment dealers argued as intervenors that they should be able to join Interac to allow their customers to use its banking machines and point-of-sale terminals. The arguments of these intervenors were not reflected in the Director's Draft Consent Order. Nevertheless, the Competition Tribunal expressed sympathy for their case, but could not act on it because it was outside its jurisdiction.[55]

The issue in both of these instances has been the same in principle. Institutions competing with payments system participants wished to offer payments services to their customers. When the cheque was the predominant form of non-cash payment, the issue was confined to the offering of chequing services. Today participation in the payments system implies much more. It means the ability to offer customers access to the services of automatic banking machines and the use of debit cards at point-of-sale terminals. In the future, this access may mean even more. It may involve access to smart cards, e-money, Internet banking and a host of other possibilities.

A recent development with respect to access to the payments system has been the work of the Payments System Advisory Committee. This committee, appointed at the same time as the Task Force, was chaired jointly by the Bank of Canada and the Department of Finance; it consisted of representatives from consumer and retail organizations and financial institutions, together with academics. It was intended to assist the Department of Finance in its review of the payments system and functioned in parallel with the Task Force because of the technical nature of payments issues.[56] To draw the advisory process to a close, the Department has now prepared a discussion paper as input to the Task Force for its consideration of payments issues in the context of its broader work.[57]

[54] Royal Commission on Banking and Finance, Report, 1964, p. 393–94.

[55] The Competition Tribunal Reasons for Consent Order states (p. 35):

> Unfortunately, the scope of this application does not allow us to do anything more to assist the intervenors with their valid concerns…. Nonetheless, as we have concluded that the actions of the CPA in this matter are beyond the scope of this application, there is little more that can be done in this forum.

[56] In the course of its work, the committee reviewed four discussion papers ("Staff Papers") prepared by the staff of the Bank of Canada and the Department of Finance that have now been made public. They may be found at www.fin.gc.ca

[57] Department of Finance, *Payments System Review Discussion* Paper (July 1998).

Benefits to Consumers

The debate on access to the payments system has been expressed primarily as an issue of business powers and their effects on the competitive positions of different financial institutions. The major public interest in the issue, however, is the impact on consumers of extending participation in the payments system.

Access to the payments system remains one of the remaining traces of the "four pillars" approach to the financial system that has increasingly eroded over the past 20 years. A consequence of the four pillars regime was that it forced consumers to establish separate relationships for different financial products, at some cost. But, most important, the segmentation inhibited competition for consumers' business and restricted their range of choice.

The extension of access to the payments system for institutions such as life insurers, mutual funds and investment dealers would represent a further breaking down of barriers. Each of these groups can improve its services to consumers through expanded access. Life insurers will be better able to compete to retain their customers' proceeds from the realization of claims and payments from annuities if their customers can make payments. Similarly, both money market funds and balances at investment dealers would become closer substitutes for the savings products of deposit-taking institutions with payments services. Consumers can benefit from greater convenience and from the prospect of greater competition for their business.

Possible Costs of Expanded Participation

The payments system by its very nature creates interdependence among participating institutions because the final settlement between institutions takes place after the transaction that created the need for the settlement. Balanced against the benefits to consumers from broader participation are the possible impacts on existing participants and their customers.

The Canadian payments system generally gives consumers immediate use of their funds when they deposit a payment item. While Canadians may take this feature for granted, customers in Germany and the Netherlands wait an average of two days to use their funds and those in the United Kingdom, Switzerland and Australia wait at least four days on average.[58] Extended participation, to the extent that it would result in longer delays, would impose direct costs on consumers. Consumers could also be affected indirectly through higher costs if their institutions must develop new procedures to assure same-day access while protecting themselves from risk.

[58] McKinsey, *The Changing Landscape,* Exhibit 6-38.

Existing participants in the payments system may face both higher cost and higher risks because of expanded participation. These risks include the credit risk that a financial institution will default on its settlement obligations, the liquidity risk that an institution will meet its obligation only after some delay, the legal risk that an institution may be legally constrained from meeting its commitments to others, and the operational and security risk that human error, equipment malfunctions, system design flaws or fraudulent access to payment information might result in payment errors or delayed payments.

These risks can create systemic risk, the risk that problems at one institution will cause others to fail to meet their obligations. At worst, the problems can spread to create difficulties for the system as a whole. While managing systemic risk must be at the forefront in the design and regulation of payments systems, especially those dealing with large-value transactions, it should be less of a concern with respect to extending access for retail payments where the size of the new institutions and their customers' transactions will both be relatively small.

Criteria for Participation

Any extension of participation in the payments system must be based on a balancing of the benefits to consumers against any possible costs that this access could impose on existing participants in the payments system and their customers. It is useful to examine criteria for access that can be applied to new entrants to limit potential concerns.[59]

System of Regulation and Oversight

Participants in the payments system need confidence that the institutions with which they deal will remain solvent and meet their settlement obligations when due. As the Payments Discussion Paper states:

> Formal regulation and supervisory oversight represent an important signal in this regard, indicating that a participant is following reasonable guidelines for prudent behaviour – relating to financial and other matters – and that some reputable body is formally charged with overseeing compliance with those rules.[60]

The paper stresses that the regulatory regime must include both appropriate solvency and liquidity standards. Solvency standards help to ensure that the participant will ultimately be able to meet its settlement obligations. But a smoothly functioning payments system also requires that these obligations be

[59] The following section is based on the Payments Discussion Paper.

[60] Payments Discussion Paper, p. 8.

met as they come due. Hence, participants in the payments system must adhere to liquidity standards in addition to solvency standards.[61]

The regulatory and supervisory regimes governing different participants in the payments system need not be identical. Participants in the payments system are regulated for two distinct reasons: their participation in the payments system and the nature of the claims they offer to customers. Some of the prudent measures governing an institution may be justified because of the types of claims they offer their customers and may not be needed for participation in the payments system. The regulatory regimes must, however, share the feature that they assure other participants in the payments system of the institution's soundness. The means to achieve this objective may differ among different types of institutions.

It is also possible for an institution to participate in the payments system when its regulatory regime does not fully meet the expected liquidity and solvency standards. In such an instance, the institution must accept additional measures to ensure its liquidity and solvency. In effect, additional rules and risk controls required by the payments system become substitutes for regulatory standards.[62] The possible impact of such measures on the operation of the system and on the quality of service provided to its users, however, must be carefully considered.

Access to Liquidity Support

A payment participant's access to liquidity support will be important for the other participants with which it deals. Liquidity support allows a financially solvent institution to fulfill its payments obligations when, during the normal course of business, it has insufficient balances to do so. Potential participants should be able to create security interests in their property in order to provide security to the supplier of the liquidity.

Legal Framework

The legal framework governing an institution will also be important to other members of the payments system both in the normal course of business and in the event of a member's failure. The legal system will determine whether the institution will be able to clear and settle payments according to the rules of the payments system. Just as important, it will also determine whether the member can pledge collateral and whether the loss-allocation rules of the payments system can be sustained in the event of an institution's failure. If potential new

[61] Being governed by a rigorous regulatory regime may also have a benefit beyond the dealings with other members of the payments system. As the Payments Discussion Paper notes, a regulatory regime with strong solvency and liquidity requirements can make an institution's cheques more acceptable to others as payment.

[62] Among possible risk control mechanisms are caps on members' multilateral net debit positions, collateral pledged by participants, and bilateral credit limits established between participating members.

entrants cannot meet these standards, changes to the legislation or regulations that govern these new entrants may be necessary to permit them to participate in the payments system.

Operational/Technical Standards

All members of the payments system must meet technical and operational standards in carrying out payment functions in order to avoid operational failures, protect the security of payment information and achieve maximum efficiency. Technical and operational standards are critical for ensuring the timeliness that is vital to activities and procedures in the payments system.

Expanded Participation: Conclusions

The Payments Discussion Paper provides a preliminary review of the business and regulatory structures that apply to each group of institutions – life and health insurance companies, investment dealers and mutual funds – seeking participation in the payments system.[63] Those for which the criteria are found to be satisfied – or for which the criteria could be satisfied by introducing restrictions on their payments system activities or other risk controls – could be permitted to participate directly in the payments system and be eligible for membership in the CPA.[64]

The Task Force believes that expanded access to the payments system is vital for strengthening competition for consumer financial services. This participation will be important, not just for the core payments system but also for other networks, such as Interac, that build on it.[65]

The Task Force also recognizes that increased participation will require careful review of potential participants, their business and their regulatory framework to determine any conditions that may be required from them. It expects that life insurers, money market funds and investment dealers will be capable of meeting the criteria with few, if any, restrictions.[66] The Department of Finance should give high priority to a prompt review of these matters so that the institutions can participate in the payments system as soon as possible.

[63] It has been suggested that money market funds would be the only mutual funds considered for participation and that the funds themselves, and not their managers, would be the participants. The issues to be addressed are quite different in each case.

[64] Payments Discussion Paper, p. 10.

[65] This issue is discussed more fully in Background Paper #1, *Competition, Competitiveness and the Public Interest*, chapters 4 and 7.

[66] Over 40 brokerage firms and about 90 percent of money market funds in the United States offer accounts with payment services with no apparent problems. While these organizations are not direct members of the payments system, their relationship with banks is similar to that between indirect and direct clearers in Canada. See *The Director of Investigation and Research v. Bank of Montreal, et al.* (1996), Competition Tribunal, Reasons for Consent Order, pp. 28–29.

Expanded Access and Governance of the Payments System

There is a strong public interest in both the reliability of the payments system and the state of competition in supplying payments and related services. Greater access by itself may not be sufficient to effectively expand the choices available to, and the competition for the business of, Canadian users of payments services. It will not mean much if the groups provided with access are unduly constrained by rules and practices that limit their ability to provide full payments services to their customers. As a result, there may be a need to reconsider the governance of the payments system to ensure that the public interest in the payments system is adequately reflected.

At present the governance of the payments system is in the hands of the CPA, which itself is governed by a Board of Directors with equal representation from the chartered bank members and the non-bank deposit-taking institutions. The Board establishes the by-laws, rules, standards and guidelines that shape the operations of the CPA and the clearing and settlement systems in Canada. By-laws adopted by the Board require the approval of the Governor-in-Council, whereas the rules established by the Board are binding without any further approval.[67]

The existing governance structure of the CPA has some provision for outside influences on its decision making. OSFI reports annually to the Minister of Finance on the CPA's compliance with its Act, but it does not have "either rule-making or cease and desist powers with respect to CPA operations."[68] The Bank of Canada now has powers under the Payment Clearing and Settlement Act of 1996 to supervise clearing and settlement systems in order to control systemic risk to the financial system.

The CPA itself has taken measures to increase openness to outside views. It now has a Stakeholder Advisory Council that advises the Board from the perspectives of a variety of interest groups. Further, the CPA Consultative Committee provides a forum through which members of the CPA Board and representatives from the Department of Finance discuss public policy issues. Nevertheless, aside from the need to gain approval for its by-laws from the Governor-in-Council, the CPA operates autonomously.

The present structure of the CPA's decision making, augmented by new participants, appears to be appropriate for ensuring reliability of the payments system because all members depend on the performance of the others and have a

[67] The Chair of the CPA, a senior official of the Bank of Canada, has the power to determine whether a proposed rule is consistent with the CPA's by-laws.

[68] *Achieving the Public Policy Objectives: The Governance of the Payments System in Canada*, Background Paper for discussion by the Payments Advisory Committee, prepared by the staff of the Bank of Canada and the Department of Finance, December 1997, p.14.

vested interest in technical standards and practices that support the reliability of the system. In addition, it ensures that industry expertise with respect to technical aspects of the payments process will be reflected in decisions. On the other hand, the present structure appears less well-suited to dealing with matters of competition and innovation, both of which can provide challenges to existing members. As the Payments Discussion Paper states:

> … decisions made by direct participants may at times favour their interest and priorities over those of others affected by those decisions, including individuals and corporate users of the payments system and providers of similar or related services.[69]

Review of CPA Decisions

The Task Force believes that there is a need to ensure a proper balance between efficiency, safety and competition in the payments system. To achieve this, the Task Force proposes that the Minister should have the power to review and revoke any changes in the rules of the CPA, as well as the power to approve in advance the by-laws of the CPA or any changes in the by-laws.

Review of CPA decisions in itself may not always be sufficient. Existing rules and by-laws may become outmoded, especially in light of rapidly evolving payments technology, and may need reconsideration. The Task Force also proposes that the Minister of Finance have the power to issue directives to the Board of the CPA to make changes to by-laws, rules or operating practices, when such changes are deemed to be in the public interest.

The rapid change in the payments system creates a need for a periodic stocktaking to ensure that the system is evolving in the right directions. The Minister should, from time to time, establish a committee with broad representation from interests such as consumer and other user groups, suppliers to the payments system such as payroll companies, and computer and communications companies, together with financial sector representatives. This committee should undertake a review of how the system is evolving, and advise the Minister with respect to the development of the system and any measures needed to protect the public interest in the system. The committee's mandate should expressly include considering the proper balance between the public policy goals of efficiency, safety and competition in the development of the system.

[69] Payments Discussion Paper, p. 13.

CPA Governance

The proposals for review of CPA decisions set out above address concerns about industry groups overseeing an activity with such a strong public interest focus. While the Task Force does not have specific proposals regarding a reconstituted board for the CPA, there are several points that should be considered.

With respect to the CPA's mandate for the operation of payments systems, a board of participant representatives and representatives of major users and suppliers such as payroll companies, and computer and communications providers, ensures that industry expertise with respect to technical aspects of the payments processes will be reflected in decisions. The review committees to be appointed periodically by the Minister will provide a vehicle for broader input from the public sector and consumers, so these groups may not need to be represented on the CPA Board. However, the Task Force expects that even without formal board representation, the CPA would continue to solicit direct public input though the CPA Stakeholder Advisory Committee or a similar process. The Task Force also expects that close working relationships will continue among the CPA, the Bank of Canada and other federal authorities.

In summary, the Task Force believes that its proposals regarding the payments system will benefit Canadians by:

- increasing the number of suppliers of transaction accounts and other payments services by providing direct access to the payments system for qualifying non-deposit-taking institutions; and
- ensuring that the broad public interest is served by providing a process to review and, if necessary, direct the decisions of the industry-controlled CPA.

Insurance Retailing

Canada, like other developed countries, has seen considerable convergence in financial services since the mid-1980s. There has been an increasing integration of banking and insurance around the world, with this phenomenon having been termed "bancassurance." While the federal regulations prohibit complete integration of banking and insurance, the bancassurance phenomenon already exists in Canada. Banks, trusts and credit unions have long sold a limited range of insurance products (such as creditor life insurance) that are closely related to their lending businesses. The cooperative sector has long-standing links between deposit-taking and insurance. Since 1992 most large deposit-taking institutions in Canada have established insurance subsidiaries (see Exhibit 4.1). Bancassurance can take a number of forms ranging from marketing agreements to cross-shareholdings, and to control by banks or insurance companies of subsidiaries in the other activity.

Exhibit 4.1

Insurance Subsidiaries of Selected Canadian Deposit-Taking Institutions, 1997

(offshore reinsurance subsidiaries excluded)

Institution	Life insurance subsidiaries	Property & casualty insurance subsidiaries
Royal Bank	Westbury Canadian Life Insurance RBC Life	Voyageur Insurance RBC General Insurance Assured Assistance Inc.
Canadian Imperial Bank of Commerce	CIBC Life Insurance Co. Ltd.	CIBC General Insurance Co. Ltd. Personal Insurance Co. of Canada (CIBC Insurance)
Bank of Montreal	None	None
Scotiabank	Scotia Life Insurance Co. (formerly Glacier National Life Insurance)	Scotia General Insurance Co. (formerly Canada Sec. Assurance)
Toronto Dominion Bank	TD Life Insurance Co.	TD General Insurance (formerly Nova Scotia General)
National Bank	National Bank Life Ins. Co. (acquisition from Canassurance Life) National Bank Financial Services Inc. (joint venture with MetLife)	None
Hongkong Bank of Canada	None	Canada Direct Insurance Inc.
Canada Trust	CT Financial Assurance Co.	Meloche Monnex Inc.
Desjardins	Desjardins-Laurentian Life Group • D-L Life Assurance Co. • Laurier Life Insurance Co. • Placements Laurentienne • Sigma Assistel • CAPSS	Société de portefeuille du Groupe Desjardins assurance générales • Assurances générales des caisses Desjardins • La Sécurité assurances générales
Credit Union Central of Canada[1]	Credit Union Insurance Services (joint venture between Co-operators and CUMIS) • Co-operators Life • CUMIS Life	Co-operators General Ins. Co. CUMIS General

[1] Other credit unions, centrals and cooperatives share in the ownership of the insurance affiliates.

Sources: company annual reports.

Current Regime

Federally incorporated deposit-taking institutions (DTIs) are permitted to sell a specified range of insurance products through their branches.[70] In addition, they may have subsidiaries that can sell insurance of any kind using other distribution channels. DTIs may not share customer information with an insurance company regardless of whether the company is a subsidiary or unrelated, and may not target-market insurance sales to their existing customer base. The restriction on target marketing means that DTIs, for example, may enclose a flyer promoting auto insurance with the statements mailed to all its customers. However, it cannot send the information on auto insurance only to customers that have auto loans.

Recent provincial legislation has tended to follow the federal model in only permitting in-branch distribution of credit-related insurance products by provincially regulated financial institutions. Quebec provides broader powers to DTIs, and British Columbia, Manitoba and New Brunswick permit credit unions and insurance brokerages or agencies to share premises, with some restrictions (see Exhibit 4.2).

Exhibit 4.2
Credit Union / Caisse Populaire Distribution of Insurance

Credit unions may sell limited range of insurance products in branch, similar to federal regulations.	BC, Man., Sask., Alta., Ont., NS, NB, PEI, Nfld.
In addition to selling limited range of insurance products in branch similar to federal regulations, credit union and insurance brokerage or agency may share premises.	BC,[1] Man., NB[1]
Insurance employees may sell general insurance in branches of DTIs.	Quebec law prior to Bill 188
Licensed employees of DTIs may sell general and life insurance in branches.	Quebec law after passage of Bill 188, June 1998.

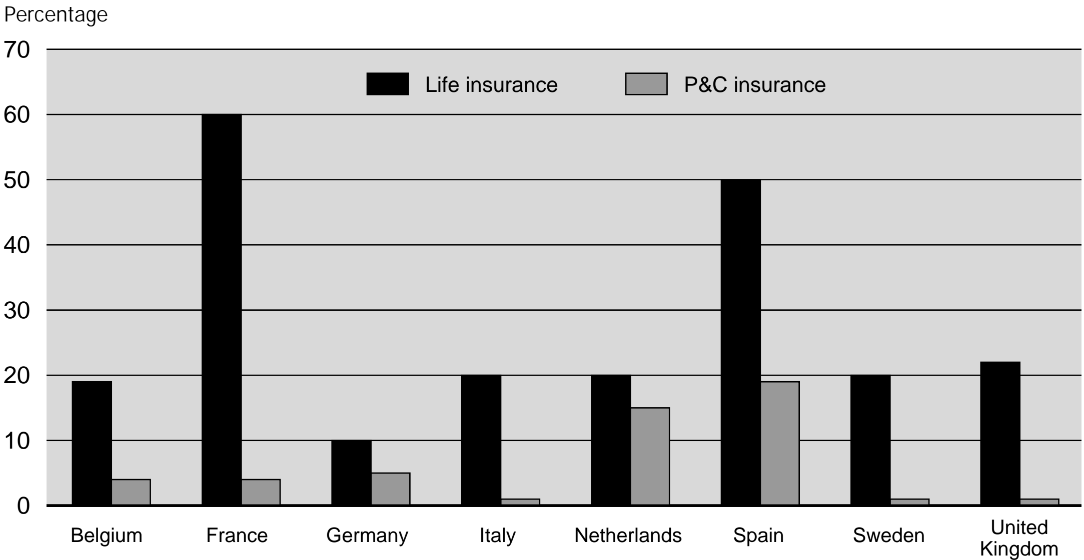
1 Restrictions to ensure that DTI branch and insurance offices are "separate and distinct" may be met by having a common lobby.

70 The Insurance Business (Bank) Regulations pursuant to section 416 of the Bank Act (and the parallel trust company regulations) allow the following products to be sold in branches: credit or charge-card related insurance, creditor disability insurance, creditor life insurance, creditor loss of employment insurance, creditor vehicle inventory insurance, export credit insurance, mortgage insurance and travel insurance. Prior to 1992, federally incorporated DTIs were not permitted to underwrite insurance. For many years travel insurance and credit-related insurance underwritten by unrelated insurance companies had been sold through branches, and this power was continued in the 1992 legislation. In 1992 federally incorporated DTIs gained the power to underwrite insurance through subsidiaries.

The policy discussion over distribution by DTIs seldom makes a distinction between the differing types of insurance because the policy issues are similar despite the differences in life and general insurance markets.

Bancassurance activities in most countries focus on life insurance, with the share of the property and casualty insurance market held by DTIs generally amounting only to a fraction of the life insurance share (see Exhibit 4.3). In Canada, about 10 percent of the general insurance market is held by DTIs, either directly or through subsidiaries and affiliates (see Exhibit 4.4). A significant portion of this share is due to the ownership linkages between the credit union movement and Co-operators Group Limited, which alone has about 6 percent of the Canadian general insurance market, as well as to the 11 percent share of the Quebec market held by Desjardins.

Exhibit 4.3
Market Share of Bancassurance in Europe, 1996



Source: *ARGUS,* June 20, 1997.

Many of the insurance products sold through branches are underwritten not by a bank subsidiary but instead by insurance companies unaffiliated with the deposit-taking institutions, and are distributed through a networking agreement.[71] This is likely to change over time as the DTIs' insurance subsidiaries develop or acquire more expertise and capacity.

[71] Networking is the sale of a financial product by one financial institution or market intermediary that is produced (or "manufactured") by another financial institution. While the arrangements continually vary, and over time the bank-owned insurance subsidiaries are likely to do more underwriting, all the large federally incorporated financial institutions are involved in networking the insurance products of unaffiliated companies.

Exhibit 4.4
Insurance Distribution by Canadian Deposit-Taking Institutions

1) Percentage of Total Market, 1994

	Through branches[1]	Subsidiaries or affiliates
General insurance	3	7
Life insurance	4	6

[1] Includes "permitted" products such as travel insurance and group creditor life, plus in-branch sales in Quebec and sales of credit union-affiliated insurance brokerages sharing premises where provincial legislation permits.

Source: Brent Sutton, *Bancassurance Activities in Canada: A Primer on the Issues*, Conference Board of Canada, 1996

2) Premiums Written by DTI Affiliates, 1996 and 1997

Institution	Gross life premiums written ($ millions)		Gross P&C premiums written ($ millions)	
	1996	1997	1996	1997
Royal Bank of Canada	95	100	15	15
Desjardins	1,400	1,570	420	438
Bank of Nova Scotia	3.8	3.9	1.14	4.5
Bank of Montreal	none	none	none	none
Toronto-Dominion Bank	73	100	0	0
CIBC	130	161	200	259[1]
Canada Trust	71	85.6	0	266.9[2]
Hongkong Bank of Canada	none	none	0.605	6.91
National Bank	N/A	N/A	none	none

N/A: Not available publicly; the bank did not respond to Task Force requests for the data.

None = No such affiliate.

0 = Affiliate reports no premiums written.

[1] P&C data for CIBC are Net Premiums Earned, as the Gross Written premium numbers would significantly overstate the size of business because of quota share arrangements in place between CIBC's two P&C entities.

[2] Auto, home, small business and travel insurance through subsidiaries of Meloche Monnex Inc. Acquired by CT Financial in April 1997.

Sources: Information provided to the Task Force by individual institutions, annual reports.

Historical Development

Until 1992, federally incorporated DTIs were excluded from the insurance business in Canada with the exception of selling a limited range of insurance products, such as creditor life insurance, that had historically been viewed as incidental to the business of banking. Insurance companies could have deposit-taking subsidiaries and, as of the end of 1991, Standard Life, Sun Life, Metropolitan Life, Mutual Life and Manulife all owned trust companies. The most developed bancassurance activity in Canada before 1992 was in Quebec, where insurance affiliates of the caisses populaires were permitted to distribute

insurance through the branches of the caisses. In addition, credit unions in a number of provinces owned insurance brokerages. Deposit-taking institutions quickly took advantage of the expanded business power provisions of the 1992 legislation to establish or acquire insurance subsidiaries. To date, the bulk of the growth in the deposit-taking share of insurance activities has come from new incorporations or relatively small acquisitions.

Distribution of insurance was one of the most highly charged issues in the debate over the 1997 review of the federal legislation. DTIs argued for expanded powers, which were strenuously opposed by insurance industry groups. The Minister of Finance announced in the March 1996 budget speech, "We have concluded that the financial sector has yet to fully adjust to this [1992 legislative] framework. Therefore, the present restriction on banks selling insurance will be maintained."[72] This announcement served to suspend a debate that had been continuing unabated since before the 1992 legislation. The 1996 White Paper later made it clear that the 1997 review was to be relatively narrow in scope and technical in focus.

International Experience

Links between banking and insurance have a long history throughout the world, particularly in Europe. The broad forces of change that have affected the financial services industry have helped to fuel the growth of bancassurance. As most industrialized countries face an ageing population with an increasing number of net savers, consumers have increasingly looked to wealth management advice and insurance products such as annuities rather than traditional deposits. Responding to this change in consumer preference, deposit-taking institutions around the world have sought a bigger role in insurance markets. In a number of countries such as Germany and France, tax treatment encouraged early entry by banks into life insurance as they found their deposit products uncompetitive with insurance products offering a tax-advantaged savings vehicle.

Changing consumer preferences have also provided an incentive for insurance companies to develop linkages with deposit-takers. Commodity products, such as individual term life insurance and many annuities, are expensive to distribute through a traditional agent or brokerage channel. Insurance companies in many countries have looked at marketing agreements with deposit-taking institutions as a way to reduce the high costs associated with distribution through an agency sales force. Financial institutions seeking economies of scale and scope have sought to provide a broad range of insurance and banking products, both through common delivery channels such as bank branches and through separate distribution channels operating within a common ownership

[72] Budget Speech, Hon. Paul Martin, P.C., M.P., Minister of Finance, March 6, 1996.

structure. Bancassurance is one manifestation of the broader trend toward financial services firms providing the full range of products and services required by customers.

Worldwide, most bancassurance activity has involved life insurance products, with sales of property and casualty insurance by deposit-taking institutions generally not accounting for a significant share of the market

One of the determinants of how bank-insurance linkages have developed is the regulatory framework. Exhibit 4.5 provides an overview of business powers for selected countries. Most countries provide some latitude for deposit-taking institutions to engage in insurance activities. Even in the United States, which is typically viewed as having a highly restrictive regime because banks cannot underwrite insurance, banks representing more than 70 percent of U.S. deposits distribute insurance.[73]

Europe

Beginning in the mid-1980s, most of the major French banks incorporated insurance subsidiaries. Banks have made great inroads into the market, with about 60 percent of life insurance now being sold through banks. A major reason for this success has been the sale of standardized life products with a savings component, taking advantage of favourable tax treatment of insurance products versus deposits. Most of the large banks and insurance companies have linkages to major players in the other sector.

The linkages in France have not all been bank-dominated, with Union des Assurances de Paris (UAP), the third-largest life insurer in France, having acquired Banque Worms (16th-largest in France) in 1984. Another large insurer, Groupe des Assurances Nationales (GAN), has a controlling interest in Crédit Industriel et Commercial (CIC), the eighth-largest bank.

Banks in Germany began to focus on the insurance business in the late 1980s, largely spurred by a long-term decline in deposit growth at the expense of tax-advantaged life insurance savings. Prior to this, a few of the major banks had sold insurance on an agency basis, and the *landesbanks* marketed the products of the state-controlled insurance companies in their regions. Banks and life insurance companies are permitted to have subsidiaries in the other sector, although there are a number of ownership restrictions and the possibility of the regulator prohibiting an acquisition.

[73] Association of Banks in Insurance, *Fact Book* (Washington, D.C., 1995).

Exhibit 4.5
Insurance Powers of Deposit-Taking Institutions

	In-house business powers		Ownership of subsidiaries		Use of customer information	
Country	Underwriting of insurance	Distribution of insurance	Insurance agencies	Insurance companies	In-house-marketing	Marketing by outside firms
Canada	No	No[1]	Yes[2]	Yes	No[3]	No
France	No	Yes	Yes[4]	Yes[4]	Yes[4]	No
Germany	No	Yes	Yes[4]	Yes[4]	Yes[4]	Yes[4]
Netherlands	No	Yes	Yes	Yes	Yes	No[5]
United Kingdom	No	Yes	Yes	Yes	Yes	Yes
United States	No[6]	Yes[7]	Yes[8]	No[9]	Yes	Yes

Notes

1 Federally incorporated deposit-taking institutions may distribute certain types of insurance through their branches. These are: credit or charge-card related insurance, creditors' disability insurance, creditors' life insurance, creditors' loss of employment insurance, creditors' vehicle inventory insurance, export credit insurance, mortgage insurance and travel insurance. Provincially regulated DTIs in Quebec prior to June 1998 could distribute group life insurance products through their branches, and general insurance through licensed employees of their affiliated insurance companies located in the branches. The Desjardins caisses populaires made extensive use of this power. Bill 188 permits licensed DTI employees to sell insurance.

2 Not all provinces permit credit unions to own insurance agencies.

3 Customer information may not be communicated to an insurer, but non-targeted promotional material such as a mailing to all credit card customers is permitted.

4 Deposit-taking institutions may undertake this activity but may face greater restrictions than other financial institutions.

5 Targeted marketing is not prohibited by law in the Netherlands. However, Dutch deposit-taking institutions have agreed not to undertake such activities. This agreement is detailed in an agreement with the Dutch Bankers Association.

6 There are a small number of grandfathered exemptions.

7 Banks chartered in 38 states can distribute insurance. A small number of banks previously engaged in insurance were grandfathered under the Garn–St. Germain Act, 1982, which restricted the insurance activities of bank holding companies. National banks may act as insurance agencies in towns with a population of less than 5,000.

8 Not permitted in all states. Most bancassurance activity is undertaken in insurance agency subsidiaries or affiliates. Some states require banks to use "Third-Party Marketing Agreements" as banks are restricted in their ability to own agencies or have their own licensed agents.

9 Bank holding companies have been explicitly excluded from most insurance business since the Garn–St. Germain Act, 1982, but there are some exceptions and grandfathering provisions. State regulations vary.

Sources: *Financial Conglomerates* (OECD, 1993); Robert A. Eisenbeis, "Banks and Insurance Activities," in Saunders and Walter, eds., *Universal Banking* (New York: New York University 1996); James R. Barth, Daniel E. Nolle, Tara N. Rice, *Commercial Banking Structure, Regulation and Performance: An International Comparison* (Washington, D.C.: Office of the Comptroller of the Currency), Economic Working Paper 97-6, March 1997; Association of Banks in Insurance; The Conference Board of Canada; regulatory authorities in various countries.

An insurance company led the German approach to *allfinanz*, the combination of banking, insurance and securities in the same entity. In 1988, Aachener and Muenchener Group, the fifth-largest insurer, acquired the 14th-largest bank in Germany. The three largest German banks responded to this trend to *allfinanz* in different ways: Deutsche Bank by incorporating its own insurance company, Dresdner through a marketing agreement with Allianz (the largest insurer in Germany), and Commerzbank through a joint venture with Deutsche Beamtenversicherung, a mutual insurance company. Bank penetration of the

insurance market has been slow, with bancassurance activities accounting for about 10 percent of life and 5 percent of general insurance sales in Germany.

Banks in the Netherlands have long had the ability to distribute insurance. Until 1990, however, there was a strict separation of banking and insurance underwriting. Banks and insurance companies were limited to holding 5 percent of the voting shares of a firm in the other sector. These restrictions were relaxed in 1990 and led to several large insurance-bank mergers. In 1991, National Nederlanden, the largest insurer with approximately 20 percent of the life market and 10 percent of the general insurance market, formed a holding company (ING) with NMB-Postbank, the third-largest deposit-taker. Many of the large insurers own mortgage banks (this was permitted prior to 1990) and other smaller banks. ABN-Amro has developed its own insurance operations. Unlike the trend in other countries, the dominant partner in bancassurance activities in the Netherlands tends to be an insurance company.

Banks and building societies in the United Kingdom have long had the ability to distribute insurance, subject only to the requirement that it be sold solely by licensed intermediaries. An informal agreement between the Bank of England and the Department of Trade and Industry to restrict cross-ownership of banks and insurance companies ended in the mid-1980s. Following this, the large clearing banks and building societies began to incorporate or acquire small to mid-sized insurers, and many also entered into cooperative marketing agreements with insurance companies. By 1992, all major insurers with the exception of the largest, Prudential U.K., had some form of relationship with a bank or building society. Deposit-taking institutions distributed about 14 percent of all U.K. life insurance in 1989 and about 22 percent in 1996.

While the focus of bancassurance has been on life products, Royal Bank of Scotland built a new general insurance subsidiary, Direct Line, which has become a worldwide model for direct insurance sales by both bank-owned insurers, such as CIBC Direct in Canada, and other P&C companies such as ING. Direct Line sells exclusively by telephone, and does not share premises or staff with its bank parent. Use of customer information is restricted by the March 1992 voluntary Code of Banking Practice, which prohibits the release of customer information by banks to their affiliates without the express consent of the customer. Quite apart from this restriction on the use of information, Direct Line opted not to rely on branch referrals because of its strategy of accepting only certain categories of risk. While branch referrals are permitted with consumer consent, there is a concern that the banking relationship would be endangered if Direct Line declined to underwrite insurance for a referred customer. Despite the success of Direct Line and its imitators, independent brokers continue to sell the bulk of general insurance in the United Kingdom.[74]

[74] Insurance Bureau of Canada, *Preparing for 1997*, January 1996.

United States

As detailed in the notes to Exhibit 4.5, despite some quite stringent federal laws and insurance licensing restrictions in some states, U.S. banks are active in the insurance market. U.S. banks focus on distribution of third-party products, with the bulk of bank insurance sales being composed of annuity products supplied by unaffiliated life insurance companies. Canadian insurers such as Sun Life, Great-West Life, Manulife and Canada Life distribute their products through banks in the United States. Banks account for about a quarter of all annuity sales in that country. Reliable estimates of the share of other life and general insurance products distributed through banks and thrifts are not available, but the market share is quite small. About 55 percent of general insurance in the United States is distributed by independent brokers.[75]

Since 1916, banks in the United States have had the ability to act as insurance agencies in towns with populations of less than 5,000. This small town exemption was introduced to provide more competition in smaller centres that were viewed as underserved by the insurance industry. Banks and bank holding companies have also been permitted to sell a narrow range of insurance products "incidental" to the business of banking. While the permitted products differ, the concept is similar to the current Canadian limits on insurance that can be distributed through branches. A series of recent court cases have provided greater business powers within existing legislation,[76] and more states are providing insurance powers for state-chartered banks. As a result, the percentage of banks involved more broadly in the sale of insurance is likely to increase significantly.

One of the major recent events in the United States is the development of a regulatory regime for the distribution of insurance through banks, with the support of both banks and insurance agents. For many years there has been tension between banks, which have sought broader insurance powers, and insurance agents and brokers, who have opposed the expansion. State licensing requirements, which in some cases made it difficult or impossible for banks and/or their employees to obtain the necessary licences, were frequently seen as barriers to greater bank involvement in insurance.

[75] Ibid.

[76] *Independent Insurance Agents of America v. Ludwig*, D.C. Court of Appeals, 1993, established that the "small town exemption" does not place geographic restrictions on the solicitation activities of a bank's insurance agency business or the location of its insureds, meaning that national banks can serve a broad clientele from an office located in a small town. *NationsBank of North Carolina v. Variable Annuity Life Insurance Company*, U.S. Supreme Court, 1995, found that the sale of annuities issued by life insurers is incidental to the business of banking and is therefore a permissible activity for national banks. *Barnett Bank of Marion County v. Nelson*, U.S. Supreme Court, 1996, established that the Office of the Comptroller of the Currency has the power to pre-empt all or part of state laws which prevent or significantly interfere with a national bank's ability to sell insurance from small town locations, meaning that states will no longer be able to maintain restrictions on the ability of banks, their employees or affiliates to obtain insurance licences.

Recent court decisions (see note 76) determined that the Office of the Comptroller of the Currency could override discriminatory state licensing requirements, and also meant that insurance could be delivered nationwide from a single small town location. In essence, this meant that a national bank could sell insurance without having a state licence if the laws of that state discriminated against banks by, for example, prohibiting the employees of banks from holding insurance licenses. Faced with the prospect of unlicensed competition, the insurance lobby in the United States shifted its focus from trying to keep the banks out of the insurance distribution business to developing a workable regulatory regime that would include banks.

Since insurance is a state responsibility, legislation can vary significantly. One way of achieving some level of consistency is to use "model codes," which are generic templates for legislation developed by the National Association of Insurance Commissioners (NAIC). The model code for bank distribution of insurance has the support of both banking and insurance agents' industry associations. Illinois became the first state to enact the model code, effective October 1, 1997.

The key elements of the Illinois regime are as follows:

- Any deposit-taking institution may become an insurance agency (not an underwriter) licensed to sell any kind of insurance that other insurance agents can sell.
- Any employee of a deposit-taking institution, subject to meeting salesperson licensing requirements, may sell insurance anywhere, including in the branch.
- Larger institutions are required to separate the lending and insurance functions, but referrals can be made freely and the lending and insurance functions can take place in the same area of the branch.
- Banks can use customer information to solicit insurance business but cannot release it to a third party without customer consent.
- Disclosure requirements deal with the risks of tied selling. They include the requirement for prominent display of the following wording: "You may obtain insurance required in connection with your loan or extension of credit from any insurance agent, broker or firm that sells such insurance. Your choice of insurance provider will not affect our credit decision or your credit terms."
- Banks selling insurance are prohibited from using health information obtained from a customer's insurance records for any purpose other than its activities as a licensed insurance agency.[77]

[77] Illinois House Bill 586.

Many of the key elements of the Illinois model code have been reflected in the development of Quebec's Bill 188.

The development of bancassurance activities in various countries reflects the unique circumstances in each jurisdiction. However, there is clearly a worldwide trend toward closer links between banking and insurance, with the share of the insurance market accounted for by deposit-taking institutions and their affiliates showing increases in most countries. It is important to note that insurance companies and their traditional distributors appear generally able to continue to compete in an environment of increasing bancassurance; indeed, in the Netherlands and to a lesser extent in France, the dominant player in bancassurance arrangements is frequently an insurance company. Most bancassurance activities have focussed on life insurance, perhaps because there is a greater similarity between banking and life insurance than banking and general insurance.

Reconsidering Current Policy

Since the introduction of the 1992 legislation and regulations, DTIs have been proposing changes to permit:

- sharing of information between deposit-takers and related insurance companies;
- targeted marketing (e.g., sending material about car insurance only to customers with car loans, rather than having to send the promotional material with all account statements or all credit card bills); and
- distribution of insurance through branches.

DTIs argue that distribution through branches and the ability to use customer information to market insurance would provide consumer benefits in the form of lower costs, more choice, increased access to insurance and more convenient service delivery. They also suggest that DTI distribution would enable cost-effective delivery to lower-income Canadians, expanding the size of the insurance market in Canada. A particular competitive concern of DTIs is that since they are not permitted to sell annuities or refer their customers to their insurance subsidiaries, long-term DTI customers converting RRSPs into annuities almost inevitably purchase an annuity from a life insurance competitor of the DTI. DTIs have not advanced the argument that expanded insurance powers are vital to international competitiveness. They have, however, suggested that distribution of insurance through branches might make it feasible to maintain branches that would otherwise become uneconomic.

The arguments against providing this increased competition are threefold:

- Increased competition will be short-lived if the large banks are able to exercise oligopolistic power over the market.

- Increased competition may result in job losses among the existing players in the insurance sector if the new entrants are successful.
- Consumers may be subjected to coercive sales practices and abuse of personal information.

Many submissions to the Task Force suggested that allowing DTIs to retail insurance would create unfair competition for existing insurance distributors, and would lead to difficult adjustments and loss of employment. It was contended that a bank could use its position as lender to coerce consumers to buy insurance as a condition of receiving other services (particularly credit) when it was not, in fact, in the best interest of the customer to purchase insurance from the bank. It was also suggested that banks controlled so much personal information that they would have an unfair marketing advantage over insurance agents and brokers.

Most of the submissions to the Task Force touching on the insurance issue have been from industry groups, but this high level of industry concern is not matched by consumers. Public opinion research conducted for the Task Force indicates that less than one third of Canadians are personally concerned about this issue. Most Canadians want to be able to choose where they buy insurance, but there is also concern that banks selling insurance would have too much consumer information and that competition would increase only in the short run.[78] This is consistent with concerns previously expressed by the Consumers' Association of Canada (CAC) about the longer-term potential for banks to exercise market dominance.

Business power restrictions have to be considered in the context of broader changes in the financial services sector and the Task Force's vision of the future of the sector in Canada. While debate understandably tends to focus on the short-term interests of current and potential providers of services, the ultimate concern that should govern any business power restriction is the impact on consumers.

Benefits to Consumers

Allowing DTIs to distribute insurance will expand the opportunities for Canadians to purchase it. Research conducted for the Task Force indicates the following:

> Amongst lower income Canadians, a minority report that they have life, home or apartment, or separate health insurance. A small majority (56 percent) report that they had automobile insurance. In total, nearly one in five (17 percent) reported that they did not have any of the different types of insurance. This compares to at most 5 percent in other income groups.[79]

[78] Ekos Research Associates Inc., *Public Opinion Research Relating to the Financial Services Sector*, (Ottawa, September 1998), pp. 55, 56.

[79] Ibid., p. 18.

The survey did not identify why different respondents do not have insurance, and the Task Force is cautious about concluding that there is an underserved market in Canada. Nevertheless, experience elsewhere suggests that DTI involvement in insurance distribution has increased the overall size of the insurance market.

In the United States, expanded distribution of annuities by banks has, at least in the short run, increased "total revenue for the industry and agents' earnings,"[80] as the total size of the market has increased. American consumers responded to the increased availability of annuity products by purchasing more, and this phenomenon is expected to be repeated as U.S. banks expand their sales of life insurance products other than annuities.[81]

A truism in the industry is that life insurance is sold, not bought, as most consumers are not proactive in identifying and filling their need for insurance. Less than half of Canadian households each year are contacted through current distribution channels. As illustrated in Exhibit 4.6, prospecting by agents and brokers understandably focusses on the higher-income segments. Even though households with annual income of less than $50,000 were more likely to purchase insurance, households with incomes of more than $50,000 were 40 percent more likely to be contacted by an agent than a household with income of less than $20,000. Given the relationship between the size of the sale and the commission earned, agents and brokers have a strong incentive to focus their efforts on the segments likely to yield a large sale.

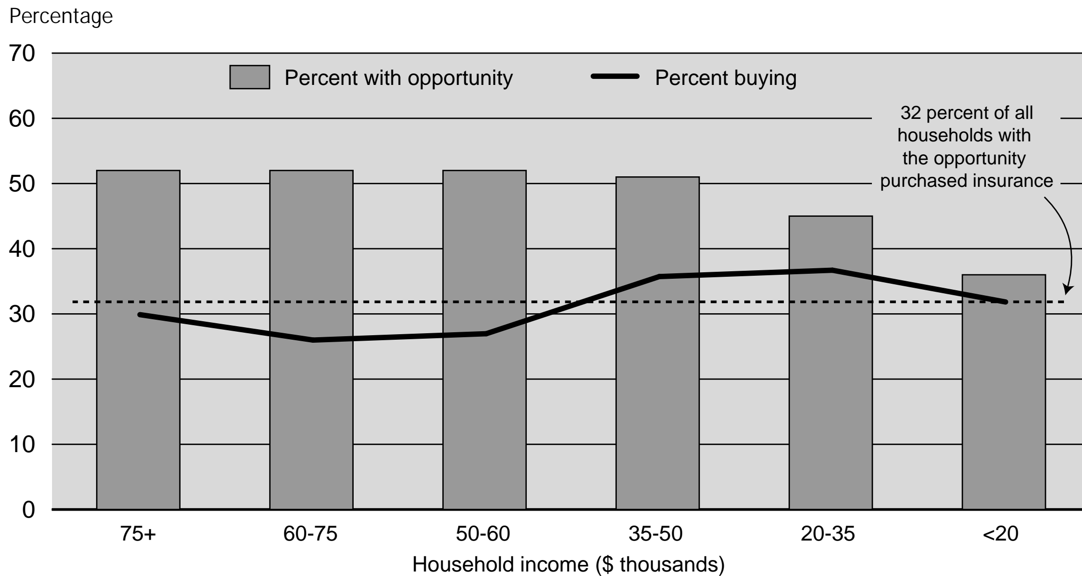
Exhibit 4.7 illustrates both the increasing percentage of policies sold to higher-income earners and the larger premium income derived from the sale of what are typically policies with much higher face value.

One of the arguments in favour of permitting DTIs to retail insurance through their branches and to use, with express consent, consumer information to market insurance, is that the improved economics facilitates serving lower-income consumers who may not be targeted by a traditional commissioned salesperson. The evidence from the United Kingdom, where licensed salespersons can obtain "warm leads" from banks and building societies, is that these agents are much more productive than those who prospect in the traditional way. Similar synergies are the basis of bancassurance activity throughout the world. Such higher productivity can make it economic to target lower-income earners.

[80] Duff & Phelps Credit Rating Co., "Bancassurance, Part II," *Insurance Insights*, June 1997.

[81] Ibid.

Exhibit 4.6
Households with the Opportunity to Buy Insurance in the Last Year



Source: LIMRA, *Trends in Canadian Insurance,* 1997.

Exhibit 4.7
Ordinary Life Sales to Persons with Annual Income over $50,000

	1991	1995
Percentage of policies	13	18
Percentage of premiums	30	33

Source: LIMRA, Trends in Canadian Insurance, 1997.

Protecting Consumers

The Task Force takes very seriously the issues of coercive tied selling and privacy of customer information. The potential for tied selling and abuse of personal information exists within the current array of banking products. The Task Force has made proposals that it believes will effectively address these issues.[82]

Informed customer consent is a more common approach for dealing with privacy concerns than an outright prohibition on offering products or sharing information. The nature of the consent required, the process for requiring it, and the need for full and understandable disclosure are all essential to an adequate privacy regime. The recommendations of the Task Force will considerably strengthen the current regime.

[82] *Empowering Consumers*, Task Force Background Paper #3.

The potential for coercive tied selling exists whenever multiple products are delivered through the same retailer. There is no evidence to suggest that the sale of insurance is so fundamentally different from all other business transactions that it cannot be sold through a distribution channel that also delivers other products to consumers. If this were the case, the logical conclusion would be that insurance agents and brokers should not be able to sell other products such as securities or provide financial planning advice for fear that they would engage in tied selling or abuse personal information.

The Task Force does not believe that the ability to sell multiple products to consumers should be denied because of tied selling concerns. Rather, the practice of coercive tied selling should be attacked directly through a legislated ban with serious sanctions and requirements for full and understandable disclosure. The Task Force proposals on tied selling will achieve that goal.

The Task Force notes that large Canadian life insurers are active suppliers of the insurance products distributed by banks in the United States. Clearly, distributing insurance through a bank does not create consumer concerns that could only be addressed by banning such sales. Otherwise, as responsible institutions, Canadian life insurance companies would not engage in the practice.

On balance, the Task Force believes that consumers can be protected by measures other than an outright prohibition, and that consumers should have the ability to choose where they purchase insurance. If, as the life and general insurance industries maintain, their businesses are already highly competitive and customers are already well served, DTIs will have great difficulty in gaining market share as customers will continue to choose to purchase insurance through existing channels.

More competition is in the interests of consumers generally. The Task Force believes it likely that low- and middle-income Canadians will be the principal beneficiaries of having basic insurance products, such as individual term life insurance, available through the branch networks of deposit-taking institutions.

Accordingly, the Task Force proposes that restrictions be eliminated on deposit-taking institutions retailing insurance through their branches and using their customer information files to retail insurance, subject to the adoption of the proposed privacy and tied selling regimes.

Many submissions, have expressed concerns about the necessity of ensuring that only appropriately educated and licensed salespersons serve consumers. This important part of ensuring consumer protection has been addressed provincially. Requirements vary among the provinces, and there is a need to upgrade the educational requirements for market intermediary licensing.[83]

[83] This is developed more fully in *Empowering Consumers*, Task Force Background Paper #3.

While the Task Force views a high national standard in licensing requirements as desirable, in the first instance any new entrants should be subject to existing consumer protection provisions. Accordingly, the Task Force is of the view that employees of deposit-taking institutions engaged in the sale of insurance should comply with applicable provincial requirements with respect to the education and licensing of insurance salespersons, so long as such requirements are non-discriminatory.

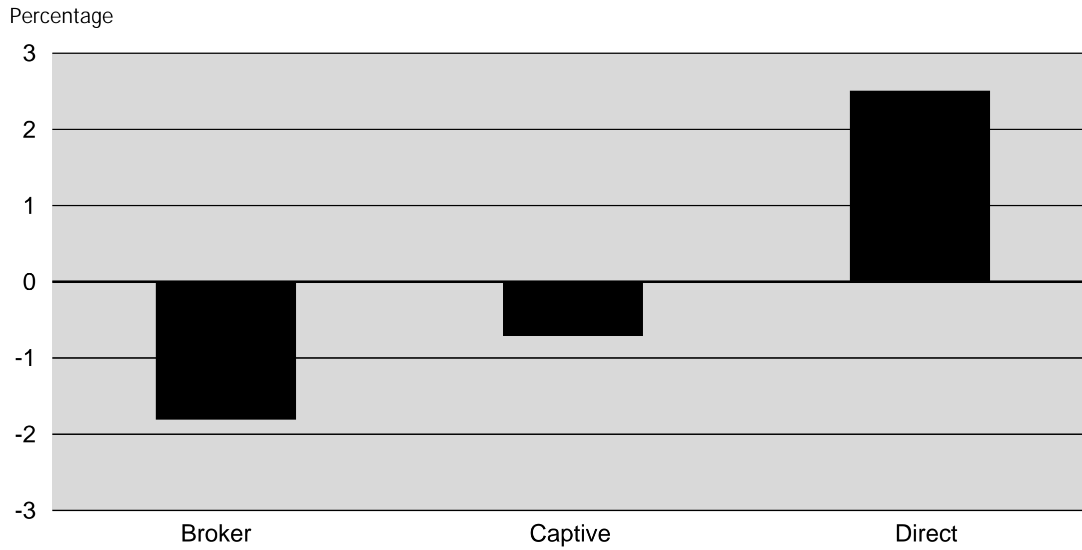
The Task Force notes that a number of provinces have regimes that prohibit employees of deposit-taking institutions from obtaining insurance licences. The Task Force encourages the insurance and deposit-taking sectors to work with the provinces in developing a practicable regime that ensures the protection of consumers without discriminating against employees of DTIs. The Task Force has taken note of the Illinois model code and Quebec's Bill 188, and it believes that these approaches could serve as the basis for a model code that would result in uniform standards across the country for licensing and, indeed, for other consumer protection issues. Such a model code, coupled with a system of mutual recognition among the provinces, would address the concerns raised in many submissions to the Task Force about multiple and inconsistent insurance regulatory regimes across the country.

Impact on Existing Players

Quite aside from the debate over DTI retailing of insurance, it is clear that the distribution of both life and general insurance is changing. Exhibit 4.8 shows that direct response sales, which involve the use of call centres and the Internet, have grown at the expense of both traditional brokerage and captive agent distribution of general insurance. If only personal insurance is considered (and commercial insurance is excluded), direct response accounted for approximately 20 percent of direct premiums written in 1997, up from about 12 percent just three years earlier.

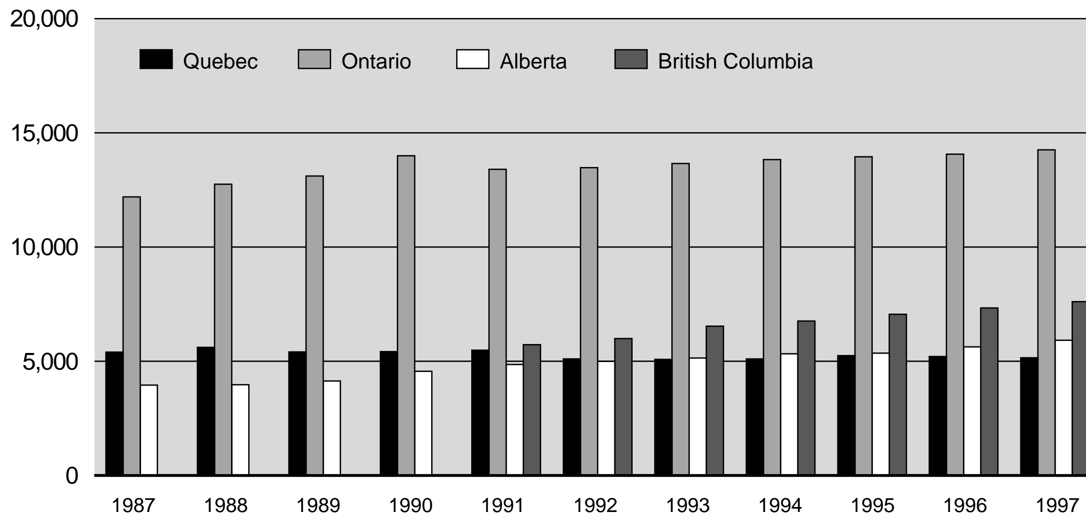
Attracted by the success in the United Kingdom of Direct Line, a subsidiary of the Royal Bank of Scotland, new entrants such as CIBC Insurance and existing players such as Bel Air and the Cooperators are using call centres instead of brokers. The number of independent insurance brokerages in Canada has been steadily declining as the market has consolidated. Employment in brokerages has declined by 13 percent since 1991, but the number of licensed brokers and agents has increased in most provinces (see Exhibits 4.9 and 4.10). This reflects the use of technology within brokerages, meaning that fewer employees are required to support the activities of the licensed salespeople.

Exhibit 4.8
Growth in Premiums by Distribution Channel
General Insurance, 1991–95



Sources: Canadian Underwriter; Ted Belton, RBC Insurance.

Exhibit 4.9
Total Licensed General Insurance Brokers/Agents by Province

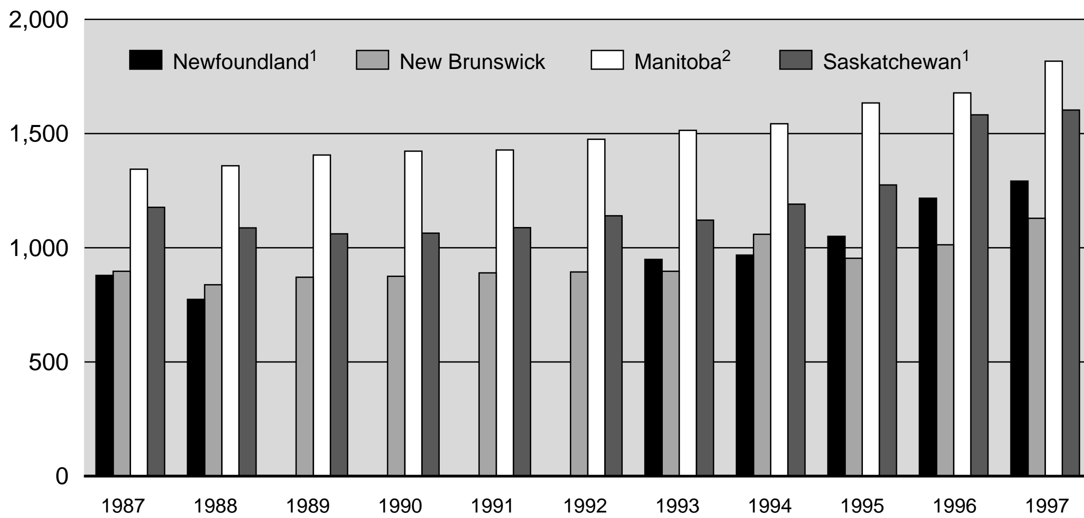


Note: B.C. data only available from 1991.

Sources: ACAPQ, RIBO, Alberta Treasury, Insurance Council of B.C.

Exhibit 4.10

Total Licensed General Insurance Brokers/Agents by Province



[1] Includes those licenced to sell accident and sickness insurance. 1989-92 data not available.

[2] Includes provincial auto licences.

Sources: New Brunswick Department of Justice, Insurance Councils of Saskatchewan and Manitoba, Newfoundland Department of Government Services and Lands.

The life sector has shown a similar trend, although the development of alternative distribution channels is not as advanced (see Exhibit 4.11). Most Canadian life insurance companies are now engaged in some form of direct marketing.[84] The number of full-time life agents declined by 4.5 percent to 17,250 between 1986 and 1996.[85] Similarly, productivity per agent has also been steadily declining, with the average Life Underwriters Association of Canada (now the Canadian Association of Insurance and Financial Advisors) member selling 74 individual life polices in 1987 and 54 in 1996.[86] Products such as term insurance and annuities are more likely than whole life policies to be sold through distribution channels other than career agents. Taken together, these data indicate that Canadians are taking advantage of a range of distribution channels. The traditional life agent system is already being transformed into one that focuses more and more on the provision of advice as consumers increasingly choose to purchase commodity-type products through less expensive distribution channels.

[84] A 1995 Canadian Life and Health Insurance Association (CLHIA) survey indicated that 60 percent of 51 responding companies were then engaged in direct marketing and a further 21 percent were planning to engage in or were interested in engaging in direct marketing. *Direct Marketing of Insurance in Canada*, CLHIA, September 1995.

[85] LIMRA, *Trends in Canadian Insurance*, 1997.

[86] Ibid.

Exhibit 4.11
Individual Life Premium Market Share

Distribution channel	1989	1995
"Own" agents	68	55
Independent agents	29	33
Independent marketing organizations	N/A[1]	7
Direct response	0	1
Manufacturer-distributor agreements	1	2

[1] Not collected separately in 1989, included in Independent agents, was less than 4 percent of market in 1989.
Source: LIMRA, *Trends in Canadian Insurance*, 1997.

It is clear that consumers are taking advantage of new distribution channels and, regardless of whether federally incorporated DTIs gain expanded insurance business powers, both the life and general insurance sectors are restructuring and will continue doing so.

While the incumbents are understandably concerned about the impact of new entrants on their profitability and employment, the Task Force agrees with the view of Standard and Poors: "Experience worldwide, ranging from New Zealand to Europe, suggests that banks and life insurers can both succeed when competing directly against one another and there is no reason Canada should be an exception."[87] Indeed, the Task Force believes that life insurance companies, strengthened by demutualization and expanded payments system access as proposed, can position themselves as major competitors to the banks across a broad range of financial services.

In the general insurance segment, products which are viewed as commodities, such as auto and home-owners' policies, are best suited to direct response or branch distribution. As noted above, many companies have already moved to embrace these new channels. However, it should not be overlooked that these commodity-type products are only part of the market. Commercial lines account for about 40 percent of general insurance premiums in Canada, and in provinces with government-provided auto insurance, commercial lines constitute a larger share of the market. Commercial lines continue to be sold through brokers and specialist agents, and there is no indication that new entrants will threaten this part of the business.

The evidence from Quebec suggests that distribution of insurance through DTIs expands the number of delivery channels from which customers can choose. The previous regime in Quebec permitted general insurance to be sold by an insurer on the premises of a deposit-taking institution since 1987. Under

[87] Standard and Poor's, *Canadian Life Insurance Market Report*, May 1997, p. 7.

Quebec's Bill 188 passed in June, 1998, insurance may be sold by employees of deposit-taking institutions, subject to restrictions. Sales have to take place in a separately designated area of the branch through employees not involved with deposit-taking and lending. The DTI would have to register with the Bureau des services financiers and the Bureau will regulate the DTI employees involved in insurance sales. This includes meeting certification or licensing requirements. Bill 188 permits a caisse populaire employee to sell life and general insurance, subject to licensing requirements and the restrictions on the use of information in the Quebec privacy code.

There are about 90 general insurance companies active in Quebec, with Desjardins having 11.4 percent of the market (see Exhibit 4.12). Much of the Desjardins market share has been gained through the ability of an employee of the general insurance affiliates to share premises in the local caisse. This undoubtedly contributed to the 5 percent decline in the number of licensed general insurance brokers in Quebec between 1987 and 1997, but the Quebec market remains served by a range of distribution channels.

Exhibit 4.12
Five Leading General Insurers in Quebec, 1997
Direct Premiums Written, Total Market $3.8 billion

Company	Market share
AXA Canada	13.2
Desjardins	11.4
ING Canada	11.0
General Accident	7.7
Guardian Group	4.8

Source: *Canadian Insurance*, Statistical Issue, 1998.

There are about 120 life insurance companies active in Quebec, with Desjardins Life having about 18 percent of the market (see Exhibit 4.13). Desjardins is currently limited to selling group insurance through the caisses. Bill 188 increases the potential to sell life insurance through the caisses, as an appropriately licensed employee will be able to sell individual life products as well as the previously permitted group products.

Desjardins, with approximately 45 percent of retail banking in Quebec, is much more dominant within the province than is any DTI in any other region of the country. Insurance agents, brokers and insurance companies have all continued to be strong competitors, with the result that Desjardins' share of insurance markets is much smaller than its share of deposit-taking.

Exhibit 4.13
Leading Life Insurers in Quebec, 1996
Premium Income, Total Market $5,787 million

Company	Market share
Desjardins-Laurentian	18.7
Great West Life and London Life	10.6
Mutual Life and Metropolitan Life	9.5
Industrielle-Alliance	7.2
SSQ-Vie	6.3

Source: *En Perspective*, Desjardins Études économiques, March 1998.

A number of submissions to the Task Force explicitly state or imply that the banks would price insurance products at a loss until they gained market share, and then would reap higher returns by imposing price increases. This argument presupposes that there are high barriers to entry into the insurance market. Most insurance groups in other contexts have argued the opposite, noting that there are low barriers to entry in both the life and general insurance market, and that the markets are very competitive. This means that if the incumbents were earning excess profits, new entrants would be expected to be attracted to the market.

The evidence to date from deposit-taking institutions entering insurance markets is that they have not engaged in predatory or loss-leader pricing. The pricing of general insurance by the affiliates of deposit-taking institutions tends to be middle-of-the-pack.[88] There is no evidence to suggest that federally incorporated DTIs would be more likely to engage in anti-competitive pricing if they were able to distribute insurance through their branches.

On balance, while incumbents understandably view new competitors as potentially disruptive, the Task Force believes that consumers, and not the regulatory framework, should determine how insurance is purchased. The available evidence suggests that existing distribution channels will not disappear if insurance is distributed through branches of DTIs. While there will be some consolidation, other forces already at work are causing consolidation throughout the insurance industry.

The Task Force does believe that the incumbents require a period to prepare for the new competitive landscape and accordingly it proposes that there be a

[88] The Insurance Brokers Association of Canada and the Insurance Bureau of Canada (IBC) provided data from the Ontario Insurance Commission on 1997 auto insurance rates, and the IBC provided data on Quebec auto insurance rates for 1996. The rates of the insurance affiliates of DTIs tended to be in the middle of each class.

reasonable transition period to allow adjustment to the new competition in the traditional insurance distribution network. In particular, the current restraints should be lifted effective January 1, 2002, for all deposit-taking institutions subject to the prior adoption of the Task Force proposals on tied selling and privacy. The Task Force hopes and expects that during the transition, many of the current insurance companies will emerge as stronger competitors to the larger institutions not only in insurance but in other financial services. The transition period should also benefit people currently employed in the distribution of life and general insurance. Experience internationally and in provinces where credit unions own insurance brokerages suggests that there are opportunities for insurance salespeople to form effective partnerships with new entrants.

Encouraging Smaller Competitors

Federal DTIs have used competitive equity with the cooperative sector as one of their arguments for being allowed greater insurance retailing powers. In most provinces, the credit union share of retail financial services is much smaller than that of the banks. However, the unique nature of the Quebec market, where Desjardins is the dominant provider of retail banking services, makes the situation particularly acute for National Bank and Laurentian Bank. Both banks have the bulk of their business in Quebec and do not have the same power to distribute insurance as their principal competitor, Desjardins.

The Task Force is of the view that the smaller DTIs offer platforms that might be developed to provide greater competition to the larger institutions, and it believes that other existing players and potential new entrants should be encouraged to offer greater competition to the larger banks. The Task Force therefore proposes that deposit-taking institutions with less than $5 billion in shareholders' equity be allowed to retail insurance through their branches and use their customer information files as soon as appropriate amendments with respect to tied selling and privacy are proclaimed.

Leasing Light Vehicles

DTIs have argued that consumers should have the choice of leasing vehicles from a bank or trust, suggesting that this would lead to lower lease rates. They argue that leasing is a consumer substitute for lending, and therefore leasing of vehicles should be part of their business as it is for banks in the United States and other countries. They do not advance the argument that leasing powers would make them more internationally competitive. The banks, do, however, note that the restrictions prohibit them from competing in Canada with foreign-controlled finance companies such as Ford Credit, which face bank competition in retail leasing in their home jurisdictions.

Auto dealers and manufacturers are united in their opposition to expanded leasing powers for DTIs. A central element of their position is that allowing banks into leasing will reduce the profitability of auto dealers, resulting in job losses in many communities across Canada. It has also been argued that consumers will not benefit from bank entry because there will be a long-term reduction in competition, and that increased business powers will enable the large DTIs to coerce consumers and dealers. Concern over privacy of information has also been expressed.

Consumer groups have generally not joined the debate over the light vehicle leasing issue. The Consumers' Association of Canada has not raised this issue with the Task Force. However, in earlier discussions of light vehicle leasing, the Association has favoured bank entry into leasing, provided the entry is through start-ups rather than by acquisition of existing lessors.[89] A survey of Canadian Federation of Independent Business (CFIB) members indicates that a large majority opposes the granting of additional business powers to banks. Aside from a general concern that banks are already too large, CFIB members are concerned about employment loss in local communities. In the survey, insurance and leasing powers were covered in the same question, so it is not possible to determine whether there were different opinions on the two issues.[90]

Current Regime

Federally incorporated financial institutions (banks, trusts and insurance companies) may not lease light vehicles, either directly or through subsidiaries. Credit unions and caisses populaires, which are governed by provincial legislation, are able to lease vehicles in all provinces except Newfoundland and New Brunswick. Provincial trust companies also have leasing powers in most provinces.[91]

The light vehicle leasing market in Canada is dominated by the financing arms of the auto manufacturers (see Exhibit 4.14). The majority of the credit union and caisse populaire share of the leasing market is based in Quebec, with Location Desjardins Inc. leasing nearly 6,900 retail light vehicles in 1997. This places Desjardins among the 10 largest retail vehicle lessors in Canada, with about 1.4 percent of the total market,[92] or approximately 7 percent of the Quebec leasing market. Some credit unions in other provinces also have successful leasing businesses.

[89] Consumers' Association of Canada, "The Reform of Financial Services Regulation in Canada: The Consumers' Perspective," April 1990.

[90] Canadian Federation of Independent Business, Submission to the Task Force, Oct. 31, 1997.

[91] National Trust offered light vehicle leases as permitted for an Ontario incorporated trust company. Following the purchase by Scotiabank, National Trust was obliged to cease light vehicle leasing.

[92] Vertex Consultants Inc., *Canadian New Vehicle Leasing Data*, April 1998.

Exhibit 4.14
Estimated Leasing Market Shares, 1997

Manufacturers' finance companies	70-80%
Top 20 commercial lease companies	10-12%
All other commercial lease companies	3-5%
Top 45 dealer lease companies	4-6%
All other dealer lease companies	6-9%
Credit union / caisse populaire	2-3%
Total market	$31 billion

Source: DesRosiers Automotive Consultants.

About one third of all dealers own a lease portfolio,[93] and only about 40 dealers (less than 1 percent of the dealers in Canada) lease as many as 200 units per year for their own portfolio.[94] Aside from the approximately 45 dealers leasing 200 or more units per year, the average dealer-owned leasing operation does an annual volume of about 25 vehicles.[95] All dealers combined account for an estimated 10 to 15 percent of the light vehicle leasing market.

Historical Development

Prior to the 1980 Bank Act, permissible business powers for banks did not include leasing. One of the proposals of the August 1976 White Paper on banking was to extend the powers of banks to include leasing. As a result of concerns raised by auto dealers, the 1980 Bank Act revision required that leasing be undertaken in a subsidiary, and it prohibited banks from leasing vehicles weighing less than 21 tonnes. The 1992 legislation explicitly extended this prohibition to federal trust companies and life insurance companies.[96] The question of eliminating

[93] DesRosiers Automotive Consultants estimates that between 35 and 45 percent of Canadian auto dealers have a lease portfolio. The Canadian Automobile Dealers Association (CADA) estimates that 37 percent of its members have a lease portfolio (CADA submission, October 1997, p. 17).

[94] Vertex Consultants using R.L. Polk Canada registration data for 1996 and 1997.

[95] Number of leases calculated by Vertex Consultants using R.L. Polk Canada registration data. Total dealer leasing in 1996 was 57,116 units. Of these, 21,000 are attributable to approximately 45 dealers leasing 200 or more units per year. DesRosiers Automotive Consultants estimates there were 3,714 auto dealers in Canada in 1996, with 35 to 45 percent of dealers doing in-house leasing. This gives a range of 1,300 to 1,670 dealer lease operations. If we deduct the approximately 45 dealers leasing more than 200 units per year, we find that the average dealer leases about 20 to 30 vehicles per year.

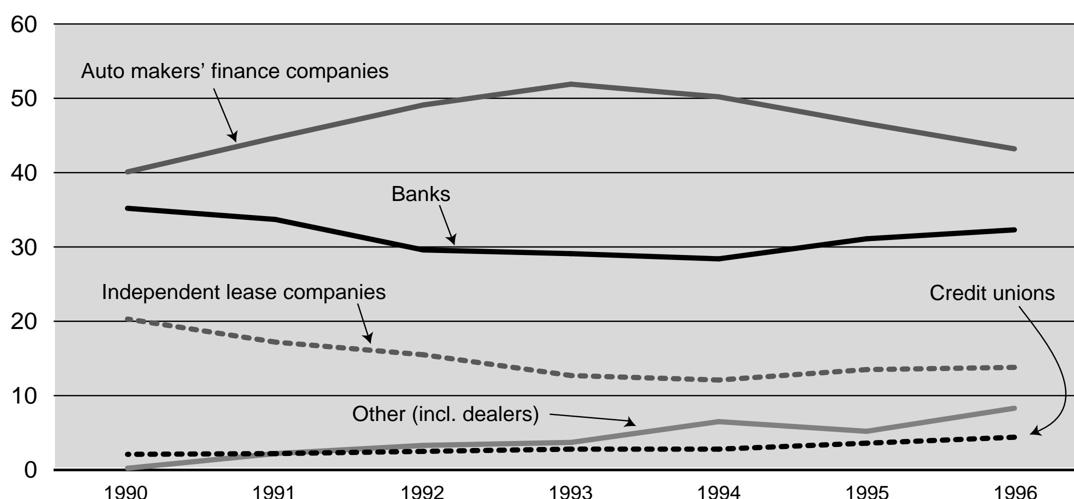
[96] Section 417 of the Bank Act prohibits a bank from any personal property leasing in which a financial leasing company is not permitted to engage. Paragraph (b) of the definition of a financial leasing corporation in sector 464 (1) provides that a financial leasing corporation may not:
i. Direct its customers or potential customers to particular dealers in the leased property or the property to be leased,
ii. Enter into lease agreements with persons in respect of any motor vehicle having a gross vehicle weight, as that expression is defined by the regulations, of less than twenty-one tonnes, or

the restriction was widely debated prior to 1992, and has taken on a greater significance as the percentage of leased light vehicles has increased.

International Experience

Banks in most developed countries are not restricted from light vehicle leasing,[97] and the largest players in auto leasing, the financing arms of the large auto makers, are active internationally. Canada appears to be the only developed country where bank leasing powers have been a major policy issue.

Exhibit 4.15
U.S. Automobile Leasing Market Share



Sources: CNW Marketing, DesRosiers Automotive Consultants.

The U.S. leasing market is significantly different from that in Canada. U.S. banks play a major role but the financing arms of the auto manufacturers are still dominant. Exhibit 4.15 shows that despite some fluctuation, U.S. banks have held about a one-third share of the market since 1990. The combined share of the auto manufacturers' finance companies and the banks in the United States is about 80 percent, which is approximately the same as the share of the auto manufacturers' finance companies alone in Canada. In its annual

iii. Enter into lease agreements with natural persons in respect of personal household property, as that expression is defined by the regulations.

The key provisions of the Financial Leasing Corporation Regulations are:

9. No financial leasing corporation shall enter into, or accept assignment of, a financial lease agreement or conditional sales agreement other than … [one] the primary purpose of which is the extending of credit to a lessee or purchaser.
14. The aggregate of the estimated residual value of all leased properties held by a financial leasing corporation … shall not at any time exceed ten percent of the aggregate of the cost of acquisition of those leased properties by the financial leasing corporation.

[97] Leasing is one of the banking activities subject to mutual recognition in the European Union. This means a bank may lease anywhere in the EU so long as it is permitted to do so in its home country. See the EU Second Banking Directive.

report, General Motors notes that the major competitors of General Motors Acceptance Corporation (GMAC) are "banks and credit unions and other financial services companies."[98]

As in Canada, a similar shift toward leasing as the preferred consumer option for financing vehicles is in evidence in the United States. While leasing has not reached the same heights of popularity in the United States, it has dramatically changed the auto finance landscape. Between the late 1950s and 1990, commercial banks had been the largest suppliers of motor vehicle financing to consumers. The growth in the popularity of leasing and the finance companies' larger share of leasing meant that by 1996 finance companies' consumer automotive receivables were more than a third again as large as the U.S. banks' total of $160 billion (see Exhibit 4.16).

Exhibit 4.16
U.S. Finance Company Automotive Receivables
($ billions)

		1990	1996
Loans		**96.1**	**123.0**
	Owned	79.8	86.3
	Securitized	16.2	36.7
Leases		**22.2**	**94.3**
	Owned	22.2	86.7
	Securitized	N/A	7.6
Total		**118.2**	**217.3**

Source: "Survey of Finance Companies, 1996," *Federal Reserve Bulletin*, July 1997.

Reconsidering Current Policy

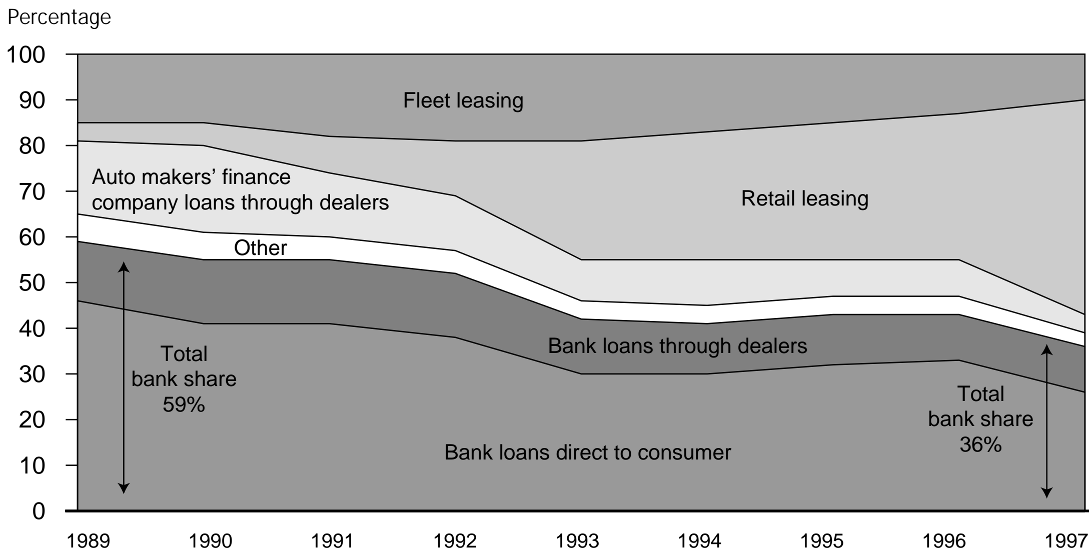
Consumers in Canada have turned increasingly to leasing as an alternative to vehicle ownership, with about 47 percent of new retail vehicle deliveries being leased in 1997, up from 4 percent in 1989. The auto manufacturers' finance companies have seen their market share of total vehicle financing increase as a result of their domination of leasing, which has been the growth segment of vehicle financing (see Exhibit 4.17).

Exhibit 4.18 illustrates that new vehicle financing accounts for approximately 40 percent of total consumer credit. Banks remain significant players in auto loans but, since they are excluded from the leasing market, their share of the new vehicle financing market declined to 36 percent in 1997 from 59 percent in 1989 (see Exhibit 4.17).

[98] General Motors Annual Report, 1997, p. 44.

Exhibit 4.17
New Light Vehicle Financing

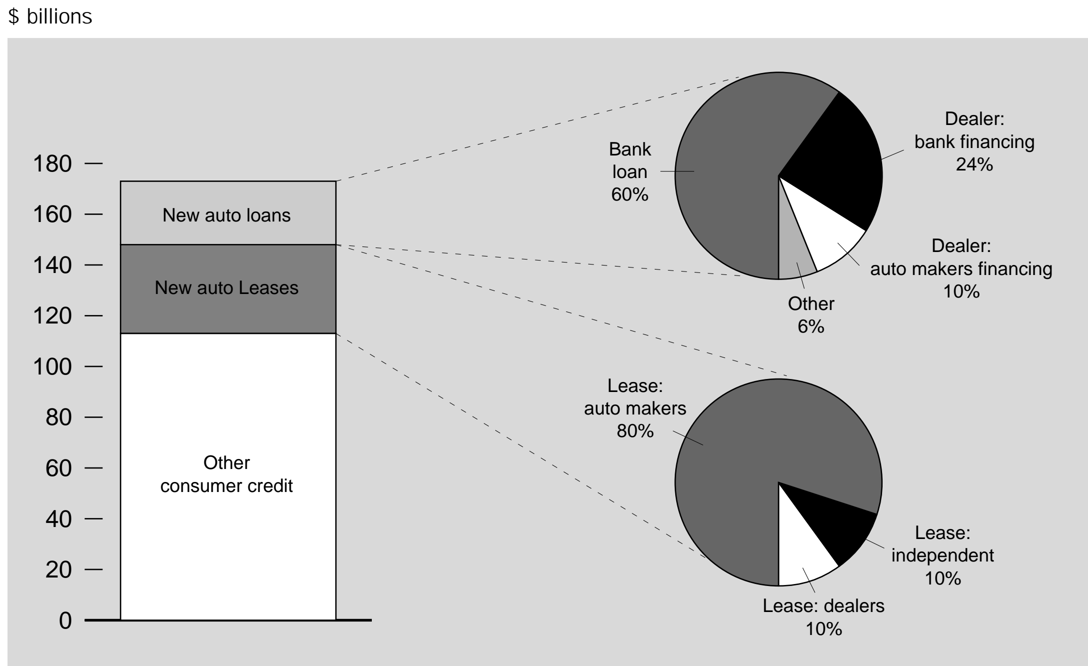
Percentage



Sources: DesRosiers Automotive Consultants.

Exhibit 4.18
Consumer Credit 1997

$ billions



Note: Consumer credit total equals Bank of Canada consumer credit plus estimated new vehicle leases outstanding of $35 billion.

Sources: Bank of Canada, Total Auto Loans and Leases, Auto Loan Market Share, DesRosiers Automotive Consultants; Lease Market Share, Vertex Consultants Inc.

It has been suggested that one of the reasons why banks have been excluded from light vehicle leasing is that leasing is a commercial rather than a financial business.[99] This view is not consistent with the view of regulators and major industry participants. The current federal Financial Leasing Corporation Regulations distinguish between a business that is primarily providing financial leases, which are deemed to be instruments to provide credit and thus part of the business of banking, and operating leasing, which is not a permitted activity. Both the Federal Reserve and the Office of the Comptroller of the Currency list leasing as a permitted banking activity in the United States. General Motors Acceptance Corporation views itself as providing "a broad range of financial services including consumer vehicle financing, vehicle extended service contracts, full service leasing and fleet leasing."[100]

Two snapshot studies of U.S. and Canadian lease and loan rates were provided to the Task Force by the Canadian Bankers Association (CBA).[101] The Canadian Vehicle Manufacturers' Association challenged the methodology and conclusions of these studies.[102] The Task Force recognizes that there may be significant differences in the leasing markets in Canada and the United States which make the data not directly comparable, and is aware of the methodological difficulties in undertaking meaningful comparisons. The Task Force has not drawn definitive conclusions from these studies. However, the Task Force has noted GMAC's report that its Canadian lease volumes increased by 46 percent in 1997, while "the decline in U.S. and international retail and lease financing revenues from 1996 to 1997 was attributable to continued competitive pressure in these markets."[103] The Task Force believes that Canadian consumers should have the benefit of similar competitive pressures.

As with the distribution of insurance, much of the argument focusses on the impact of new competitors on the existing players rather than on the ultimate impact on consumers. The only way in which consumers would not benefit from the entry of new competitors is if the new entrants were able to dominate the market and then engage in anti-competitive pricing, or if the new entrants were to engage in coercive tied selling or abuse of personal information, so that these negatives outweighed the positive aspects of greater choice and price competition.

[99] See the Submission of the Canadian Finance and Leasing Association, October 31, 1997, p. 5, and Canadian Auto Dealers Association, *The Vehicle Leasing Business: Protecting the Consumer and Small Business*, Submission to the Task Force on the Future of the Canadian Financial Services Sector, October 1997, p. 59.

[100] General Motors Annual Report, 1997, p. 44.

[101] Vertex Consultants Inc., *Canadian New Vehicle Leasing Data*, October 1997 and April 1998.

[102] See *Relative Competitiveness of Vehicle Loans and Leases in the U.S. and Canada*, prepared for the Canadian Vehicle Manufacturers Association and the Association of International Automobile Manufacturers of Canada by Bank Lease Consultants Inc., May 1998.

[103] General Motors Annual Report, 1997, p. 46.

The Task Force has considered these arguments, and on balance it believes that the benefits of greater consumer choice in auto leasing substantially outweigh the disruption that may take place in the dealer marketplace. Accordingly, the Task Force proposes that sections 417 and 464 of the Bank Act and the parallel sections of the Trust and Loan Companies Act and Insurance Companies Acts should be amended to remove the current prohibition on the leasing of vehicles of less than 21 tonnes.[104]

Protecting Consumers

Dealers and manufacturers have argued that bank entry will not benefit the consumer because of a long-term lessening of competition, because of the ability of banks to coerce both individual customers and dealers, and because of the potential for misuse of information. As noted in the discussion of insurance, the Task Force is very concerned about the possible coercion of customers and abuse of personal information. However, the Task Force believes that consumers are best served by disclosure, conduct and consent standards of the type it has proposed rather than an outright prohibition on the offering of more than one product by a single institution.

Dealers have expressed concern that DTIs might be able to favour one dealer over another by directing customers to specific vendors, or bypassing the dealer directly to acquire cars from the wholesaler. This is an issue in connection with the commercial leasing that banks are currently permitted to undertake. It has been addressed in the Bank Act, which prohibits a bank from directing "its customers or potential customers to particular dealers in the leased property or the property to be leased" for the leasing currently permitted. This provision would also apply to auto leasing.

Another concern is that banks might use the terms and conditions attached to credit supplied to the dealers to make dealer financing less viable. This is a concern that has long existed in connection with loan financing, and is best addressed through competition in the market. In addition to the current sources available to dealers, which include the captive finance arms of the manufacturers, the Task Force has elsewhere made recommendations which it expects will lead to the development of vibrant competitors.

Another concern is that, despite the short-term increase in competition, bank entry might reduce competition in the long run. While it has been strenuously argued that DTIs would cross-subsidize their lease products until they gained dominant positions and then would exercise market power to increase prices, there are two factors that make this unlikely. First, the financing affiliates of the

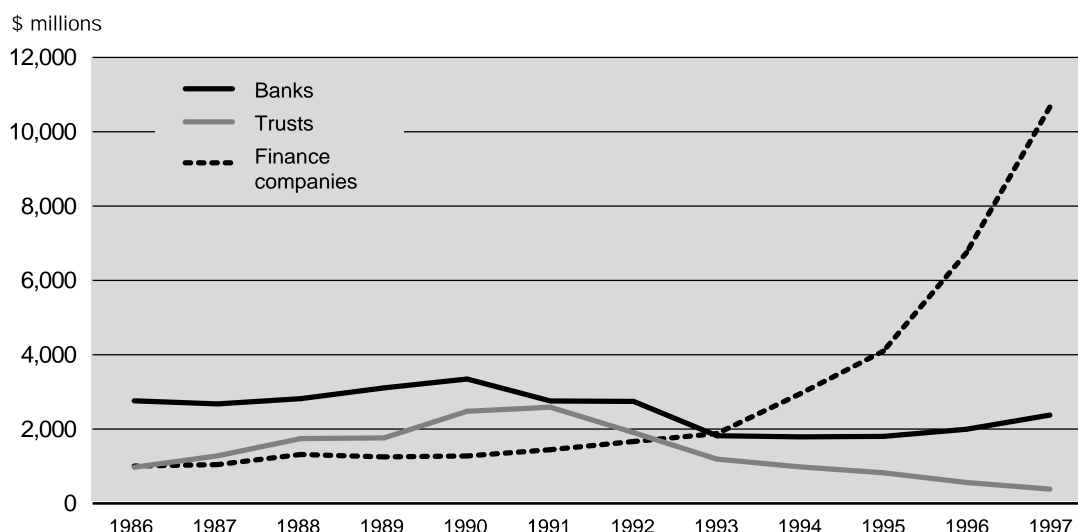
[104] The residual value provisions of the Financial Leasing Corporation Regulations would have to be amended to accommodate light vehicle leasing.

vehicle manufacturers have deep pockets that would allow them to wait out attempts at predatory pricing. Second, unlike some other financial services markets, the Consumers' Association of Canada notes, "The auto leasing industry is a competitive market that is quite easy to enter and exit."[105] It is therefore unlikely that market power could be exercised, as new entrants would be attracted if the existing players were earning excessive profits.

Impact on Existing Players

Existing players are understandably concerned about the impact of new competitors on their profitability and employment levels. The extent to which new entrants would affect the incumbents depends on the existing level of competition in the sector. In the first instance, it is not at all clear that new entrants will be successful in gaining significant market share. If the current market is as competitive as the auto dealers, lessors and vehicle manufacturers have maintained in their submissions, new entrants will have difficulty in making inroads. The Task Force is of the view that consumers, not regulators, should choose where they lease vehicles, and it is by no means certain that they will choose banks. If, as has been argued by the auto industry, consumers already have the best leasing options available, then new entrants will not be able to become dominant players. This has certainly been the case in other types of leasing, where, as illustrated in Exhibit 4.19, banks are small players with a declining market share.

Exhibit 4.19
Business Leasing Receivables



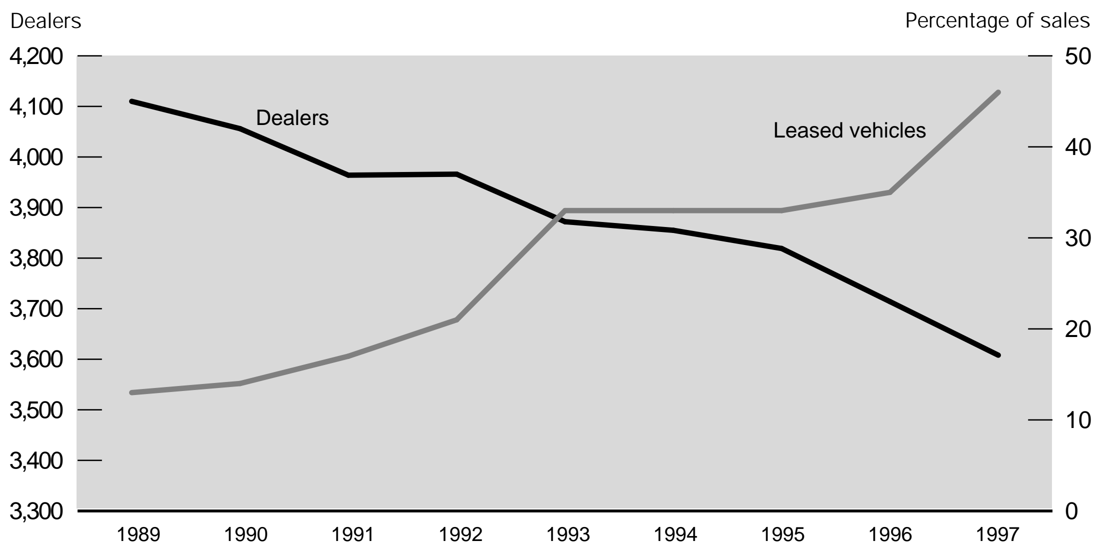
Source: Bank of Canada.

[105] Consumers' Association of Canada, "The Reform of Financial Services Regulation in Canada: The Consumers' Perspective," April 1990 p. 29. This view is substantiated by the proliferation of small leasing companies now active in Canada.

Leasing, as a number of submissions note, does require specialized skills to deal with residual risk and disposal of the assets at the end of the lease. Since 1980, banks have been permitted to lease assets other than light vehicles, and yet, as illustrated by Exhibit 4.19, specialized financing companies dominate the commercial leasing market. Some banks decided that leasing is not an attractive business, and those that have targeted the business have discovered the difficulty in competing with the specialized companies. One of the major advantages that dealers will retain is access to the customer at the point of sale.

Even if the new entrants are highly successful, the bulk of the impact is likely to be felt by the auto manufacturers' finance companies rather than the dealers. A complicating factor in assessing the impact on dealers is the consolidation trend already in evidence. As illustrated by Exhibit 4.20, there has been a 12 percent decline in the number of dealers since 1989, a period in which leasing has increased from 13 to 46 percent of the light vehicle market. Like many other sectors, automobile distribution is changing in response to technology and consumer preferences.

Exhibit 4.20
Number of Dealers and Leasing as a Percentage of Vehicle Sales



Sources: DesRosiers Automotive Consultants.

Although the impact of increased competition as a result of DTI leasing on dealer employment is difficult to assess, the Task Force notes that a very small number of automobile dealers now account for virtually all of the in-house leases. As detailed earlier, only about 45 dealers lease as many as 200 vehicles annually. Only about one third of all dealers have an in-house lease portfolio, with the average dealer leasing about 25 units annually.

However, in order to allow a reasonable transition for dealers who do rely significantly on in-house leasing, the Task Force proposes that deposit-taking institutions not be allowed to lease automobiles to consumers until January 1, 2002, subject to prior adoption of its recommendations on tied selling and privacy.

Encouraging Smaller Competitors

The Task Force is of the view that smaller DTIs and insurance companies offer platforms that might be developed to provide greater competition to the large banks, and that new entrants should be encouraged to compete with the established large players. The Task Force therefore proposes that federally incorporated trust and insurance companies, as well as banks with less than $5 billion, should have a "first mover" advantage. These institutions would be able to lease light vehicles as soon as appropriate amendments are implemented to address the Task Force's concerns in the areas of tied selling and privacy. Banks with more than $5 billion in shareholders' equity would not be able to lease light vehicles until the end of the transition period proposed above, on January 1, 2002.

Summary

The three business power revisions proposed by the Task Force are intended to provide consumers with a wider choice of providers of financial services. Opening the payments system to new competitors, subject to an acceptable prudential framework, will introduce more competition into one of the markets that is at present the most concentrated: the provision of retail transaction accounts. Consumers, not regulators, should choose the providers of auto leasing and insurance. The privacy and tied selling provisions proposed by the Task Force will address important consumer protection issues. While there may be some disruption felt by existing competitors as a result of new entrants, the Task Force is of the view that providing wider choice to consumers and the potential savings from new competition should have a higher policy priority than attempting to preserve the status quo.

Chapter 5

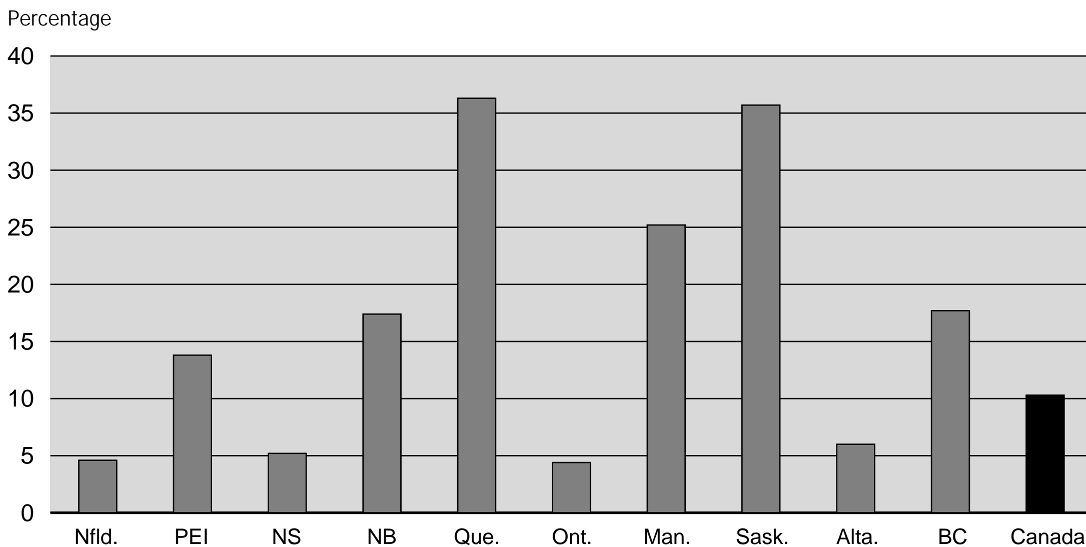
The Cooperative Sector

Cooperative financial institutions play a major role in meeting the needs of Canadians, and this role could gain in importance as the financial sector restructures.

The Mouvement Desjardins has been remarkably successful in Quebec, building a full-service financial conglomerate from a strong base of local caisses. Credit unions have a significant presence in many provinces, but have low penetration in the large Ontario market and a fragmented national structure (see Exhibit 5.1). The Co-operators Group, an insurance company owned by other cooperatives, is the fourth largest general insurance company in Canada (ranked by Direct Premiums Written).

The cooperative sector warrants special attention because there is an opportunity, which in the view of the Task Force must be seized now, for the credit union movement to build a system that is capable of achieving in the rest of

Exhibit 5.1
Credit Union and Caisse Populaire Share of Deposit-Taking Institution Assets, 1997



Note: Provincial bank and trust company assets exclude head office and unallocated assets in Canada, credit union and caisse populaire data excludes centrals and affiliates.

Sources: Bank of Canada, Statistics Canada, Credit Union Central of Canada, Alberta Treasury Branches.

Canada the same level of success achieved by the Mouvement Desjardins in Quebec. Credit union leaders and members must meet the challenge, but government can help by providing a legislative framework that enables cooperatively owned institutions to thrive.

This chapter first provides an overview of the credit union and caisse populaire sector, including a brief examination of its strengths and the challenges it faces. It then outlines policy concerns and presents the conclusions and proposals of the Task Force on issues of specific concern to the sector.

Sector Overview

The distinguishing feature of cooperative ownership is that each member has one vote regardless of the number of shares held. Cooperative structures generally embody a "bottom up" decision-making process. Members elect the board of their local credit union or caisse populaire. Credit union representatives in turn elect the boards of provincial centrals (or regional federations in Quebec), which in turn elect the directors of the Confédération des caisses populaires d'économie Desjardins du Québec and Credit Union Central of Canada (CUCC).

The three-tiered structure (locals, provincial centrals or regional federations, the Confédération or Credit Union Central of Canada) imposes costs on the cooperative sector, as each organization has its own directors and administrative functions. There are also benefits, because the structure permits many decisions to be made in local communities or on a provincial basis.

The Confédération, the third tier for the Desjardins caisses, provides a broad range of centralized services for the federations and local caisses. In contrast, Credit Union Central of Canada provides a relatively modest range of services, with provincial centrals more typically being the providers of services to local credit unions. Although there recently has been some consolidation of functions by the provincial centrals (for example, Saskatchewan and Alberta have combined their payments processing), more typically each provincial central provides a range of support services to local credit unions. While the specifics differ by province, services typically include:

- marketing, product development and public relations;
- research;
- member education and professional development programs;
- electronic data processing;
- systems and manuals to facilitate day-to-day operations;
- management counselling;
- legal and taxation services;

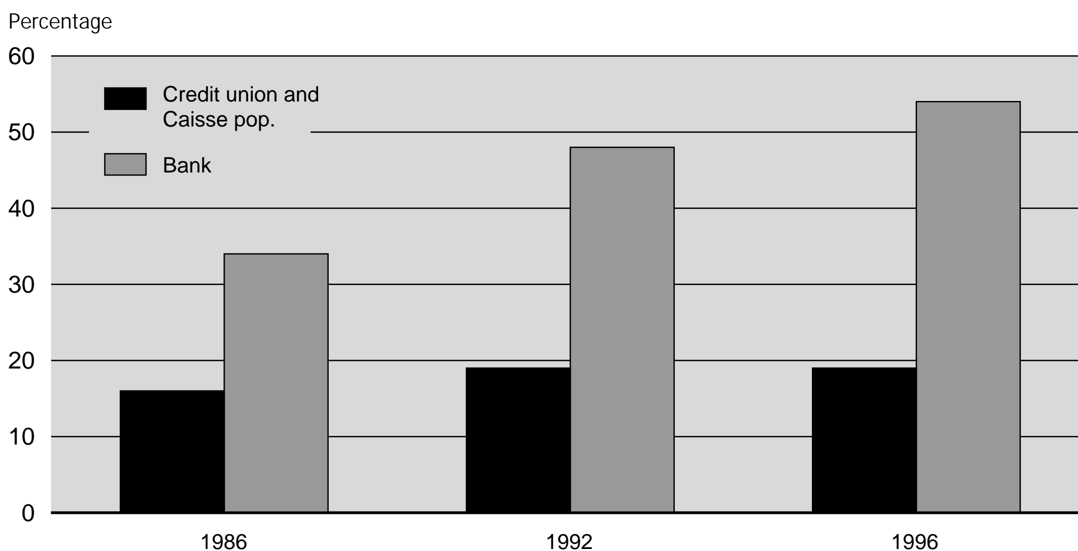
- treasury functions; and
- government relations.

As a result, there are nine provincial infrastructures in the credit union system to serve somewhat fewer members and total assets than Desjardins serves with its single, more centralized infrastructure.

The provincial centrals and Credit Union Central of Canada play another important role in addition to this "service bureau" function. Credit Union Central of Canada oversees the national liquidity pool for the Canadian credit union system. Local credit unions are typically required by their provincial legislation to maintain liquidity deposits with their provincial central, which in turn participates in the national liquidity pool. This meets an important prudential requirement by providing a liquidity reserve to satisfy unexpected demand for withdrawal. The liquidity pool is an essential part of the regulatory regime that permits centrals to provide local credit unions with access to the Canadian payments system. In Quebec, Desjardins provides liquidity support for local caisses through the federations and at the provincial level. Desjardins also provides payments system access for the local caisses as one of the group clearers in the Canadian Payments Association.

Caisses populaires and credit unions differ significantly from the banks in the nature of their business. While the banks have earned increasingly larger portions of their income from fee-based businesses such as securities dealing and mutual funds, cooperatives have remained much more focussed on traditional

Exhibit 5.2
Other Income as a Percentage of Net Interest Income



Source: The Conference Board of Canada.

intermediation businesses (see Exhibit 5.2). Credit unions and caisses typically earn higher net interest margins than the banks, but this advantage is offset by higher operating costs (see Exhibit 5.3).

Exhibit 5.3
Net Interest Margin and Operating Expenses (percentage of total assets, 1996)

	Net interest margin	Operating expenses
Banks	2.2	2.2
Credit unions / caisses populaires	3.5	3.4

Source: The Conference Board of Canada, OSFI.

Mouvement Desjardins

Since its founding in Lévis, Quebec, in 1900, the Mouvement Desjardins has grown to be the largest financial institution in the province. It has over 5 million members of 1,275 local caisses. The caisses have historically had strong ties to local parishes. Desjardins also has about 360,000 affiliated members through 141 caisses and three federations located in New Brunswick, Ontario and Manitoba. Desjardins is governed by provincial legislation.

The Confédération des caisses populaires d'économie Desjardins du Québec can be viewed as a holding company controlled by the regional federations, which are in turn controlled by the local caisses. The Confédération holds the Desjardins investment in a range of financial affiliates, including major life and general insurance companies, brokerage, trust and mutual funds, and a Florida savings bank. A number of the major affiliates have outside shareholders, a situation that facilitates the raising of capital and creation of strategic alliances while the Mouvement Desjardins retains control. The Desjardins structure illustrates the practical application of the holding company flexibility proposed by the Task Force in Chapter 3 of this paper.

The Mouvement Desjardins is a major competitor in all financial services markets in Quebec, with particular strength in retail products (see Exhibit 5.4). As outlined in more detail in ***Competition, Competitiveness and the Public Interest*** (Task Force Background Paper #1), the strength of Desjardins in Quebec, coupled with the significant share of the National Bank, makes the Quebec market quite different from the rest of Canada. The large banks are much less important providers of products and services, particularly in the retail market, than they are elsewhere in Canada.

At the end of 1997, the Mouvement Desjardins had about $55 billion in assets held by the local caisses, with a further $13 billion in assets of the Confédération and affiliated companies.

Exhibit 5.4
Desjardins Share of Quebec Market, 1997

	Percent
Deposits	44.0
Mutual funds	5.7
RRSPs	24.7
Consumer credit	32.3
Residential mortgages	39.2
Commercial credit	22.9
Agricultural credit	44.5
Life Insurance[1]	18.7
General insurance[1]	9.9

[1] 1996 data
Source: *En perspective*, Desjardins Études économiques, March 1998.

Credit Unions

There are about 4.5 million credit union members outside Quebec, served by about 870 credit unions.[106] While it is common to speak of the credit union system, this is a misnomer because it implies a degree of centralization and standardization that generally does not exist.

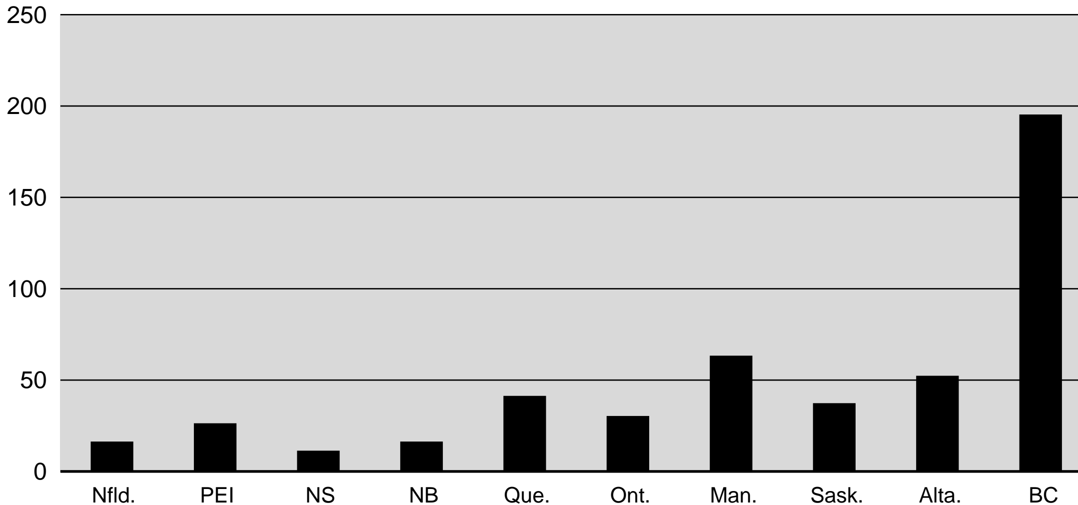
As shown earlier in Exhibit 5.1, the assets of credit unions and caisses populaires (excluding assets of centrals and affiliates) amount to approximately 10 percent of deposit-taking institution assets in Canada. However, the cooperative sector is far more important in Saskatchewan, with about 35 percent of DTI assets in the province. Manitoba, British Columbia and New Brunswick also have cooperative sectors that are much better developed than the national numbers would suggest, while credit unions have a much lower penetration in Ontario and in Atlantic Canada outside New Brunswick.

Exhibit 5.5 gives a further indication of the significant differences in the credit union movement in each province. British Columbia is home to 6 of the 10 largest credit unions in Canada (see Exhibit 5.6). The relatively large average size of BC credit unions is reflective of their very strong positioning in the urban areas of the lower mainland and around Victoria.

[106] There are 141 caisses populaires in New Brunswick, Ontario and Manitoba that are affiliated with the Mouvement Desjardins. There are also about 15 caisses populaires in Ontario affiliated with Credit Union Central of Canada.

Exhibit 5.5
Average Size of Credit Union / Caisse Populaire by Province, 1996

$ millions, total assets



Source: Credit Union Central of Canada.

Saskatchewan, despite a 25 percent reduction since 1990, still has more than 150 credit unions. While the number of credit unions in that province has declined, the number of service outlets has remained constant, reflecting the growth of multi-branch credit unions. There are a few large urban-based credit unions and a much larger number of smaller rural credit unions. Manitoba and Alberta have also seen significant consolidation and, like Saskatchewan, have a few large urban-based credit unions and more numerous smaller rural ones.

Ontario reflects a heritage of closed-bond credit unions based on a single employer.[107] Despite a 60 percent reduction in the number of credit unions over the last 10 years, Ontario is still populated by a large number of small credit unions and caisses populaires, many with a closed-bond history, and a smaller number of growing community-based credit unions.

Despite their small average size, credit unions and caisses populaires in New Brunswick are significant players in retail financial services in the province. The caisses, which are affiliated with Desjardins, have generally been more successful. In addition to strong leadership within the province, the Acadian caisses have benefited from the ability to purchase centralized services from Desjardins at a much lower cost than would be borne by a single caisse or even all the New Brunswick caisses collectively.

[107] Membership in a closed-bond credit union is limited to people sharing a common bond of association, such as the same employer, union or parish. Membership in an open-bond or community-bond credit union is available to anyone living in the community.

Credit unions in Nova Scotia, Prince Edward Island and Newfoundland tend to be small units that have had difficulty gaining major market share. Even more so than for credit unions in other provinces, the major challenge is to cost-effectively deliver a range of services through a network of small autonomous local institutions.

Exhibit 5.6
Ten Largest Credit Unions

Credit Union	Province	Total assets ($ millions)
1) Vancouver City Savings	British Columbia	4,836
2) Surrey Metro Savings	British Columbia	1,934
3) Richmond Savings	British Columbia	1,734
4) Pacific Coast Savings	British Columbia	1,260
5) Westminster Savings	British Columbia	900
6) Capital City	Alberta	896
7) Civil Service Co-op	Ontario	855
8) Niagara Credit Union	Ontario	847
9) First Heritage Savings	British Columbia	838
10) Hepcoe Credit Union	Ontario	793

Source: CUCC Payments and Research Analysis Department.

Local credit unions are governed by the legislation of their incorporating province. Provincial centrals are incorporated pursuant to provincial legislation, with six of the centrals having opted to also be regulated federally under the Cooperative Credit Associations Act.[108] Credit Union Central of Canada is regulated pursuant to a federal Act.

Opportunities and Challenges

The cooperative system has many inherent strengths, which have contributed to its success to date and position it well for the future. The Mouvement Desjardins is already extremely well positioned, with a dominant market share in Quebec. Credit unions in the rest of Canada have to overcome more challenges in order to take advantage of the opportunities that will arise as the financial sector restructures. Many of the challenges noted below apply only to the credit union system or apply with greater urgency for credit unions than the Desjardins caisses.

[108] British Columbia, Alberta, Saskatchewan, Manitoba, Ontario and Nova Scotia have opted into the federal regime primarily to meet one of the requirements for participating in the clearing system.

The fundamental strength of credit unions and caisses populaires lies in their solid roots in their local communities. They are owned and controlled by local residents. There is more likely to be continuity in the staffing of their branches, thereby avoiding the "churning" often criticized as giving rise to poor relationships in other deposit-taking institutions, particularly the banks.

Credit unions and caisses populaires have been innovative in meeting their customers' needs in terms of lending policies, mortgage options, line of credit options and the introduction of new accounts such as daily interest savings. Consumers in a number of surveys have indicated higher satisfaction levels with credit unions than with other deposit-taking institutions. Credit unions are tax-advantaged relative to their larger competitors because credit union profits are generally taxed at small business rates. There are also certain exemptions available to credit unions on capital taxes.

A particular strength of credit unions in Western Canada (and also of caisses populaires in Quebec) has been providing financing to small commercial and agricultural enterprises. While the total of credit union commercial loans is dwarfed by the volume of business loans provided by the banks, virtually all credit union commercial lending is in authorizations under $1 million, with the average loan outstanding being much smaller. As a result, credit unions are the leading providers of SME credit in British Columbia, Manitoba and Saskatchewan.[109] Credit unions in parts of Alberta, Ontario and Atlantic Canada have in the past experienced unfortunate levels of losses in commercial lending, which have in some cases led to more stringent regulatory constraints. The Task Force is of the view that the ability to forge strong local relationships positions credit unions ideally to serve small commercial and agricultural enterprises. Accordingly, it encourages provincial authorities to ensure that restrictions on credit union commercial lending are no more than those required for prudential purposes.

Local relationships and community responsiveness position credit unions and caisses populaires to grow and prosper as other financial institutions consolidate or change their business focus. In the future, branches will be used less for traditional transaction functions, such as deposits and withdrawals, and more for relationship-based functions such as small business lending and wealth management. The credit union philosophy, business orientation and practice, founded as they are in strong customer relationships, should adapt well to this environment.

However, the credit union system clearly faces challenges. There is a serious structural problem in coordinating the use of the system's capital because of its fragmentation. Some credit unions have surplus deposits, while others have to

[109] More detail on the SME lending market is provided in *Competition, Competitiveness and the Public Interest*, Background Paper #1, Ch. 3.

curtail lending activity because of a lack of funding. Many credit unions have capital well in excess of regulatory requirements because they lack good lending opportunities in their local areas, while fast-growing credit unions have difficulty building their retained earnings quickly enough to support their growth.

Raising capital to support growth is a challenge for many credit unions. Since shares are generally redeemable when a member closes an account, credit union shares are more akin to deposits and most provincial regulators treat them as such. Retained earnings are the only real capital for most credit unions, so in a period of rapid growth it can be difficult to build equity quickly enough to meet regulatory requirements. Some credit unions and caisses have used various forms of preference shares, debentures and non-voting common shares as means of raising additional capital. These innovations have received a mixed reception in the credit union system. The notion of raising capital outside the membership is seen by some as contrary to the cooperative ownership model.

System-wide decision making is difficult and slow given the system's democratic structure. Strategic decisions often involve conflicts between credit unions that are big and small, urban and rural, aggressive and complacent, profitable and poor, realistic and idealistic. There is always a high potential for lack of concerted action because of disagreements within the system over fundamental issues.

There is evidence of declining participation by members in managing the credit union. Annual meetings rarely attract more than 5 to 10 percent of the membership. The credit union movement in many areas has had difficulty in attracting younger members.

There is a tremendous amount of duplication of effort, administration, human resources and backroom activities as each credit union is an entity on its own. The same issue of duplication is true for the various centrals. For example, each central has a treasury function looking after the investment of reserve funds. Such a function is expensive to operate and requires expertise and skill to manage. Merging such a core function is possible but would cause jurisdictional debate. The system is limited by provincial boundaries and regulations.

Many credit unions have not been able to meet the growing needs of the more sophisticated consumer. The consumer is demanding more than just the basic savings and loan services. The rather large number of small credit unions makes it difficult to develop new products and technology given the lack of resources and economies of scale.

The credit union system will need a renewed vision in order to meet these challenges. Neither the Task Force nor government can provide this vision, but the regulatory framework can better support the decisions that are made by the system.

Regulatory Issues

The Task Force proposes that a cooperative bank option be made available as a means of enhancing the ability of the sector to compete. A federal bank charter might be used by the existing players in the cooperative sector in two ways. In one model, a cooperatively owned bank might make an effective vehicle to provide strong central services to local credit unions and caisses. There are "bankers' banks" in the United States whose only business is providing services to community banks which otherwise might not be able to afford the necessary investment in systems (more detail is provided in Chapter 2 of this paper; see Exhibit 2.7). There are also international models such as the Rabobank in the Netherlands (see Exhibit 5.7).

A second way in which a federal cooperative bank charter might be useful is by providing a convenient vehicle for credit unions to operate outside their province. Van City, the largest credit union in the country, incorporated a Schedule II bank subsidiary in order to offer services outside British Columbia. The cooperative bank option presents a simpler structure since, with the permission of its provincial jurisdiction, a credit union could apply for continuance as a federally chartered cooperative bank.

The credit union system has struggled to provide the increasingly broad range of services demanded by its members. The restrictions of the current ownership structure can be an impediment, as provincial legislation is not always conducive to operating across the country, and the federal cooperative legislation has significant business power limitations. The cooperative bank option would be a vehicle to deal with these issues, and is consistent with the suggestions made to the Task Force by Credit Union Central of Canada and the Mouvement Desjardins.

While the cooperative bank option opens up new avenues for the cooperative sector, the Task Force also believes that greater flexibility can be provided within the existing Cooperative Credit Associations Act. A number of areas of concern have been identified by the sector.

Cooperative credit associations are distinguished from other federally incorporated financial institutions by the fact that they exist primarily to serve their member institutions. This has resulted in business power restrictions that limit the way in which members of credit unions can be served directly by the centrals. Cooperative credit associations have different capital structures from banks or insurance companies, which means that there may be prudential issues to be addressed if they are provided with expanded business powers.

Exhibit 5.7
Rabobank Nederland

The Rabobank Nederland ("Rabobank") is a cooperative banking group based in the Netherlands. It is also one of the largest financial institutions in the world. As such, it provides an interesting example of what the potential is for the cooperative movement.

The rabobanks, formerly known as agricultural credit banks, were founded around 1900 as cooperative societies modelled on the German Raiffeisen banks, in order to serve as savings banks and credit institutions for the local agricultural communities. Independently operating within their own region, they are associated with the Cooperatieve Centrale Raiffeisen-Boerenleenbank, know as Rabobank Nederland for short. The Rabobank group provides services to almost 500 autonomous local banks that make up the Rabobank cooperative. This institution acts, among other things, as treasurer for the local banks. The Dutch National Bank (Nederlandsche Bank) has delegated to it the supervision of the liquidity and solvency positions of its members.

While activities of the rabobanks overlap with those of the universal banks, there remain differences in emphasis. Traditionally, the customers of the rabobanks were private individuals and small enterprises outside the towns. These still make up a sizable portion of the rabobanks' business, and the expertise they developed in these regions has allowed the Rabobank to become a world leader in agricultural finance. At present, the rabobanks are strong competitors of the universal banks as suppliers of all kinds of financial services to the whole of Dutch trade and industry. This is illustrated by the fact that Rabobank is one of the few financial institutions in the world to have a Triple-A credit rating.

Today, the Rabobank is an independent banking cooperative that looks very much like a typical European universal banking group. Rabobank Group includes a cluster of subsidiary companies dedicated to specialized activities. These include De Lage Landen (leasing and trade finance), Interpolis (insurance), Robeco (asset management, 50 percent Rabobank owned), Gilde Investment Management (venture capital), Schretlen & Co. (private banking), Nedship Bank (ship financing), and Rabobank International, which itself has two subsidiaries, Rabo Securities and Rabo vastgoed (domestic real estate projects). On July 13, 1998, Rabobank NV announced its intention to merge with Achmean Holding NV, a large cooperative insurance company. If completed, this transaction would create the largest financial services group in the Netherlands.

The Rabobank has targeted certain international niche markets for expansion. Building on its expertise in this area, the Rabobank has decided to concentrate its efforts on international agribusiness, a sector worth US$5 trillion a year. To this end, it has created a specialized department – the agri-project finance team – purely to source and structure agribusiness financings. Rabobank is also heavily involved in the financing of hospitals and other aspects of the health care industry. It is already active in these niches in the Netherlands as well as in the United States and Canada. In 1997, Rabobank upgraded its presence in Canada from a representative office to a Schedule II bank.

Rabobank has a 90 percent market share of all bank credit granted to the agricultural sector in the Netherlands. Some 40 percent of small and medium-sized companies bank with Rabobank, as do approximately 15 percent of the larger companies. Rabobank handles 35 percent of the private savings market, 25 percent of the residential mortgage market and about a third of all payment transactions in the Netherlands.

The cooperative ownership structure may mean that the same minority investment regulations that apply to other financial institutions are more constraining for credit union centrals. Each of these issues is addressed below.

The business power restrictions in the Cooperative Credit Associations Act prohibit delivery of products and services to non-members. If a provincial central or the Canadian Central wishes to provide services to a third-party financial institution, that institution must first have a substantial investment (10 percent) in the central's subsidiary service corporation. Only with that investment in place is the service corporation able to provide full services to the financial institution. In contrast, Canadian banks can provide the same services directly to third-party financial institutions, without the intervening cost of a service corporation and the need for cross-relationships. Centrals would like the ability to provide wholesale services to other institutions directly. Possible ways of using this expanded business power are:

- providing payment system services to existing smaller deposit-taking institutions or new entrants like mutual fund companies and insurance companies;
- selling access to the Interac Automated Teller Machine networks or the future Mondex system; and
- providing wholesale financial services, such as treasury and foreign exchange, to commercial businesses.

This expanded business power would potentially allow the credit union system to recoup its investments in systems and technology over a larger base of customers. It could thus turn the treasury functions it requires to manage its own liquidity into a profit centre.

A related issue is that the restriction which requires a central to deal only with its members (i.e., the individual credit unions) means that centrals cannot deal directly with the members of local credit unions. There are many small credit unions that are unable to afford the staff or the expertise to support the marketing and sale of various products that financial institutions, including other credit unions, offer across Canada. Centrals would like the ability to deal directly with the membership of the credit unions in order to provide the products that local credit union is unable to support. One way this could work is for the central to provide services through a call centre. Such services could be provided now, but not without the expense of operating through subsidiaries. A subsidiary structure adds substantial cost and complexity to the delivery of products and services to credit union members.

Credit Union Central of Canada is also concerned that the Minority Investment Regulations do not adequately facilitate joint ventures between centrals. The Bill C-82 amendments enacted in 1997 provide some relief, but Credit Union

Central has made two further proposals (see Exhibit 5.8). In each case, the restrictions on centrals parallel the minority investment restrictions on banks, trusts and insurance companies. Credit Union Central of Canada makes the point that the cooperative ownership structure requires greater flexibility in order to allow effective competition with other institutions.

Exhibit 5.8
Credit Union Central of Canada Proposals for Investments in Subsidiaries

CUCC's first proposal concerns situations where the aggregation of the substantial investments by centrals does not provide a level of joint/aggregate control. An example would be a situation in which four credit union centrals each have a 12 percent minority holding in an investment, with the remaining 52 percent owned by a private entity. In aggregate the centrals have 48 percent ownership and clearly do not have majority control. Minority investments are covered under section 390(3)(a)(ii) of the Cooperative Credit Association Act, which then subjects such minority investments to the Minority Investment Regulations.

The Minority Investment Regulations limit the total that a credit union central can invest in minority investments (including all shares, loans and guarantees that are provided to the entities by the centrals) to 50 percent of the central's capital. Credit Union Central of Canada has requested that the restrictions be eased by excluding loans from the calculation of the 50 percent capital limitation rule. The prudential rationale underlying the current restriction is that there needs to be a limit on the total exposure of the central in investments that it does not control.

The second proposal is to amend the definition of the word "control" in the Cooperative Credit Associations Act for the purposes of section 390. The intent of the proposed amendment is to avoid the application of the 50-percent-of-capital limit on minority investments in situations where two or more centrals collectively have a controlling interest in an investment. An example would be a situation in which four credit union centrals each have a 20 percent minority holding in an investment with the remaining 20 percent owned by a private entity. If one regards the four centrals as one investor, then they have aggregate control with 80 percent ownership. However, because each central has less than majority control, its investment, including loans, in the entity is included in its minority investments, which are limited to 50 percent of its capital.

Credit Union Central of Canada has recommended that the definition of control be amended to recognize "joint/aggregate" control by two or more centrals. With such a change, each central could then treat its investments in such jointly controlled entities as investments in controlled entities rather than minority investments. This provides greater flexibility for the centrals, as the 50-percent-of-capital restriction on such investments would not apply. The prudential rationale for the current approach relates to the regulator's ability to intervene, if necessary, in the activities of a subsidiary. If the subsidiary is not controlled, the parent may not be able to cause it to take specific actions directed by the regulator. However, this concern might not apply if two or more centrals, regulated by OSFI, jointly had control, as the joint shareholders acting collectively would have a voting majority in the subsidiary.

The Task Force is sympathetic to the requests of the credit union sector, especially given the potential that credit unions offer to be more vigorous competitors to the largest institutions. The proposals set out above would transform the role of centrals in a significant manner. Instead of having a primary role of providing a central coordination of liquidity support to the system, Credit Union Central of Canada is proposing an expanded role that would turn the centrals into "central cooperative banks." Centrals would continue in their role of providing liquidity support, but would also have the ability to provide retail and wholesale services directly to their members and the public at large.

The Task Force endorses the intent and direction of the requests made by the credit union system and proposes that credit unions, the regulator and policy makers work jointly to develop a new regulatory framework for cooperative credit associations. This framework would include expanded business powers and related prudential issues such as:

- capital requirements;
- isolating the liquidity support function from commercial activities;
- governance structures, including the need for independent boards for joint ventures and subsidiaries; and
- board and management capacity to take on additional business risk.

The Task Force believes these concerns can be addressed, with the result that the credit union sector will have the necessary flexibility to transform itself into an even more vigorous competitor. In addition, the Task Force proposals on cooperative bank charters will open new opportunities for participation by credit unions and cooperatives in the financial services sector.

Chapter 6

Conclusion

This background paper has examined the important structural issues of who can own regulated financial institutions, how the institutions can organize themselves and what business powers they are allowed to exercise. While the discussion of many of these issues necessarily has a distinctly institutional focus, in developing its proposals the Task Force has looked to the ultimate impact on Canadian consumers of financial services and products.

The ownership regime proposed by the Task Force is intended to benefit Canada and Canadians by maintaining the essential features of safety and soundness, continuing a core Canadian-controlled presence in the financial system, and encouraging enhanced competition in the marketplace. These goals can be reached by:

- a size-based ownership regime that is consistent for all federally incorporated financial institutions;
- retention of a widely-held requirement for the largest financial institutions, coupled with a more flexible definition of "widely held" that contributes to improved governance and facilitates alliances and acquisitions;
- transition rules for demutualizing insurance companies and smaller banks that provide a conducive environment for them to compete with the largest institutions; and
- new ownership options, including closely held smaller banks and a cooperative bank option, in order to increase the potential for competition from new and existing players.

The Task Force has proposed additional organizational flexibility options that will benefit Canadian consumers by lessening the regulatory burden borne by financial institutions and passed on to their customers. There are many activities undertaken by financial institutions that are not regulated, or less regulated, when carried on by other financial institutions or commercial entities. The ideal of functional regulation is not attainable because institutions, not functions, fail. However, to the extent that the activities which for public policy reasons must be regulated can be isolated within a corporate structure, it will be possible to impose a much less stringent regulatory burden on other related entities.

The scope for such nuanced regulation in the present financial institution parent model is limited by the fact that the parent is itself a regulated financial institution. The Task Force endorses efforts to provide even more flexibility within the current model, and also proposes that a regulated holding company option be made available for all federally incorporated financial institutions.

The business power revisions proposed by the Task Force are intended to broaden the range of potential providers of financial services to Canadian consumers. The Task Force is of the view that benefits to consumers must take precedence over any potential disruption to existing competitors when facing new entrants. Accordingly, the Task Force proposes that insurance companies, money market mutual funds and investment dealers be permitted to directly access the payments system. While conscious of the need to ensure the continued integrity of the payments system, the Task Force believes that systemic risks can be managed in a way that does not create significant barriers to entry by these participants in the payments system. This approach will introduce more competition into one of the markets of most concern to Canadians: the provision of retail transaction accounts.

The Task Force believes that there are no prudential or competition reasons why consumers and not regulators should have the right to choose where they wish to purchase insurance and obtain auto lease financing. There are important consumer protection issues, but these same issues already exist within the range of powers currently permitted to federally incorporated financial institutions. The Task Force is making proposals to address privacy and tied selling. Subject to the adoption of these proposals, it believes that deposit-taking institutions should have greater insurance retailing powers and federally incorporated financial institutions should be able to lease light vehicles.

While the benefits to consumers must take precedence over the interests of current competitors, the Task Force has proposed a transition period to mitigate the initial impact. In the case of insurance distribution and light vehicle leasing, the Task Force has further proposed that smaller institutions should have a first-mover advantage. This proposal is consistent with the view that smaller DTIs and insurance companies are important platforms for building vibrant competitors to the largest institutions.

The Task Force has focussed special attention on the cooperative sector because of the potential of credit unions to build a competitive presence throughout Canada matching the level of success of the Mouvement Desjardins in Quebec. The Task Force has noted the important role that cooperatives, community banks and postal banks play in many countries, providing an important counterweight to the largest financial institutions.

While government cannot legislate a vibrant second tier of financial institutions, it can provide a framework that facilitates required changes. Accordingly, the Task Force has proposed a cooperative bank option that will assist the cooperative sector in two ways. First, it would provide an effective vehicle for delivering central services to local credit unions. Second, it would provide a means for credit unions to expand outside their province by applying, with the permission of the provincial jurisdiction, to continue as federally chartered cooperative banks. The Task Force also endorses, subject to necessary prudential restraints, specific requests made by Credit Union Central of Canada for more flexibility within the existing Cooperative Credit Associations Act.

Taken together, the organizational structure proposals of the Task Force are a package that tilts the balance of the regulatory regime toward greater competition while still maintaining necessary prudential safeguards. Although the proposals affect institutions in the first instance, consumers will ultimately be the beneficiaries of greater competition and reduced regulatory costs.