SENATE OF CANADA

First Session, Thirty-third Parliament, 1984-85-86

TOWARDS A MORE COMPETITIVE FINANCIAL ENVIRONMENT

Sixteenth Report
Standing Senate Committee on
Banking, Trade and Commerce

May 1986

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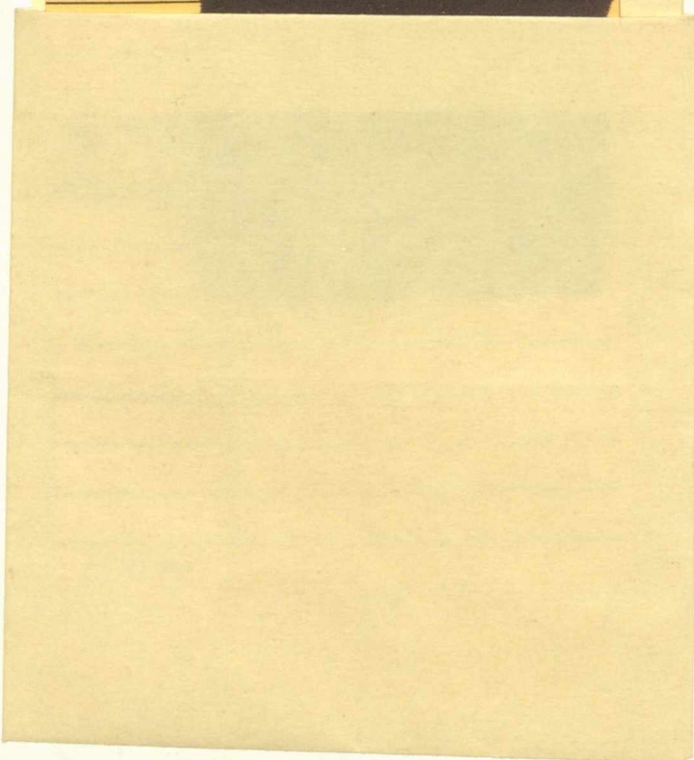

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First Session
Thirty-third Parliament 1984-85-86

Première session de la
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SENATE OF CANADA

SÉNAT DU CANADA

Proceedings of the Standing Senate Committee on

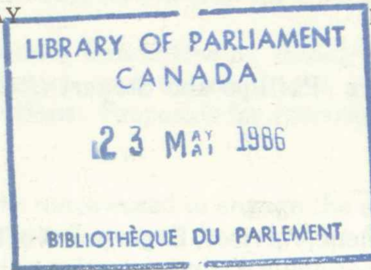
Banking, Trade and Commerce

Délibérations du Comité Sénatorial permanent des

Banques et du commerce

Chairman
The Honourable LOWELL MURRAY

Président
L'honorable LOWELL MURRAY



Thursday, May 1, 1986

Le jeudi 1er mai 1986

Issue No. 45

Fascicule No. 45

Fifteenth proceedings on:

"The Regulation of Canadian Financial Institutions: Proposals for Discussion" and the "Final Report of the Working Committee on the Canada Deposit Insurance Corporation (CDIC)"

Quinzième fascicule concernant:

«La réglementation des institutions financières du Canada: propositions à considérer» et le «Rapport final du Comité d'étude sur la Société d'assurance-dépôts du Canada (SADC)»

SIXTEENTH REPORT OF THE COMMITTEE

SEIZIÈME RAPPORT DU COMITÉ

MEMBERSHIP OF THE COMMITTEE

(as of April 23, 1986)

The Honourable Lowell Murray, M.A., Chairman

and

The Honourable Senators:

Anderson, Margaret
Barrow, A. Irvine, F.C.A., R.I.A.
Buckwold, S.L., B.Comm., LL.D. (Hon.)
*Doody, C. William
Flynn, Jacques, P.C., Q.C.
*Frith, Royce, Q.C.
Godfrey, John Morrow, Q.C.
Kelly, William M., M.E.I.C.
Kirby, Michael, Ph.D.
MacDonald, Finlay *(Halifax)*
*MacEachen, Allan J., P.C.
Olson, H.A., P.C.
Perrault, Raymond J., P.C.
*Roblin, Duff, P.C., C.C., LL.D.
Simard, Jean-Maurice, C.A.

**Ex officio Members*

Note: The Honourable Senators Phillips and Steuart *(Prince Albert - Duck Lake)* also served on the Committee.

Research Staff:

Professor Thomas J. Courchene, Advisor, Department of Economics, University of Western Ontario; École nationale d'administration publique, Montreal;
Mr. Gérald A. Lacoste, Counsel, Martineau Walker, Montreal;
Mr. Basil Zafiriou, Chief, Economics Division, Research Branch, Library of Parliament.

Timothy Ross Wilson

Clerk of the Committee

ORDERS OF REFERENCE

Extract from the *Minutes of the Proceedings of the Senate*, Wednesday, February 6, 1985:

"With leave of the Senate,

The Honourable Senator Doody moved, seconded by the Honourable Senator Flynn, P.C.:

That the Standing Senate Committee on Banking, Trade and Commerce ahve power to engage the services of such counsel and technical, clerical and other personnel as may be necessary for the purposes of its examination and consdieration of such legislation and other matters as may be referred to it.

After debate, and
The question being put on the motion, it was
Resolved in the affirmative."

Extract from the *Minutes of the Proceedings of the Senate*, Tuesday, June 25, 1985:

"Pursuant to the Order of the Day, the Senate resumed the debate on the motion of the Honourable Senator Doody, seconded by the Honourable Senator Phillips:

That the Standing Senate Committee on Banking, Trade and Commerce be authorized to study and report upon the document entitled: "The Regulation of Canadian Financial Institutions: Proposals for Discussion", tabled in the Senate on 23rd April 1985; and

That the Committee be empowered to engage the services of such professional, clerical and technical personnel as may be required for the purpose of the said examination.

After debate,

With leave of the Senate and pursuant to Rule 23, the motion was modified to read as follows:—

That the Standing Senate Committee on Banking, Trade and Commerce be authorized to study and report upon the following:

(i) the document entitled: "The Regulation of Canadian Financial Institutions: Proposals for Discussion", tabled in the Senate on 23rd April, 1985;

(ii) the document entitled: "Final Report of the Working Committee on the Canada Deposit Insurance Corporation (CDIC)", tabled in the Senate on 18th June, 1985; and

(iii) the subject-matter of bills, in advance of their coming before the Senate, and other matters relating to these documents.

After debate, and—
The question being put on the motion, as modified, it was—
Resolved in the affirmative."

Charles A. Lussier

Clerk of the Senate

REPORT OF THE COMMITTEE

The Standing Senate Committee on Banking, Trade and Commerce has the honour to present its

SIXTEENTH REPORT

In obedience to the Order of Reference of June 25, 1985, your Committe has proceeded to inquire into matters relating to the regulation of Canadian financial institutions and the Canada Deposit Insurance Corporation and now presents its final report.

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ACKNOWLEDGEMENTS

In June 1985, this Committee was instructed by the Senate to study and report on the documents entitled: *The Regulation of Canadian Financial Institutions: Proposals for Discussion* (the "Green Paper"); and *Final Report of the Working Committee on the Canada Deposit Insurance Corporation (CDIC)* (the "Wyman Report").

In December 1985, we tabled an interim report containing our conclusions and recommendations on the Wyman Report and on the general subject of deposit insurance.

What follows is our final report on the regulation of Canadian financial institutions.

This study was conducted at a time when the state of the financial services industry in Canada was the subject of unprecedented public debate and controversy.

The Committee had to consider some of the matters that gave rise to this controversy: in particular the failure of two small chartered banks in 1985, and changes in ownership that took place in the industry during the period of our study. It would have been irresponsible to ignore the implications of these events for our overall study — there were lessons to be learned from them. Still, we tried at all times to keep our sights on the future, on the kind of financial services industry that will best serve the Canadian consumer and the nation in a changing and ever more competitive world.

In addressing these issues, the Committee has been very fortunate to have the advice and assistance of Professor Thomas J. Courchene, Professor of Economics at the University of Western Ontario, London, Ontario and former Chairman of the Ontario Economic Council; of Mr. Gérald A. Lacoste, former Chairman of the Quebec Securities Commission who is now a partner with the law firm Martineau Walker of Montreal; and Mr. Basil Zafiriou, Chief of the Economics Division of the Parliamentary Library's Research Branch.

Over the period of this study, the Committee also dealt with a large number of tax and other financial and economic initiatives referred to us. Altogether we met during this period for a total of over 106 hours, and heard testimony from 48 groups and individuals.

This schedule has required extraordinary effort on the part of our Senate staff, and the Committee gratefully acknowledges their co-operation and assistance, in particular that of our Clerk, Mr. Timothy Ross Wilson.

PREFACE AND OVERVIEW: TOWARDS A MORE COMPETITIVE FINANCIAL ENVIRONMENT

PART I
CONSUMER PROTECTION AND FINANCIAL INSTITUTION STABILITY

A. A PERSPECTIVE ON THE REGULATORY PROCESS

Introducing Discipline Throughout the System

The Four Pillars

Regulation by Function

FHCs and the Four-Pillar Approach

Centralizing Regulatory Functions

1. **The Standing Senate Committee on Banking, Trade and Commerce views the historical evolution of federal and provincial roles in the regulation of the Canadian financial sector as an important ingredient of Canada's social capital. Hence, the reform of the Canadian financial sector should, as much as possible, respect the existing institutional and federal-provincial division of powers and responsibilities.**

2. **Accordingly, the Committee opposes the consolidation of regulatory/supervisory powers in a single, all-powerful regulatory agency.**

3. **Ensuring consumer protection and institution stability is best achieved by the introduction of greater discipline with respect to all four regulatory components — the Canada Deposit Insurance Corporation (CDIC), the primary regulators, the auditors and corporate governance — rather than placing excessive reliance on any one component.**

4. **If concerns such as solvency and self-dealing are to be addressed effectively, there must exist primary regulators with authority over the entire operations of the institution. Thus, the Committee favours the present system which aligns regulators and institutions according to the institution's core function. This practice of assigning separate primary regulators to each core function has come to be known as the "four-pillar" approach.**

5. The forces of competition and technology are inducing financial institutions to undertake cross-pillar activities — activities that fall outside the competence and jurisdiction of the primary regulator. Given that the line of demarcation between various types of financial instruments is progressively more blurred, it is neither possible nor desirable to restrict an institution's activities to its core function. However, any such cross-pillar activities must be subject to monitoring by one of the primary regulators.

6. Thus, the challenge is to ensure that each dollar deposited with an institution is regulated somewhere while at the same time ensuring that this does not lead either to regulatory overlap or to the "un-levelling of the playing field".

B. DEPOSIT INSURANCE

7. The CDIC should be constituted as a separate institution with its own board of directors drawn from both levels of government, the private sector and member institutions.

8. The CDIC will function as an insurer. Its role shall be one of administering the deposit insurance funds. Since these funds are financed through premiums from insured institutions, the CDIC shall have the responsibility of acting as agent for these member institutions in managing and protecting the assets of these funds, for the ultimate benefit of insured depositors.

9. In the normal course of events the CDIC will delegate its regulatory powers to the primary regulators. In return, the primary regulators will be required to establish a set of arrangements that would operate as an "early warning system" to signal those institutions that may be experiencing problems.

10. The CDIC would become directly involved in the supervision and regulation of the institutions identified as potential problem institutions by the early-warning system. The range of powers that the CDIC would have in order to restore these institutions to financial health would include the authority to alter leverage ratios, the authority to issue cease and desist orders with respect to selected activities and/or practices and the authority to assemble its own qualified team of examiners.

11. If the CDIC determines that an institution is no longer insurable, this information will be communicated immediately to the relevant primary regulator and to the responsible minister. Normally, this would trigger the process of winding down that institution.

12. The possibility exists, however, that the government responsible for the institution will want to keep it in operation in spite of the fact that the CDIC deems it to be no longer insurable. The Committee believes that this is the government's prerogative. However, we also believe that, in all such cases, the CDIC's exposure with respect to such an institution must be limited as of the date of the notice to the relevant minister that the CDIC has determined that the institution is no longer insurable. Thus any further liabilities or exposure must be the responsibility of the relevant government.

13. The level of deposit insurance should remain at $60,000 until the reconstituted CDIC is in place and operating for at least one full year. Beyond this period, a majority of the Committee is in favour of full insurance up to $25,000 and 80 per cent insurance for the next $50,000.

14. The CDIC should operate on the basis of separate "pools" — one for banks, one for trust companies and one for credit unions. Losses by a member institution would be made up by a series of surcharges levied on other members of the same pool. The rationale for these segregated funds is that they will encourage a desirable degree of industry self-regulation. The CDIC would welcome the Canadian Life and Health Insurance Association (CLHIA) and the securities industry as members, but the Committee recognizes that these sectors prefer, at present, to operate their own consumer protection plans or funds.

15. Finally, the Committee views deposit insurance as a privilege, not a right. Thus, the CDIC must have the authority to set standards for insurability and, indeed, to refuse insurance to those institutions which do not meet these standards or whose primary regulators do not follow CDIC guidelines.

C. INCREASING THE EFFECTIVENESS OF PRIMARY REGULATORS

Exercising Existing Powers

16. To a considerable degree, the recent problems in the financial sector appear to reflect not so much an inadequate range of regulatory powers as an inadequate exercise of existing powers. To the extent that this is the case, it is important that legislators do not react to recent events by endowing regulators with unnecessary and unwarranted powers.

Increasing Existing Powers

17. Increases in regulatory powers should be restricted to those areas where existing powers limit the ability to monitor the soundness and solvency of an institution or to restore problem institutions to financial health. They should not be utilized to supplant management's prerogative to manage and direct an institution.

18. The most serious weakness of the existing regulatory framework is the lack of procedures or mechanisms to identify problem institutions on a timely basis.

An Early-Warning System

19. Primary regulators must be required to develop a computerized data base to serve as the building block for an early-warning system. Other components of the system would include the monitoring of brokered deposits and the establishment of an institutional rating system modelled, for example, after the U.S. CAMEL system. (CAMEL is an acronym for Capital adequacy, Asset quality, Management ability, Earnings quality and Liquidity.) The CDIC would become directly involved in the supervision and regulation of institutions that fall below some minimum threshold level in terms of the rating system or, more generally, in terms of the indicators relating to the early-warning system.

D. AUDITORS

Upgrading Standards

Enhancing Reporting Requirements

Appointment of Auditors

Auditors and Audit Committees

20. **The Committee recommends that the CDIC, the primary regulators, industry representatives and the CICA work together in developing reporting and assessment standards that will reflect more accurately an institution's exposure to risk. In particular, it is important that financial statements strive to reflect the current or market values of assets. This requires more uniform reporting across institutions for non-performing loans and provisions for losses.**

21. **All financial institutions should be required to submit to annual audits by two firms. One of these firms should be appointed by the primary regulator. The rationale for this recommendation is two-fold: first, to enhance the independence of auditors and, second, to encourage an audit perspective that takes into account the interests of depositors as well as shareholders. Unlike a somewhat similar recommendation by the House of Commons report, which would have the second auditor follow separate audit standards and report to the primary regulator rather than to management, we would prefer to have the audit and reporting standards and regulations remain as they currently are.**

22. **The Committee recommends that the auditors be required to attend the meetings of the institution's audit committee.**

23. **The present procedures whereby auditors report on inappropriate practices or procedures to the extent that they affect the institution in a "material" way place an inappropriate degree of judgemental responsibility on the auditors. The Committee recommends that the auditors be required to report to the audit committee all instances of self-dealing, malfeasance and transactions outside the apparent powers of the financial institutions, in accordance with the guidelines established by the audit committee.**

24. **Copies of the post-audit reports to management and the audit committee of the board of directors must be provided simultaneously to the primary regulator.**

E. CORPORATE GOVERNANCE

Standards of Care and Diligence for Directors

25. **The Committee recommends that directors exhibit, in exercising their powers and discharging their duties, a degree of skill that may reasonably be expected from persons of their knowledge and experience.**

26. **The Committee recommends comprehensive indemnification provisions for a director of a regulated financial institution against costs and expenses incurred in respect of a civil, criminal or administrative action to which the director was a party if the director acted honestly and in good faith with a view to the best interests of the institution and if the director had reasonable grounds for believing that his or her actions were lawful.**

Self-Dealing

The Green Paper Position

The Essence of the Self-Dealing Concern

27. **The Committee rejects the Green Paper proposal for a general ban on all non-arm's-length transactions (NALTs). Rather, the objective of an approach to**

self-dealing ought to be to prevent potentially "abusive" NALTs while allowing constructive ones to proceed. Toward this end the Committee proposes a three-pronged procedure that would incorporate a system of NALTs review. We also provide for appropriate regulatory oversight, safeguards, public redress and sanctions.

A Three-Tiered Approach to Self-Dealing

Tier One: A Selective Ban

28. The first tier is an outright ban on a selective set of self-dealing transactions that by their very nature would jeopardize consumer protection and the stability of the institution. Here, the Committee follows the recommendation of the House of Commons report that representatives from the primary regulators, the professional associations (including lawyers, accountants, appraisers and actuaries) and the financial institutions be involved in drawing up the selective list of prohibited transactions.

Tier Two: Business Conduct Review Committee

29. Every financial institution would be required to establish a Business Conduct Review Committee (BCRC) of the board of directors to review in advance all non-arm's-length transactions to ensure that they do not either expose minority shareholders and consumers to abuse, or materially increase the risk of insolvency to the institution.

30. The BCRC will be comprised of not less than three "outside", "disinterested" or "independent" members of the board of directors. A director is deemed not to be qualified to serve on the BCRC if:

- he or she is an officer, employee, solicitor, auditor or has any professional association with the financial institution or an affiliate of the financial institution, or is a relative of any of the foregoing individuals;
- he or she is a significant shareholder in the financial institution, i.e. holds more than ten per cent of the outstanding voting shares individually or in combination with associates; and
- he or she has significant financial interests in or with the institution, e.g. a significant borrower.

31. As a safeguard to assure the independence of BCRC members, the Committee proposes that provision be made for interested parties to be allowed to apply to the courts to determine whether members are truly independent and thereby qualified to act. This right could be exercised by the regulators, minority shareholders or the public.

32. The role of the BCRC is to ensure that all NALTs are consistent with the prices, terms and conditions that would prevail in arm's-length transactions.

33. The BCRC should have the right to retain independent professional counsel.

34. The BCRC would be responsible for establishing procedures and guidelines to ensure that all related-party transactions are brought to its attention for pre-clearance and either approved or disallowed.

35. If the BCRC disallows any NALT, the transaction cannot proceed.

36. The Committee recommends that there be statutory requirements for all directors, senior management, auditors, solicitors and associated professionals to report all related-party transactions to the BCRC.

37. All decisions of the BCRC will be reported immediately to the auditors, to the audit committee of the financial institution and to the members of the board of directors.

Tier Three: Pre-Clearance with the Primary Regulator

38. The third tier is a provision for pre-clearance with the primary regulator for certain sorts of self-dealing transactions. Such transactions would include:

- **NALTs involving particularly sensitive assets such as real estate, or closely-held corporations or other generally illiquid assets for which there is no reliable independent basis of evaluation;**
- **individual transactions over a certain size or cumulative NALTs over a certain percentage of assets; and**
- **all NALTs for a specified period of time after the establishment of a new financial institution or upon a change in control of an existing financial institution.**

Redress and Safeguards

39. The Committee proposes that, upon the application of a member of the public or the regulatory authorities, the legislation confer on the courts the power to set aside improper related-party transactions and to direct that the related party account to the institution for any profit or gain realized in such transaction. This type of remedy is already available under the *Canadian Business Corporation Act* (CBCA), but it should apply to all regulated financial institutions.

Recapitulation

40. The Committee believes that with these provisions in place, all third parties and regulators will have a high degree of assurance that any and all self-dealing transactions are in the best interests of the institution, its shareholders, and its customers and are being carried out at prices that would fairly reflect those which would occur in arm's-length or market transactions.

41. Beyond some learning period, the Committee is of the view that financial institutions will be able to cope rather well with these provisions. Undoubtedly, it will be the case that these institutions will henceforth have to conduct their affairs with considerably more concern for their customers and minority shareholders. However, this is entirely appropriate since, as will be detailed later, the *quid pro quo* is greater flexibility and maneuverability in the market-place.

F. SELF-DEALING WITHIN A CONGLOMERATE

Should Holding Companies be Regulated?

42. The regulation of financial holding companies would add yet another substantial layer to the regulatory process. To the extent that the rationale for this is to control self-dealing, we believe that the concern is unwarranted given

the previous recommendations addressing self-dealing. Since there are two sides to every transaction, each episode of self-dealing will be subjected to scrutiny in at least one institution and if the NALT is designed to be between two affiliated companies it will come under the scrutiny of both BCRCs. Accordingly, the Committee rejects the Green Paper proposal for federally regulated financial holding companies.

Cross-Pillar Activity and Self-Dealing

43. **Where one financial institution has a controlling interest in another financial institution operating in a different pillar, either the institution itself or its affiliate must have 35 per cent of its shares traded publicly. For financial conglomerates, if the holding company does not have 35 per cent of its shares traded publicly, all of its subsidiaries must be publicly traded to the extent of 35 per cent. Since schedule A banks, mutual companies and credit unions are, or are deemed to be, widely held they could, under these provisions, hold wholly-owned subsidiaries. The rationale for this provision is to enhance the role of corporate governance in monitoring self-dealing. A public share ownership of 35 per cent is probably sufficient to ensure that professional financial analysts will monitor the operations of the firm. This added scrutiny and increased public awareness will provide yet another incentive for institutions to ensure that their business conduct review committees function properly.**

44. **Where there is a difference between the percentage of shares publicly traded and the percentages of voting rights publicly traded, it is the latter that is the focus of our recommendation.**

Financial and Non-Financial Activities

45. **Financial holding companies should be prohibited from engaging in non-financial activities. This general ban should not preclude allowing financial holding companies from operating subsidiaries, such as data processing units, which are designed to service the needs of the financial conglomerate or that derive from or are closely related to the principal operations of the financial conglomerate.**

46. **Non-financial institutions should be able to engage in financial activities provided they do so through a financial holding company structure. Either the financial holding company must have 35 per cent of its shares publicly traded or else all of its subsidiaries must have 35 per cent of their shares publicly traded.**

G. CONFLICTS OF INTEREST

47. **The Committee is of the view that the combination of enhanced disclosure, effective corporate governance, and the establishment and monitoring of Chinese Walls represents an adequate approach to controlling abuses of conflicts of interest. This is particularly the case since many of the new cross-pillar activities will probably be undertaken through separate institutions which, in turn, will be subject to the supervision of the relevant primary regulator.**

H. SUMMARY

48. **The Committee is satisfied that the preceding recommendations will ensure an effective supervisory and monitoring system with respect to consumer protection, institution soundness and system stability.**

PART II
ENHANCING COMPETITION

A. INTRODUCTION

49. The Committee endorses the principles relating to competition and efficiency enunciated in the Green Paper. However, in conducting the analysis the Committee was also influenced by the following concerns:

- **the ultimate role of the financial system is to transfer funds efficiently from lender to borrower;**
- **government policy in the financial arena should avoid the imposition of a preconceived structure on the financial system;**
- **the policy framework for the financial sector must encourage rather than inhibit innovation;**
- **any set of reforms must ensure that our successful institutions remain world class and that other institutions have the flexibility to achieve this status; and**
- **where possible, the reform process ought to work from, and build upon, our existing strengths.**

B. BROADENING SOURCES OF CREDIT AND CUSTOMERS' OPTIONS

The Process of Financial Integration

An Approach to Institution Flexibility

50. Subject to certain criteria and priorities to be detailed later, the Committee welcomes all four general approaches to financial diversification:

- **within-institution expansion of powers;**
- **subsidiaries;**
- **upstream and downstream holding companies; and**
- **networking.**

C. EXPANDING IN-HOUSE POWERS

Commercial Lending

- **Trust Companies**
- **Insurance Companies**
- **Credit Unions**
- **Summary**

51. The present qualitative approach to investment should be replaced by a quantitative or prudent portfolio approach that would be monitored by the

investment committee of the board of directors. The essential features of this portfolio approach would be that quantitative limits would be established with respect to the proportion of the portfolio that can be invested in each type of security.

52. **As far as the investment limits relating to commercial lending/leasing, the Committee is in favour of establishing an all-inclusive maximum of 20 per cent of assets for trust companies and insurance companies. It may be appropriate to have these limits escalate to the maximum levels in terms of a series of thresholds based, say, on the amount of capital.**

53. **Provided that the regulation of credit unions and caisses populaires outside Quebec satisfies the prudential standards established by the CDIC, the Committee is also in favour of expanding the commercial lending powers of credit unions, in phases again based on capital, up to a maximum of 20 per cent of assets. Since the regulations relating to credit unions are essentially in the domain of the provinces, this recommendation is directed principally to the CDIC in terms of the conditions on which it should be willing to accept credit unions for deposit insurance, other prudential considerations assumed to be in order.**

Other Cross-Pillar Activities

54. **There is probably scope for allowing greater in-house expansion of powers into other cross-pillar activities, provided that they are regulated or monitored by the responsible primary regulator. The Committee's approach is to be flexible unless a case can be made that such an expansion of in-house powers would run counter to the public interest.**

55. **The Committee concurs with the House of Commons report that life-insurance companies be allowed to act as trustee of funds payable on insurance contracts, registered pension plans and registered retirement savings plans. However, as a general rule, the Committee would prefer that institutions wishing to engage in the estate, trust and agency business do so through affiliated institutions rather than through an expansion of in-house powers.**

D. DIVERSIFICATION THROUGH SUBSIDIARIES

56. **Financial intermediaries should be allowed to diversify their financial activities through subsidiaries. However, subsidiaries of financial institutions should not be in the non-financial area, except to the limited extent referred to in the recommendations of the previous chapter. Moreover, the 35 per cent rule relating to publicly traded stocks will also apply: either the institution or the subsidiary must have 35 per cent of its stock publicly traded.**

57. **Equity investment in subsidiaries must be deducted from base capital in order to avoid double leveraging. A 20 per cent ownership stake in a subsidiary should be the threshold level for triggering this provision against double leveraging. This should ensure that only institutions with a strong financial base could take advantage of diversifying through subsidiaries.**

E. HOLDING COMPANIES

58. **Diversification across the pillars by either upstream or downstream holding companies should be permitted.**

59. **Double counting of capital would not be permitted, even for mutual life companies and credit unions. However, these institutions should be allowed to issue preferred stocks and subordinated debentures.**

60. **For institutions desiring even greater commercial lending ability, a schedule B bank should be permitted as part of a holding company. Such banks would be restricted in terms of size. To exceed these limits would be possible only if they adopted the widely-held, schedule A route. The rationale for this approach is to encourage the development of regional banks as well as to allow regional institutions to use the schedule-B bank route to diversify their assets across regions.**

F. NETWORKING

61. **The Committee takes a very favourable view of networking, with two provisos. Tied selling must be prohibited and networking fees should be above board and subject to monitoring by the relevant regulator.**

G. INTERNATIONAL ASPECTS

62. **The Committee endorses the existing approach toward foreign ownership of Canadian trust and life companies; transfer of ownership or control of existing Canadian financial institutions to foreign interests should be restricted, or at least subject to ministerial approval, but new entry should be freely allowed.**

63. **Given the growing internationalization of the markets for credit and capital, Canadian regulatory policy should avoid initiatives which could result in our institutions being denied access to foreign markets.**

64. **Mutual life companies incorporated in Canada should be deemed Canadian institutions.**

H. CAPITAL REQUIREMENTS

65. **The Committee endorses the generally accepted view that higher initial capital requirements are required for financial institutions, but cautions against setting these requirements so high as to unduly restrict entry.**

I. SECURITIES INDUSTRY

The Structure of the Securities Industry

The Increasing Foreign Penetration

The Approach of the Official Reports

The Committee's View

66. **The Committee recognizes that policy with respect to the securities industry falls under the legislative domain of the provinces. Nonetheless, the securities industry plays such a pivotal role in Canadian capital markets that no overview of the regulation of the Canadian financial system can be complete without some reference to the operations of securities markets.**

67. **The Committee also recognizes that the Green Paper and the House of Commons report appear in principle to be willing to include the securities industry as an integral part of their overall designs for reform. In particular, should the provinces be willing, these reports would allow securities firms to come under the umbrella of a financial holding company (the Green Paper and the House of Commons report) or become a subsidiary of a financial institution operating in a different pillar (the House of Commons report).**

68. **Consistent with the general approach we have taken to the opening up of the financial system, the Committee recommends, for consideration by the provinces:**

- **that securities firms be treated like any other financial institution in terms of being able to be part of an upstream or downstream holding company or subsidiaries of a financial institution operating in another pillar; and**

- **that securities firms themselves be given powers similar to those of other financial institutions in terms of being able to acquire subsidiaries and to form downstream holding companies.**

69. **The Committee welcomes the call by the Ontario Task Force that the province of Ontario review its policy with respect to foreign ownership of securities firms.**

J. CHARTERED BANKS

Reserve Requirements and the Level Playing Field

70. **The fact that the chartered banks are required to hold part of their reserves in the form of non-interest-bearing deposits with the Bank of Canada serves, in effect, to levy a tax on banks relative to other financial institutions. The preferred solution is for the Bank of Canada to pay interest on these reserves. Since trust companies, for example, typically hold some of their reserves with chartered banks, the Bank of Canada might look to the interest rate paid on these deposits when determining the appropriate interest rate to pay on chartered-bank deposits with the Bank of Canada.**

71. **Interest should not be paid on any chartered-bank excess reserves (i.e. reserves beyond those required) held on deposit with the Bank of Canada. Together, these two provisions — interest on required reserves and no interest on excess reserves — will ensure that the Bank of Canada's ability to exercise its monetary control function will not be impaired.**

Extending Bank Powers

72. **In principle, there is no reason why the flexible approach which the Committee has outlined for the financial system should not apply to the chartered banks. Those who would wish to constrain the chartered banks in their sphere of operations should be required to demonstrate that an extension of bank powers would be contrary to the public interest.**

73. **This is particularly the case for the securities industry. If the provinces move to allow foreign securities firms and merchant bankers to establish domestic operations, then the Committee believes it is essential that the chartered banks,**

or at least their offshore merchant-banking subsidiaries, be allowed equivalent privileges.

74. The Committee recommends that the ownership restrictions applicable to schedule A banks remain in place.

The Legislative Timetable

75. The Committee recommends that the updating of the trust company and life insurance company legislation take priority over the 1990 Bank Act revisions.

K. CONCENTRATION

76. The Committee is concerned about the degree of concentration in the financial sector. We take this opportunity to signal our intention to undertake a thorough review of the concentration issue as it relates to both the financial and non-financial sectors, including the issues raised by the commingling of financial and non-financial activities.

PART III
FEDERAL-PROVINCIAL CONSIDERATIONS

A. FEDERAL-PROVINCIAL RELATIONS AND FINANCIAL SECTOR REFORM

77. The Committee believes that the federal government can act now upon the foregoing recommendations, confident that they respect the historical and judicial evolution of powers and responsibilities in the Canadian financial system.

B. JURISDICTIONAL HARMONIZATION

The Jurisdictional Mosaic

Jurisdictional Harmonization and the Legislative Process

Jurisdictional Havens and Competitive Deregulation

CDIC, CPA, and Financial-Institution Jurisdiction

78. The Committee recognizes that the existence of multiple jurisdictions can and does complicate the operations of the Canadian financial sector. However, there may also be substantial benefits in terms of flexibility, innovation, experimentation and healthy competition. Moreover, the two most recent substantive alterations of the financial system, namely the advent of deposit insurance and the Canadian Payments Association, have been introduced in such a manner that they have served to endorse and even entrench the existing institutional and federal-provincial operating environment.

C. REGULATORY COORDINATION

Exclusive Jurisdiction

Multiple Horizontal Jurisdictions

79. The ultimate objective of regulatory coordination should be to create a structure where regulations are sufficiently compatible across jurisdictions that the markets can in effect become national markets. Some pillars are more advanced in achieving this goal than others. Frequently, however, the stumbling block is not that coordinating mechanisms are not in place, but rather that there is a lack of policy harmonization across jurisdictions.

D. POLICY HARMONIZATION

80. The Committee perceives that the institutional infrastructure designed to harmonize the financial environment at the policy level is, at present, inadequate. Accordingly, the Committee recommends that the federal government take the initiative to establish, with the provincial governments, a Permanent Committee of Ministers Responsible for Financial Institutions. This body would be responsible for achieving policy harmonization. In particular, it would be responsible for adopting a national perspective with respect to the markets in which financial institutions now operate. This global overview is essential since the Canadian financial market is much more encompassing than the domain of any one regulator or jurisdiction.

E. CONCLUSION

81. The Committee concludes by reiterating its view that what is required on the federal-provincial front is not a re-design of the underlying structures or responsibilities in the financial sector, but rather a re-orientation of existing structures in order to address the challenges of the 1980s and beyond. In this sense, the federal-provincial implications arising from the preceding recommendations call primarily for renewed and creative efforts in addressing the perennial problems of harmonization and coordination.

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PREFACE AND OVERVIEW

TOWARDS A MORE COMPETITIVE FINANCIAL ENVIRONMENT

Our point of departure in addressing the range of issues relating to the regulation of Canadian financial institutions is to endorse the nine underlying principles which appear on the first page of the Green Paper. In so doing we are echoing the views of virtually all of the submissions we received and all of the witnesses who appeared before the Committee. However, rather than simply reproducing these nine principles as they appear in the Green Paper we prefer to organize them into three broad categories:

1. Consumer Protection and Financial Institution Stability:
   - improving consumer protection;
   - ensuring the soundness of financial institutions and the stability of the financial system;
   - controlling self-dealing;
   - guarding against abuses of conflicts of interest.

2. Enhancing Competition:
   - promoting competition, innovation and efficiency;
   - enhancing the convenience and options available to customers in the market-place;
   - broadening the sources of credit available to individuals and businesses;
   - promoting international competitiveness and domestic economic growth.

3. Federal-Provincial Considerations:
   - promoting the harmonization of federal and provincial regulatory policies.

To this list of principles we would add another precept (also adopted from page 1 of the Green Paper) namely that "in a fast changing financial world, regulatory policy should avoid as much as possible the imposition of a preconceived structure on the financial system". This degree of flexibility is essential if Canadian institutions are to achieve and/or maintain world class status in today's competitive financial environment.

In contrast to the overwhelming support for the principles underlying the Green Paper, very few, if any, of the submissions to the Committee expressed support for the restructuring of the financial sector that the authors of the Green Paper derived from these principles. In part, these concerns reflect the mandatory nature of the proposed structures (such as the

mandatory federally-regulated financial holding company (FHC) for institutions operating in different pillars and the mandatory schedule-C-bank concept for institutions wishing to increase their commercial lending activities) rather than the structures themselves. Indeed, it would appear that these recommendations represent the very "imposition of a preconceived structure on the financial system", which the Green Paper itself espoused to avoid.

One approach to our reference would have been to direct attention to those areas, such as FHCs and schedule C banks, where the representations we received indicated that there may be cause for concern. Because of the interrelated nature of issues in the financial sector, it quickly became apparent that such a focus would have implications for the entire financial system. Hence, what follows is a comprehensive review of the regulation of Canadian financial institutions.

The framework for this review follows directly from the organization of the nine underlying principles. Part I deals with consumer protection and financial institution stability, Part II focuses on enhancing competition, and Part III addresses federal-provincial considerations.

In conducting this analysis, the Committee will draw upon its recent reports on Deposit Insurance and on the subject-matter of Bill C-79 (*The Financial Institutions Depositors Compensation Act*). While it is not our intention to review in detail the analyses and recommendations contained in these reports, it will be necessary to summarize them briefly in the context of the discussion of consumer protection and financial institution stability and, to a lesser degree, in the context of the discussion of federal-provincial relations.

However, whereas the emphasis in these previous reports was directed primarily towards enhancing the protection and regulatory aspects of financial sector policy, the thrust of the present report is directed more toward enhancing competition and toward providing flexibility for Canada's financial institutions to adjust to the rapid spread of technology and the increasing internationalization of the markets for credit and capital.

This emphasis on efficiency and competition is also an important underlying thrust of the Green Paper. However, the spectacular failures of the CCB and the Northland Bank a few months after the publication of the Green Paper tended to shift the emphasis of financial-sector reform toward solvency and system stability and away from efficiency and competitiveness. We, too, shall devote considerable emphasis to issues relating to self-dealing, conflicts of interest, auditing procedures and the like. Nonetheless, the view of the Committee is that, important as these solvency and stability concerns are, it is essential that they not overshadow the goals of enhancing competition and efficiency in the financial sector.

Finally, we acknowledge the contribution of two comprehensive reviews of the regulation of the financial sector, namely *Canadian Financial Institutions*, the Eleventh Report of the House of Commons Standing Committee on Finance, Trade and Economic Affairs (henceforth referred to as the House of Commons report), and the *Final Report* of the Ontario Task Force on Financial Institutions (henceforth referred to as the Ontario Task Force report).

PART I

CONSUMER PROTECTION AND FINANCIAL INSTITUTION STABILITY

The recent spate of financial institution failures has heightened concerns relating to consumer protection, solvency, the regulatory process and, more generally, the stability of the financial system. Even though the overall thrust of this report is to emphasize the competitive and efficiency aspects of the financial environment, it is essential that any and all recommendations designed to foster competition be implemented within a financial system that has the confidence of Canadians. Accordingly, it is appropriate to deal first with these concerns of consumer protection and institution/system stability.

The analysis begins with a perspective on the regulatory process. Should the present "regulation-by-institution" approach be maintained or should we move to "regulation by function"? Should the regulatory system become much more centralized, as reflected for example in the recommendation of the House of Commons Report for a National Financial Administration Agency (NFAA), or should the system reflect the status quo in this regard? The answers to these questions will have important implications for the way in which the overall supervisory system ought to be structured. For example, under an all-encompassing regulatory authority like the NFAA there would be no need for an independent Canada Deposit Insurance Corporation (CDIC). Consistent with our earlier reports, we believe that reform of the financial system should generally take place within the existing institutional and federal-provincial framework. Moreover, we believe that the appropriate approach to ensuring consumer protection and institution stability is to introduce enhanced monitoring and discipline across a broad range of fronts rather than loading enormous responsibility on any one component of the overall regulatory process.

The remainder of this chapter focuses, in turn, on each of the components of the regulatory process — the CDIC, the primary regulators, the auditors and the role of institutional self-regulation, which will henceforth be referred to as "corporate governance". Under the general heading of corporate governance we shall address the concerns relating to self-dealing not only as they apply to a single institution but also as they apply to financial conglomerates.

While attention is directed toward ensuring that each of these players has a set of powers and responsibilities that are appropriate to its respective role, emphasis is also placed on the manner in which each interacts with the overall regulatory and supervisory system. In this sense the effectiveness of the system exceeds the sum of its component parts.

A. A PERSPECTIVE ON THE REGULATORY PROCESS

Introducing Discipline Throughout the System

The role of a regulator was never an easy one. And the march of technology is dramatically increasing the complexity of the job. As W.D. Mulholland, Chairman and CEO of the Bank of Montreal, so colourfully noted in his appearance before us:

> You can move money around so fast now to so many different places through several legal jurisdictions, some of which have very strict laws against disclosure, that it isn't even funny. I can hide money in the twinkling of an eye from all the bloodhounds that could be put on the case, and I would be so far ahead of them that there would never be a hope of unravelling the trail. (...) Technology today means that that sort of thing can be done through electronic means. In a day, money can be moved through Winnipeg, Toronto, New York, Miami, the Caymen Islands, the Bahamas, and into Switzerland and I defy anyone to unravel the trail. The best thing to do is to create a structure wherein no one has to depend on the cops to catch the robbers — a structure where there is created as little incentive and as much inconvenience as possible for that sort of thing. (11:24)

In view of these comments, and similar ones by several other witnesses, the Committee has determined that the most viable approach toward ensuring shareholder and consumer protection on the one hand and institution soundness on the other is to introduce greater discipline across a broad range of fronts. Placing excessive reliance on any one approach (e.g., an outright ban on all self-dealing and/or a mandatory financial-holding-company approach to ensure that each separate institution is essentially restricted to operate in only one "pillar") will in the final analysis not likely be able to deal adequately with the inherent fungibility of money and technology and, as important, will surely be less conducive to innovation and competition than will a more balanced approach.

Such a balanced approach must of course ensure that the regulators become more effective. As outlined below, the Committee recommends, among other items, the development of a sophisticated early warning system that will identify problem institutions on a timely basis. We shall also make recommendations that will enhance the role of auditors and integrate them more fully into the overall regulatory process. Yet regardless of the powers that one gives the regulators and the auditors, the system would still depend, as Mr. Mulholland notes, "on the cops to catch the robbers". Hence, more is needed. And, in our view, this additional monitoring must come from enhanced corporate governance. It is for this reason that we shall recommend that all financial institutions strike a committee or committees of independent directors that will, among other things, have to pre-clear all non-arm's-length transactions (NALTs). And it is also for this reason that we shall argue for publicly-traded stock and minority shareholder representation on the board of directors for all financial institutions that, via subsidiaries or holding companies, engage in multi-pillar activities.

Thus, the first component of a perspective on the role of regulators is that while they are a critical part of the overall regulatory process, they are not the only part. The range of powers assigned to them should reflect the fact that there are other key actors that also have an important role to play in ensuring the soundness of the financial system.

The Four Pillars

It has been Canada's tradition to assign primary regulators to types of institutions according to the institutions' core functions rather than to assign regulators to types of functions that institutions perform although, since the institutions have historically tended to restrict themselves to their core functions, these two approaches were not that much different in practice. Recently, it has become fashionable to call this the "four-pillar" approach,

reference being to the banking, trust, insurance, and securities sectors and to their corresponding "primary" or core function regulators.

The designation is not fully appropriate since there are other institutional forms. Credit unions presumably represent a fifth pillar and, perhaps, pension funds a sixth. Moreover, the line of demarcation between types of financial instruments is becoming progressively blurred. One example will suffice. There is an emerging literature on the "securitization" of bank loans, by which is meant the reselling of portions of a loan to other institutions. Should this tendency accelerate, the loan contract will become more and more like a prospectus and these bank loans will become more and more like securities.

Finally, the simplicity implied by reference to the four pillars vanishes quickly once one takes into account the federal-provincial aspects of regulation. Banks come entirely under federal regulation while the securities industry and credit unions (except for their overview body, the Canadian Corporative Credit Society) fall entirely under provincial control. Trust companies and insurance companies can be chartered at either the federal or provincial level and their regulation is also divided across jurisdictions.

Nonetheless, the four-pillar designation of the regulatory process does convey the essential message that the primary or core-function regulator will be responsible for monitoring the institution, not only in terms of this core function but also in terms of such critical areas as solvency, self-dealing and abuses of conflicts of interest.

Regulation by Function

Over the years there have been arguments to the effect that the system ought to move toward regulation by function, by which is meant that institutions will be subject to several regulators depending on the function in question and for each of these functions the regulator will ensure that all institutions are monitored similarly. The 1976 report of the Economic Council of Canada, *Efficiency and Regulation: A Study of Deposit-Taking Institutions*, was an early advocate of regulation by function. More recently, Mr. William Dimma, Chairman of the Advisory Committee on Financial Institutions, also argued for regulation by function in a June 18, 1984 address to the Investment Dealers Association in Jasper, Alberta.

From the Committee's perspective, the problem with regulation by function is that issues such as solvency and self-dealing are institution concerns rather than function concerns. Hence, there must be a regulator that has monitoring authority over the entire institution, regardless of the various functions it performs. In this sense, we come down in favour of the present Canadian system of assigning primary or core-activity regulators to the various pillars of the financial system.

However, under the pressures of competition and technology, institutions are progressively undertaking cross-pillar activities — activities that fall outside the competence and jurisdiction of the primary regulators and, as a result, sometimes go unregulated. Again, one example will suffice. Insurance companies have for some time been offering their clients the opportunity to invest in mutual funds. These funds are not subjected to the same prospectus requirements as are the issues of regular mutual funds. This matter is now under discussion by at least one provincial securities commission.

Thus, even though we believe that it is essential that institutions be subject to the primary regulator associated with the respective pillar or sector, it is also very evident that where these institutions are allowed to engage in cross-pillar activities they must be subject to the monitoring or registration requirements of the regulator responsible for these other functions. This overall approach is broadly consistent with the status quo where many institutions are now subject to monitoring by regulators other than their primary regulators. The challenge is to ensure that each dollar deposited with an institution is subject to regulation somewhere, while at the same time ensuring that this does not lead to regulatory overlap.

FHCs and the Four-Pillar Approach

The Green Paper's proposal for federally regulated FHCs was, no doubt, related to this erosion or merging of the four pillars. Under the FHC concept, encroachment on the activities of other pillars would have to be undertaken through separate institutions subject to regulation by the relevant primary regulator. There are, to be sure, advantages to the FHC concept. Regulation would be simplified because, once again, monitoring by the primary regulators essentially collapses into regulation by function since cross-pillar operations must take place in affiliated institutions. But there are substantial drawbacks as well. We have already commented on the prescriptive and, hence, restrictive nature of the FHC structure. Moreover, since it would be federally regulated, the FHC construct represents an incursion into provincial regulatory authority which, if it does not lead to constitutional challenges, would at the very least generate a prolonged federal-provincial controversy that might unduly set back the updating of legislation that trust companies and insurance companies have been awaiting for roughly a half century.

There are, however, other grounds on which to challenge the FHC approach. The Committee is of the view that the realization of the benefits of competition, innovation and efficiency requires that institutions have the flexibility to cater to the needs of their clients. We believe that cross-pillar activity and, more generally, institutional and structural flexibility to accommodate consumer demand is part of the solution rather than part of the problem in terms of the manner in which Canadian financial institutions can maintain world-class status.

Centralizing Regulatory Functions

An alternative regulatory approach to the proliferation of cross-pillar activities is to create one all-encompassing regulating authority. This is the approach of the House of Commons report with its NFAA. The Committee recognizes that there are some positive aspects of such an omnibus regulatory authority. Except for the securities pillar, which would remain under provincial jurisdiction, the NFAA would oversee the remaining pillars and any potential problems associated with cross-pillar activities could presumably be internalized within the NFAA. In our report on deposit insurance we have presented arguments why we believe that this approach is lacking. To these reasons we would add that there may be substantial advantages to a system of "competing" regulatory agencies. Provided that there exists a set of minimum requirements applicable to all deposit-taking institutions (and one role of the CDIC would be to ensure that there would be), there may be substantial benefits to having several regulatory authorities attempting to devise effective monitoring and control procedures, where demonstrably superior procedures would then presumably be adopted by all regulatory authorities.

Finally, it is not obvious to the Committee that the recent problems in the financial sector require an overhaul of the institutional framework. On the contrary, we believe that the existing institutional environment has served Canada well and that, while the recent financial institution failures reveal substantial inadequacies in the system, these inadequacies can be addressed effectively without a wholesale revamping of the institutional framework. Thus, the Committee's approach in the earlier report on deposit insurance and the approach that we adopt in the present report is consistent with, and builds upon, the historical development of federal and provincial roles and responsibilities in the financial sector. In adopting this approach, we are reflecting the views of the overwhelming majority of the witnesses who appeared before our Committee.

In terms, therefore, of our perspective on the role of regulators and, more generally, the regulatory system as they relate to ensuring consumer protection and system stability, we advance the following observations:

RECOMMENDATIONS AND OBSERVATIONS

1. **The Standing Senate Committee on Banking, Trade and Commerce views the historical evolution of federal and provincial roles in the regulation of the Canadian financial sector as an important ingredient of Canada's social capital. Hence, the reform of the Canadian financial sector should, as much as possible, respect the existing institutional and federal-provincial division of powers and responsibilities.**

2. **Accordingly, the Committee opposes the consolidation of regulatory/supervisory powers in a single, all-powerful regulatory agency.**

3. **Ensuring consumer protection and institution stability is best achieved by the introduction of greater discipline with respect to all four regulatory components — the Canada Deposit Insurance Corporation (CDIC), the primary regulators, the auditors and corporate governance — rather than placing excessive reliance on any one component.**

4. **If concerns such as solvency and self-dealing are to be addressed effectively, there must exist primary regulators with authority over the entire operations of the institution. Thus, the Committee favours the present system which aligns regulators and institutions according to the institution's core function. This practice of assigning separate primary regulators to each core function has come to be known as the "four-pillar" approach.**

5. **The forces of competition and technology are inducing financial institutions to undertake cross-pillar activities — activities that fall outside the competence and jurisdiction of the primary regulator. Given that the line of demarcation between various types of financial instruments is progressively more blurred, it is neither possible nor desirable to restrict an institution's activities to its core function. However, any such cross-pillar activities must be subject to monitoring by one of the primary regulators.**

6. **Thus, the challenge is to ensure that each dollar deposited with an institution is regulated somewhere while at the same time ensuring that this does not lead either to regulatory overlap or to the "un-levelling of the playing field".**

With these observations as backdrop, we now proceed to develop our recommendations with respect to the regulatory and supervisory system, beginning with a reiteration of our views on deposit insurance.

B. DEPOSIT INSURANCE

In our Tenth Report, *Deposit Insurance*, we formulated 27 recommendations relating to all aspects of the structure, powers and operations of the Canada Deposit Insurance Corporation (CDIC). While it is inappropriate to reproduce all of these recommendations, it is important to outline in summary form the manner in which such a reconstituted CDIC would contribute to the enhancement of consumer protection and financial institution stability. Accordingly, the following recommendations and observations are designed to capture the thrust of the earlier report as it relates to the range of issues coming under the umbrella of the Green Paper.

RECOMMENDATIONS AND OBSERVATIONS

7. **The CDIC should be constituted as a separate institution with its own board of directors drawn from both levels of government, the private sector and member institutions.**

8. **The CDIC will function as an insurer. Its role shall be one of administering the deposit insurance funds. Since these funds are financed through premiums from insured institutions, the CDIC shall have the responsibility of acting as agent for these member institutions in managing and protecting the assets of these funds, for the ultimate benefit of insured depositors.**

9. **In the normal course of events the CDIC will delegate its regulatory powers to the primary regulators. In return, the primary regulators will be required to establish a set of arrangements that would operate as an "early warning system" to signal those institutions that may be experiencing problems.**

10. **The CDIC would become directly involved in the supervision and regulation of the institutions identified as potential problem institutions by the early-warning system. The range of powers that the CDIC would have in order to restore these institutions to financial health would include the authority to alter leverage ratios, the authority to issue cease and desist orders with respect to selected activities and/or practices and the authority to assemble its own qualified team of examiners.**

11. **If the CDIC determines that an institution is no longer insurable, this information will be communicated immediately to the relevant primary regulator and to the responsible minister. Normally, this would trigger the process of winding down that institution.**

12. **The possibility exists, however, that the government responsible for the institution will want to keep it in operation in spite of the fact that the CDIC deems it to be no longer insurable. The Committee believes that this is the government's prerogative. However, we also believe that, in all such cases, the CDIC's exposure with respect to such an institution must be limited as of the date of the notice to the relevant minister that the CDIC has determined that the institution is no longer insurable. Thus any further liabilities or exposure must be the responsibility of the relevant government.**

13. **The level of deposit insurance should remain at $60,000 until the reconstituted CDIC is in place and operating for at least one full year. Beyond this period, a majority of the Committee is in favour of full insurance up to $25,000 and 80 per cent insurance for the next $50,000.**

14. **The CDIC should operate on the basis of separate "pools" — one for banks, one for trust companies and one for credit unions. Losses by a member institution would be made up by a series of surcharges levied on other members of the same pool. The rationale for these segregated funds is that they will encourage a desirable degree of industry self-regulation. The CDIC would welcome the Canadian Life and Health Insurance Association (CLHIA) and the securities industry as members, but the Committee recognizes that these sectors prefer, at present, to operate their own consumer protection plans or funds.**

15. **Finally, the Committee views deposit insurance as a privilege, not a right. Thus, the CDIC must have the authority to set standards for insurability and, indeed, to refuse insurance to those institutions which do not meet these standards or whose primary regulators do not follow CDIC guidelines.**

The Committee assumes that Quebec will maintain its own deposit-insurance system. However, should Quebec decide to offer deposit insurance through the CDIC rather than through the Quebec Deposit Insurance Board, it would merit a place on the board of directors of the CDIC.

Underlying these proposals is our view that the role of an insurer is conceptually distinct from that of a regulator and a policy maker, although in practice these roles will overlap from time to time. Thus our recommendations for the structure of deposit insurance differ from those of the House of Commons report which integrates the regulatory and insurance function in one super body — the National Financial Administration Agency (NFAA). They also differ from the recommendations of the Final Report of the Working Committee on the Canada Deposit Insurance Corporation (The Wyman Report) which, over the short term, would have the CDIC assume very considerable regulatory powers and, over the longer term, would also fold insurance and regulation into a single agency.

With these recommendations we believe that we have substantially strengthened the role of the CDIC within the overall regulatory network. Moreover, the manner in which the CDIC is expected to interact with the other regulatory components, each of whose roles will also be strengthened, ensures that the effectiveness of the regulatory system will exceed the extra discipline that is brought to bear by each component.

We now turn to the second of the four components of the regulatory process, the primary regulators.

C. INCREASING THE EFFECTIVENESS OF PRIMARY REGULATORS

The Committee's approach to addressing the role of primary regulators is three-fold:

- first, to ensure that primary regulators have adequate technological and human resources to undertake effectively the monitoring and examining role under their existing powers;
- second, to enhance these powers where circumstances warrant; and
- third, to alter their monitoring procedures so that an effective early warning system is put in place and to establish a network of communication and information flow to and from the other partners in the overall process of regulating consumer protection and institution solvency.

We shall deal briefly with each in turn.

Exercising Existing Powers

There is a natural tendency in the wake of the recent financial-institution failures to argue for much greater powers for the primary regulators. In some cases this is clearly justified. In other cases, however, the problems were related not to an inadequate range of powers but rather to an inadequate exercise of existing powers. The Committee is not in a position to express an opinion as to whether this applies across the board, but, as a result of the in-depth review of the CCB and Northland Bank failures in connection with our *Report: Subject-matter of C-79,* it is evident that this was the case for the Office of the Inspector General of Banks (OIGB). Section 246(2) of the Bank Act requires that at least once each calendar year the Inspector General shall examine the affairs of each bank "for the purposes of satisfying himself that the provisions of this Act having reference to the safety of the interests of the depositors, creditors, and shareholders of the bank and other provisions of this Act are being duly observed and that the bank is in a sound financial condition."

To this end, the IGB is given unlimited access to the books, accounts and documents of a bank and is entitled to require the directors, officers and auditors of the bank to provide him with such information about the bank as he deems necessary. We have no desire to reiterate the litany of things that went wrong in the demise of CCB and Northland. Suffice it to say that the OIGB was unaware of the magnitude of the problems besetting the two banks and of the extent of the deficiencies in their internal policies and practices. Indeed, in his appearance before this Committee the Inspector General of Banks admitted that, in the case of Northland and CCB, the system of inspection and supervision had failed. To be sure there were plenty of extenuating circumstances associated with the failures: it may well be decades before a Canadian region once again experiences the magnitude of the recent and still on-going inflation-deflation cycle of property values and of key sector prices in Western Canada. Yet the fact remains that the resources and procedures of the OIGB were inadequate to the task. No doubt this was influenced substantially by the sixty-plus years without a bank failure and the tradition of dealing with large established banks that typically have in place satisfactory internal information and control systems. With the 1980 Bank Act revision, and the consequent issue of scores of new bank charters, the requirements on the regulatory process changed rather dramatically.

The essential point is that it is important not to overreact in terms of increasing the powers of primary regulators if indeed the problems lay elsewhere. In this regard the Committee notes with approval the recent initiatives by the Inspector General to improve the quality and timeliness of reporting by chartered banks, to introduce uniform accounting guidelines for loan losses and non- performing loans, and to ensure that his office receives on a regular basis the post-audit letters that shareholders' auditors send to management and the audit committee of the board of directors.

More generally, enhanced communication between the regulators and shareholders' auditors is essential to an effective supervisory system. As part of their normal duties, auditors are expected to evaluate the design and operation of internal systems of accounting and control in their client companies. They have an extensive knowledge of the plans and practices of the firms they audit. Short of duplicating their role, regulatory authorities must be able to rely on the auditors for the information they need to do their job adequately. Section 242(4) of the Bank Act already requires that the shareholders' auditors report to the OIGB "any transactions or conditions affecting the well-being of the bank that in their opinion are not satisfactory and require rectification". While the OIGB has other means of communication with the bank auditors, it is nevertheless a telling comment on the state of communication between these two links in the supervisory chain that apparently no report has ever been filed under this provision in many years. The recent failures of two banks have underscored the urgency of enhancing the lines of communication between the auditors and regulatory authorities and improving the flow of information between them.

RECOMMENDATIONS AND OBSERVATIONS

16. To a considerable degree, the recent problems in the financial sector appear to reflect not so much an inadequate range of regulatory powers as an inadequate exercise of existing powers. To the extent that this is the case, it is important that legislators do not react to recent events by endowing regulators with unnecessary and unwarranted powers.

This analysis should not be interpreted as implying that things are all right as far as the regulatory process goes. Obviously, things are not all right. However, there are costs to regulatory overkill, especially in terms of the efficiency and innovative capacity of the system. Significant increases in the powers assigned to regulators should be reserved to areas where they are absolutely essential. Some such areas clearly exist, as the next section indicates.

Increasing Existing Powers

The primary regulators, as well as the CDIC, must have sufficient powers to impose measures designed to restore problem institutions back to financial health. These will include powers such as the ability to alter leverage ratios and to issue cease and desist orders for certain activities and/or practices undertaken by institutions. As will be pointed out in a later section, they should also include the authority to monitor non-arm's-length transactions (NALTs) and the power to assess appropriate penalties relating to any transgressions.

It is probably not possible to devise a system of powers that will account for every eventuality. As the detailed testimony of the Superintendent of Insurance before the House of Commons Committee indicated, a review of the events associated with the various trust company failures revealed several instances where the regulators did not have adequate powers to prevent or terminate certain obviously inappropriate actions on the part of these institutions. In some of these instances, legislation has already been introduced to remedy the situation. In our review of the events surrounding the failure of CCB and Northland, we recommended that, where weaknesses are discovered, the Inspector General of Banks must have the power to require the transgressing institution to take the measures necessary to remove the identified deficiencies. However, consistent with the thrust of the present report, we also argued that it is important that increases in powers be limited to specific practices which impair the Inspector General's ability to monitor the soundness and solvency of a bank and should not be used to supplant management's prerogative to manage and direct a bank.

Finally, we wish to emphasize again that the primary regulators are only one part of the overall regulatory system. As the earlier recommendations indicate, the CDIC would also have substantial powers to deal with problem institutions. Moreover, the incentives associated with the operation of separate deposit insurance pools should ensure that the institutions themselves will take a very active interest in ensuring that the primary regulators have both resources and powers adequate to their task.

In the Committee's view the most serious weakness in terms of the existing regulatory framework is not that the powers of the regulators are inadequate. Rather, it is that there do not exist mechanisms and procedures that can identify problem institutions on a timely basis.

RECOMMENDATIONS AND OBSERVATIONS

17. Increases in regulatory powers should be restricted to those areas where existing powers limit the ability to monitor the soundness and solvency of an institution or to restore problem institutions to financial health. They should not be utilized to supplant management's prerogative to manage and direct an institution.

18. The most serious weakness of the existing regulatory framework is the lack of procedures or mechanisms to identify problem institutions on a timely basis.

An Early-Warning System

As indicated in the section dealing with deposit insurance, the primary regulators should be required to establish a set of reporting and monitoring arrangements that will operate as an early warning system to signal those institutions that may be experiencing problems. What we have in mind here goes well beyond the timely release and circulation of the traditional sorts of information flows. Specifically, the primary regulators would be required to develop a computerized data base relating to member institutions. Given the rapid spread of technology, this is hardly a tall order.

However, we recommend strongly that this be integrated on a periodic basis into an overall rating system for each institution. In this we are endorsing the suggestion contained

in the Wyman Report, which in turn draws from United States practice. Known as the CAMEL system after its five components (Capital adequacy, Asset quality, Management ability, Earnings quality, and Liquidity) the U.S. Comptroller of the Currency assigns a rating of 1 (good) to 5 (bad) for each of these five areas. As part of the U.S. regulatory system, the examining authority for member institutions that fall into the two lowest rating categories is turned over to the Federal Deposit Insurance Corporation. The Committee recognizes that such an early-warning and rating system would probably have to vary somewhat across the pillars in order to reflect the different characteristics of the core functions.

In our Deposit Insurance report, we also recommended that primary regulators ensure that member institutions for which brokered deposits exceed some minimum threshold be required to report this fact immediately and that such institutions then be kept under particularly close supervision. The existence of substantial brokered deposits need not imply that an institution is in trouble. Indeed, such deposits are an important source of funds for many institutions across the country. However, the fact remains that they are a very volatile source of funds and their presence represents a further potential early warning signal.

The Ontario Task Force carries this concern with brokered deposits much further. It recommends that institutions report the identity of such brokers and the methods and rates of remuneration that they are paying the brokers. In addition the Ontario Task Force recommends that these deposit brokers be required to register with the CDIC, one condition of which would be that a registrant disclose to clients a) the commission, if any, being paid by the financial institution taking the deposit, b) the commission rates of other financial institutions, and c) the extent to which deposit insurance is available in respect to the deposit. Without necessarily endorsing the Ontario Task Force's recommendations with respect to brokered deposits, we welcome them as further evidence that monitoring brokered deposits is an essential component of an effective early-warning system.

RECOMMENDATIONS AND OBSERVATIONS

19. Primary regulators must be required to develop a computerized data base to serve as the building block for an early-warning system. Other components of the system would include the monitoring of brokered deposits and the establishment of an institutional rating system modelled, for example, after the U.S. CAMEL system. (CAMEL is an acronym for Capital adequacy, Asset quality, Management ability, Earnings quality and Liquidity.) The CDIC would become directly involved in the supervision and regulation of institutions that fall below some minimum threshold level in terms of the rating system or, more generally, in terms of the indicators relating to the early-warning system.

D. AUDITORS

Upgrading Standards

The auditors represent the third set of players in the overall approach toward ensuring consumer protection and system stability. They are a pivotal information and monitoring link between the primary regulator on the one hand and the institution on the other. Hence, their role is critical to the working of the overall system. Evidence before us indicated that their procedures and practices in the two bank failures left much to be desired. Indeed, the Canadian Institute of Chartered Accountants (CICA) has recently appointed a special commission to review the role of auditors and to make suggestions for the improvement of auditing standards. We regard it as essential that the special commission's report and the ensuing CICA guidelines for auditors be adequate in terms of meeting the needs of the regulatory process. Nonetheless, the Committee offers the following observations with respect to the role and practices of auditors in relation to the overall regulatory process.

Enhancing Reporting Requirements

One of the current dilemmas is that managers of financial institutions have much better information on the degree of risk inherent in their portfolios than do depositors, regulators or the CDIC. This will always be the case unless techniques are put in place to assess more effectively the risk exposure and changing market values of assets and liabilities. Therefore, the Committee recommends that the CDIC, primary regulators, industry representatives and the CICA work together in developing reporting and assessment standards that will reflect more accurately an institution's exposure to risk. In practical terms, this means supplementing the existing audits, which are conducted on a "going concern" basis, with audits that reflect more accurately the current or market values of the assets of the institutions. The Committee notes that there is a considerable difference in the procedures currently applied to trust companies and banks in terms of the accounting practices for losses and non-performing loans, with the former having in place more demanding reporting requirements. While our general position is that uniformity of regulatory treatment across the pillars is not necessary, and in many cases not desirable, we believe that this area of provision for losses and non-performing loans is of such importance that the accounting procedures should become more uniform.

Appointment of Auditors

The Bank Act currently requires shareholders of a bank to appoint two firms of auditors. In our earlier report on the subject-matter of Bill C-79 we recommended that one of these two firms be appointed by the Inspector General of Banks. This recommendation is based on two principles: to enhance the independence of outside auditors and to encourage an audit perspective that takes into account the interests of depositors as well as shareholders. Unlike a somewhat similar recommendation in the House of Commons report, which would have the second auditor follow separate audit standards and report to the regulator rather than to management, we would leave audit and reporting standards the same for both auditors. However, as outlined above, we would also rely on an improved system of communication between auditors and regulators to ensure that the regulatory authorities acquire the information that they need to monitor effectively all institutions under their supervision.

This approach to auditing procedures should apply to all financial institutions.

Auditors and Audit Committees

As noted above, the auditing process constitutes a pivotal link among the primary regulators, the institutions and the market-place. We have already suggested that the post-audit reports to management and to the audit committee of the board of directors be provided to the primary regulators on a timely basis. In terms of the relationship between the auditors and the institution, we endorse the recommendation of the Ontario Task Force that it be mandatory that auditors attend all meetings of the audit committee of the board of directors.

There is, however, another important issue here that was raised by some of the witnesses that appeared before us and that was highlighted by the Ontario Task Force. This is the concept of "materiality," whereby auditors are required to comment on inappropriate procedures, practices or transactions only if they are of the opinion that these affect the institution in a "material" way. Our Committee is of the view that this places an inappropriate degree of judgmental responsibility on the shoulders of the auditors. This responsibility should be borne by the audit committee by establishing guidelines (to be cleared by the primary regulator) for the auditors as to what is or is not material. We recommend that the auditors be required to report to the audit committee of the financial institution all instances of self-dealing, malfeasance and transactions outside the apparent powers of the financial institution, subject to the guidelines established by the audit committee. As the Ontario Task Force notes, such an approach would allow the audit

committee to determine how to deal with these practices and to determine whether such practices are symptomatic of larger problems of the corporation that may need attention.

RECOMMENDATIONS AND OBSERVATIONS

20. The Committee recommends that the CDIC, the primary regulators, industry representatives and the CICA work together in developing reporting and assessment standards that will reflect more accurately an institution's exposure to risk. In particular, it is important that financial statements strive to reflect the current or market values of assets. This requires more uniform reporting across institutions for non-performing loans and provisions for losses.

21. All financial institutions should be required to submit to annual audits by two firms. One of these firms should be appointed by the primary regulator. The rationale for this recommendation is two-fold: first, to enhance the independence of auditors and, second, to encourage an audit perspective that takes into account the interests of depositors as well as shareholders. Unlike a somewhat similar recommendation by the House of Commons report, which would have the second auditor follow separate audit standards and report to the primary regulator rather than to management, we would prefer to have the audit and reporting standards and regulations remain as they currently are.

22. The Committee recommends that the auditors be required to attend the meetings of the institution's audit committee.

23. The present procedures whereby auditors report on inappropriate practices or procedures to the extent that they affect the institution in a "material" way place an inappropriate degree of judgemental responsibility on the auditors. The Committee recommends that the auditors be required to report to the audit committee all instances of self-dealing, malfeasance and transactions outside the apparent powers of the financial institutions, in accordance with the guidelines established by the audit committee.

24. Copies of the post-audit reports to management and the audit committee of the board of directors must be provided simultaneously to the primary regulator.

This focus on the role of the audit committee leads naturally into the next component of the overall approach toward consumer protection and institution stability, namely corporate governance.

E. CORPORATE GOVERNANCE

Standards of Care and Diligence for Directors

The Green Paper proposes to enhance the existing role of directors in the management of financial institutions. The Technical Supplement to the Green Paper provides the following rationale:

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

and the Bryce Royal Commission on corporate concentration advocated strengthening the role of boards of directors in monitoring the activities of management.) One argument for placing a greater burden of supervision on directors is that boards of directors for financial institutions are already charged with a fiduciary duty towards their corporations. There is, therefore, an existing base in law on which to build an enhanced role.

We agree with the Green Paper that the role of boards of directors should be enhanced in terms of providing internal scrutiny of the institution's operations. Our proposals along these lines will be outlined in the section focusing on self-dealing. However, prior to this, there are some other aspects of the Green Paper's recommendations with respect to directors that deserve attention.

Subsection 117(1) of the *Canada Business Corporation Act* (CBCA) expresses the director's duties as follows:

Every director and officer of a corporation in exercising his powers and discharging his duties shall:

a) act honestly and in good faith with a view to the best interests of the corporation; and

b) exercise the care, diligence and skill that a reasonably prudent person would exercise in comparable circumstances.

The Green Paper proposes to enhance the level of care, diligence and skill exercised from that of a "prudent person" to that of a "prudent and experienced person". We believe that this is too confining a requirement. While it is obviously desirable that many of the directors have experience in business, it is also desirable that boards of directors be able to accommodate a broader range of interests or skills. Accordingly, we recommend that directors exhibit, in exercising their powers and discharging their duties, a degree of skill that may reasonably be expected from persons of their knowledge and experience.

There is, however, one Green Paper recommendation relating to directors that we wish to support. This is the proposal relating to the indemnification of directors. As the Green Paper notes:

...the Bank Act contains comprehensive provisions for indemnification of a director against the costs and expenses incurred in respect of a civil, criminal, or administrative action to which the director was a party, where the defence was successful. Even if the defence is not successful, indemnification could be provided if the director acted honestly and in good faith with a view to the best interests of the institution, and if the director had reasonable grounds for believing that his or her actions were lawful. It would seem useful to provide such indemnification provisions for all directors of regulated financial institutions.

Such a provision will be particularly helpful in ensuring that qualified persons are attracted to serve on the Business Conduct Review Committee of the board of Directors, the role of which will be detailed in the following section.

RECOMMENDATIONS AND OBSERVATIONS

25. The Committee recommends that directors exhibit, in exercising their powers and discharging their duties, a degree of skill that may reasonably be expected from persons of their knowledge and experience.

26. The Committee recommends comprehensive indemnification provisions for a director of a regulated financial institution against costs and expenses incurred in respect of a civil, criminal or administrative action to which the director was a party if the director acted honestly and in good faith with a view to the best interests of the institution and if the director had reasonable grounds for believing that his or her actions were lawful.

Self-Dealing

Self-dealing is generally defined as a non-arm's-length transaction (NALT). This would include transactions of any kind between a financial institution and its principals. In turn, these principals would include major shareholders, directors or senior officers of the institution, or companies which the principals own or with which they are affiliated. NALTs would also inlcude transactions between a financial institution and its subsidiaries, affiliates, or holding company.

The Green Paper Position

Much of the Green Paper is devoted to various approaches to control self-dealing. Part of this concern arises from the fact that several of the financial-institution failures in recent years have been related to self-dealing. Part, also, arises from the fact that the proposed FHC structure would likely increase the potential for self-dealing. In particular, as the Green Paper notes, the existing rules governing non-arm's-length transactions do not cover the transfer of assets between a financial institution and its affiliated or controlling interests. Moreover, the Green Paper further notes that since NALTs may threaten the solvency of a financial institution, measures that attempt to deal with possible abuses of this nature through retroactive restitution to the parties damaged, be they depositors or minority shareholders, would tend to be inadequate and perhaps irrelevant. Hence, the Green Paper's recommendation is for a near-complete ban on all self-dealing.

Most witnesses before us questioned the wisdom of this approach. First of all, the potential efficiency and synergy gains that could arise from FHCs might well be dissipated by the ban on self-dealing. Second, given that the Green Paper would appear to allow greater leeway for transferring assets across subsidiaries when these subsidiaries are wholly owned, the overall result of the Green Paper's proposal might well be to trigger greater concentration of financial ownership. Third, as even the Green Paper recognized, not all NALTs are solvency-threatening and many may be conducive to efficiency. In recognition of these and other concerns, the Green Paper invited alternative proposals that would address the issues underlying NALTs. We now proceed to outline what we consider to be a preferable approach to self-dealing.

The Essence of the Self-Dealing Concern

We approach the general issue by noting that, in arm's-length transactions, the opposing interests of the parties to a transaction can be relied upon to ensure a reliable probability of a fair deal. In self-dealing situations, there is a risk that the decision can be biased to favour one party and against the interests of affected third parties such as the institution's minority shareholders and consumers of its financial services. The intent of our approach is to address directly the fundamental issue relating to self-dealing, which is the nature and quality of the self-dealing transactions and not self-dealing per se. Our objective is to prevent potentially "abusive" NALTs while allowing constructive ones to proceed.

RECOMMENDATIONS AND OBSERVATIONS

27. The Committee rejects the Green Paper proposal for a general ban on all non-arm's-length transactions (NALTs). Rather, the objective of an approach to self-dealing ought to be to prevent potentially "abusive" NALTs while allowing constructive ones to proceed. Toward this end the Committee proposes a three-pronged procedure that would incorporate a system of NALTs review. We also provide for appropriate regulatory oversight, safeguards, public redress and sanctions.

A Three-Tiered Approach to Self-Dealing

Tier One: A Selective Ban

The first tier of the procedure would involve an outright ban on a *selective* set of self-dealing transactions that by their very nature would jeopardize consumer protection and institution stability. Presumably, the activities covered under this selective ban would vary across the different types of institutions. For instance, the *Trust Companies Act* already incorporates prohibitions against lending to any major shareholders.

Initially, the list of restricted transactions would be developed by the CDIC, the relevant primary regulator or regulators, representatives of the CICA, and representatives of the financial institutions. Experience with the provisions may, over time, lead to additions or deletions from the list.

RECOMMENDATIONS AND OBSERVATIONS

28. The first tier is an outright ban on a selective set of self-dealing transactions that by their very nature would jeopardize consumer protection and the stability of the institution. Here, the Committee follows the recommendation of the House of Commons report that representatives from the primary regulators, the professional associations (including lawyers, accountants, appraisers and actuaries) and the financial institutions be involved in drawing up the selective list of prohibited transactions.

Tier Two: Business Conduct Review Committee

The second part of the procedure would require every financial institution to establish a Business Conduct Review Committee (BCRC) of the board of directors that would be charged to review in advance all non-arm's-length transactions to ensure that they do not either expose minority shareholders and consumers to abuse, or materially increase the risk of insolvency to the institution. In effect, this is a proposal for the control of self-dealing abuses through enhanced corporate governance.

The proposal follows closely the submission by the law firm of Goodman & Carr, which was included as part of the overall submission by the Department of Consumer and Corporate Affairs. The choice of the title, "Business Conduct Review Committee" is adopted from the submission by Royal Trust. We shall describe in general terms the structure, operation and duties of the BCRC, leaving the specifics to the accompanying set of recommendations and observations.

The BCRC shall be composed of "outside", "disinterested" or "independent" directors, with guidelines to ensure that these directors are indeed outside, disinterested or independent. The standard of duty and care to be exercised by these directors will not only apply to the financial institution but also to the users of the services of the corporation (e.g. depositors, policy and certificate holders). There will be a statutory requirement for all

directors, senior management, auditors, solicitors and other professionals of the financial institutions to disclose to the BCRC all related-policy transactions of which they are aware.

The role of the BCRC will be to assess all NALTs and to approve only those which are consistent with market transactions in terms of price, terms and conditions. Related-party transactions that are not approved by the BCRC cannot proceed. The BCRC will have the right to retain independent counsel, auditors, valuators and other professionals if and when the need arises.

RECOMMENDATIONS AND OBSERVATIONS

29. Every financial institution would be required to establish a Business Conduct Review Committee (BCRC) of the board of directors to review in advance all non-arm's-length transactions to ensure that they do not either expose minority shareholders and consumers to abuse, or materially increase the risk of insolvency to the institution.

30. The BCRC will be comprised of not less than three "outside", "disinterested" or "independent" members of the board of directors. A director is deemed not to be qualified to serve on the BCRC if:

- **he or she is an officer, employee, solicitor, auditor or has any professional association with the financial institution or an affiliate of the financial institution, or is a relative of any of the foregoing individuals;**
- **he or she is a significant shareholder in the financial institution, i.e. holds more than ten per cent of the outstanding voting shares individually or in combination with associates; and**
- **he or she has significant financial interests in or with the institution, e.g. a significant borrower.**

31. As a safeguard to assure the independence of BCRC members, the Committee proposes that provision be made for interested parties to be allowed to apply to the courts to determine whether members are truly independent and thereby qualified to act. This right could be exercised by the regulators, minority shareholders or the public.

32. The role of the BCRC is to ensure that all NALTs are consistent with the prices, terms and conditions that would prevail in arm's-length transactions.

33. The BCRC should have the right to retain independent professional counsel.

34. The BCRC would be responsible for establishing procedures and guidelines to ensure that all related-party transactions are brought to its attention for pre-clearance and either approved or disallowed.

35. If the BCRC disallows any NALT, the transaction cannot proceed.

36. The Committee recommends that there be statutory requirements for all directors, senior management, auditors, solicitors and associated professionals to report all related-party transactions to the BCRC.

37. All decisions of the BCRC will be reported immediately to the auditors, to the audit committee of the financial institution and to the members of the board of directors.

Tier Three: Pre-Clearance with the Primary Regulator

The third and final component of our proposal relating to self-dealing is pre-clearance with the primary regulator for certain sorts of self-dealing transactions. Included here would be certain types of transactions which, while in the normal course of events might be acceptable, would because of certain features or characteristics require pre-clearance by the regulators. Such transactions might include, drawing from the submission by Crownx:

- NALTs involving particularly sensitive assets such as real estate, or closely-held corporations or other generally illiquid assets for which there is no reliable independent basis of evaluation;
- individual transactions over a certain size or cumulative NALTs over a certain size (for example, the lesser of ½ of one per cent of assets or five per cent of surplus or any NALT which, together with previous transactions, results in a continuing investment in related party transactions above a given threshold).

In addition to these requirements, we support the recommendation of the House of Commons report that, beyond some minimum dollar threshold, all non-arm's-length transactions be pre-cleared with the primary regulator for some specified time period after the establishment of a new financial institution or upon a change in control of the institution. This will provide time for the new or newly acquired institution to develop the necessary procedures and expertise to establish a BCRC and it will also guard against those in control from siphoning off money from the institution to pay for the liabilities incurred in acquiring control.

RECOMMENDATIONS AND OBSERVATIONS

38. The third tier is a provision for pre-clearance with the primary regulator for certain sorts of self-dealing transactions. Such transactions would include:

- **NALTs involving particularly sensitive assets such as real estate, or closely-held corporations or other generally illiquid assets for which there is no reliable independent basis of evaluation;**
- **individual transactions over a certain size or cumulative NALTs over a certain percentage of assets; and**
- **all NALTs for a specified period of time after the establishment of a new financial institution or upon a change in control of an existing financial institution.**

Redress and Safeguards

As part of these self-dealing provisions, there must exist avenues for redress as well as civil and criminal provisions for enforcement and the imposition of penalties. Since it has been proposed that directors and officers have an obligation to advise the BCRC of any related-party transactions, it would be necessary that there be a legislative requirement to do so and that there be penalties for non-compliance. In addition to the criminal penalties which would result from improper related-party transactions, we propose that upon application from any member of the public or the regulatory authorities, the legislation confer on the court the power to set aside related-party transactions and to direct that the related party account to the corporation for any profit or gain realized in such transactions. This type of remedy is already available under the *Canada Business Corporation Act*. The regulatory authorities would also be given a clear mandate to punish institutions which engage in unwarranted related-party transactions. For example, repeated breaches of such rules may result in the

suspension of licence or in fines. Likewise, the primary regulator will have the right to suspend or remove BCRC members for violation of statutes, regulations and guidelines.

RECOMMENDATIONS AND OBSERVATIONS

39. The Committee proposes that, upon the application of a member of the public or the regulatory authorities, the legislation confer on the courts the power to set aside improper related-party transactions and to direct that the related party account to the institution for any profit or gain realized in such transaction. This type of remedy is already available under the Canada Business Corporation Act (CBCA), but it should apply to all regulated financial institutions.

Recapitulation

The Committee believes that with these provisions in place, all third parties and regulators would have a high degree of assurance that any self-dealing transactions are in the best interests of the institution, its shareholders, and its customers and are being carried out at prices that would fairly reflect those which would occur in arm's-length transactions.

Moreover, the Committee believes that in addition to being effective these provisions will, after some period of learning and education, prove to be not all that onerous. The earlier recommendation for indemnification of directors will help ensure that qualified persons will be attracted to serve on the BCRCs

However, in the final analysis it probably will be true that institutions will have to conduct their affairs with considerably more concern for their customers and for their minority shareholders. This is entirely appropriate if, at the same time, they are to be granted greater flexibility and maneuverability in the market-place.

RECOMMENDATIONS AND OBSERVATIONS

40. The Committee believes that with these provisions in place, all third parties and regulators will have a high degree of assurance that any and all self-dealing transactions are in the best interests of the institution, its shareholders, and its customers and are being carried out at prices that would fairly reflect those which would occur in arm's-length or market transactions.

41. Beyond some learning period, the Committee is of the view that financial institutions will be able to cope rather well with these provisions. Undoubtedly, it will be the case that these institutions will henceforth have to conduct their affairs with considerably more concern for their customers and minority shareholders. However, this is entirely appropriate since, as will be detailed later, the *quid pro quo* is greater flexibility and maneuverability in the market-place.

F. SELF-DEALING WITHIN A CONGLOMERATE

Should Holding Companies be Regulated?

The Green Paper proposes that a federally incorporated and regulated holding company would be required if a federally incorporated financial institution were among a group of two or more financial institutions that shared a common substantial shareholder. The definition of a substantial shareholder is one that holds more than ten per cent of the voting shares of each of the companies involved. The Ontario Task Force recommends that a provincial

holding company be required when the institutions operate under different legislation and are provincially chartered. Again the level of ownership that would trigger the holding company would be ten per cent.

In the view of the Committee, the net result of these recommendations would likely be a dramatic increase in the degree and scope of regulation. With a ten per cent threshold for triggering a holding company, it would be possible to have ten separate holding companies associated with a given institution. More likely is a situation where there could be several holding companies. If the institution is chartered provincially, it is also likely that some of these holding companies would be chartered federally and some chartered provincially, depending on where the associated institutions are chartered. Moreover, in large financial conglomerates there will be a pyramiding of holding companies. For example, Power Corporation is a holding company. So is Power Financial Corporation, which is 80 per cent owned by Power Corporation. So, too, is Montreal Trustco Incorporated, which is 15 per cent owned by Power Financial Corporation and 40 per cent owned by yet another holding company in the Power Corporation family (see Figure 1). Under the Green Paper proposals, it is likely that there would be still other, non-related, financial holding companies associated with either the subsidiaries or holding companies in the Power empire.

Before the system adopts this further layer of regulation, however, we believe that it is appropriate to question the rationale behind the proposal to regulate financial holding companies. The major concern appears to be related to self-dealing. However, each of the institutions coming under the umbrella of the holding company would have to abide by the comprehensive self-dealing regulations elaborated upon in the previous section. Since there are two sides to every transaction, each episode of potential self-dealing will be subject to scrutiny in at least one institution. And if the NALT is designed to be between two affiliated companies, it will come under the purview of *both* BCRCs. It seems to us that very little, if anything, is to be gained by subjecting holding companies to regulation as well. Moreover, the costs both in terms of regulation and efficiency are likely to be substantial and the potential for federal-provincial conflict great. Thus, the Committee rejects the concept of a regulated FHC.

RECOMMENDATIONS AND OBSERVATIONS

42. **The regulation of financial holding companies would add yet another substantial layer to the regulatory process. To the extent that the rationale for this is to control self-dealing, we believe that the concern is unwarranted given the previous recommendations addressing self-dealing. Since there are two sides to every transaction, each episode of self-dealing will be subjected to scrutiny in at least one institution and if the NALT is designed to be between two affiliated companies it will come under the scrutiny of both BCRCs. Accordingly, the Committee rejects the Green Paper proposal for federally regulated financial holding companies.**

Cross-Pillar Activity and Self-Dealing

Concerns relating to self-dealing are more acute for institutions that have operations in more than one pillar. This would include holding companies and it would also include financial institutions in one pillar with subsidiaries operating in another pillar. We recommend that where a financial institution has a controlling interest in another financial institution, then either the institution itself or its affiliate must have 35 per cent of its stock publicly traded. The rationale for this is to enhance the role of corporate governance in monitoring self-dealing. We believe that a public share ownership of 35 per cent is sufficient to ensure that professional financial analysts will monitor the operations of the firm. This added scrutiny and increased public awareness will provide yet another incentive for institutions to ensure that their BCRCs function properly.

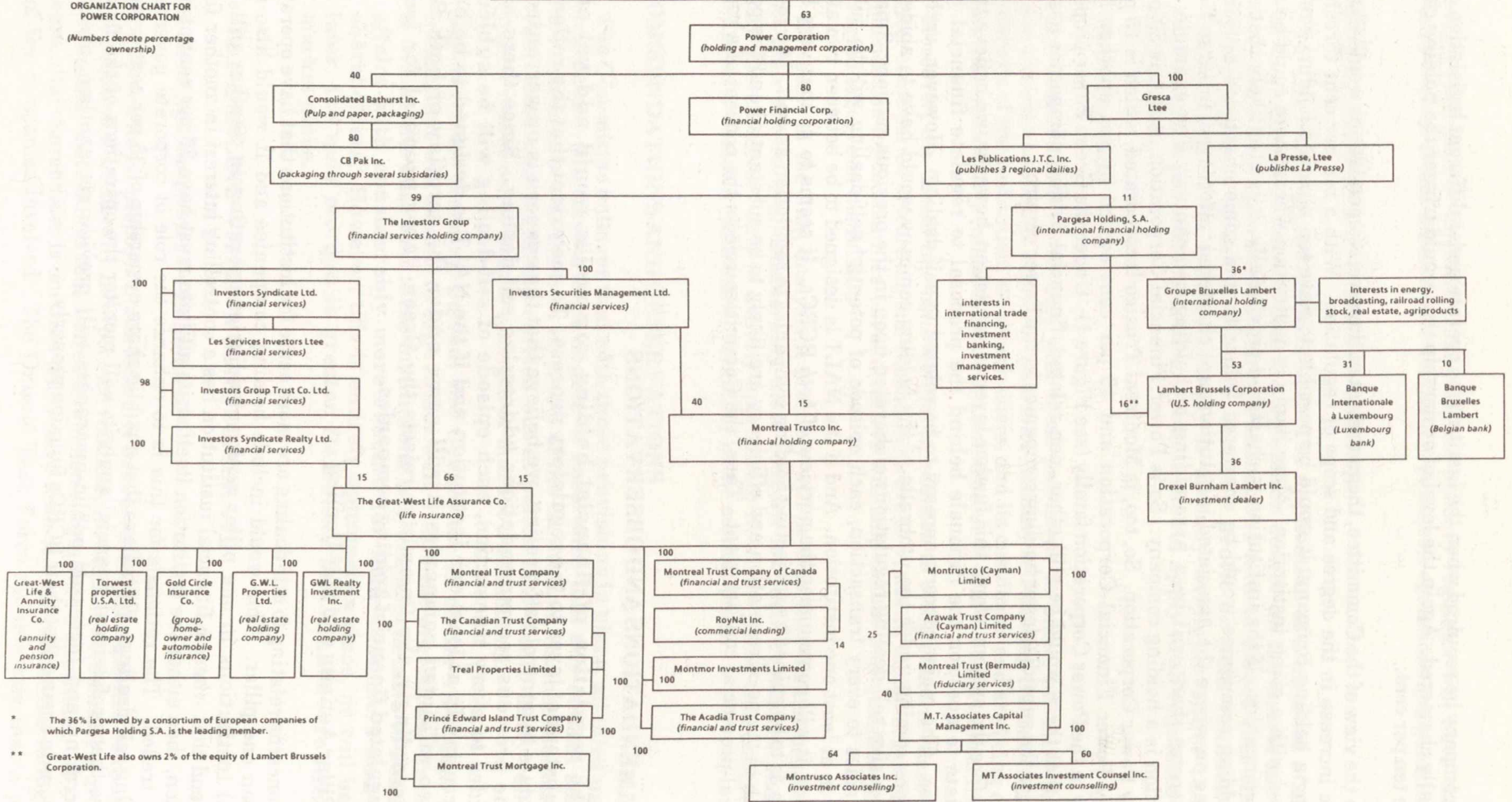

FIGURE 1 - ORGANIZATION CHART FOR POWER CORPORATION

(Numbers denote percentage ownership)

* The 36% is owned by a consortium of European companies of which Pargesa Holding S.A. is the leading member.

** Great-West Life also owns 2% of the equity of Lambert Brussels Corporation.

As an aside, it is important to note that this recommendation is designed to enhance corporate governance as it relates to self-dealing. It is not intended to reflect our judgement on the issue of the concentration of power in the financial sector. We shall have some comments on the concentration issue later. For now, we merely note that the Green Paper ignored the concentration issue entirely: it was not included among the underlying principles relating to financial sector reform.

Returning to the issue at hand, the implication of the 35 per cent provision can be elaborated by means of a few examples. If an insurance company were to acquire a trust company, then either the insurance company or the trust company must be publicly traded to the extent of 35 per cent. Hence, a publicly-traded financial institution could operate wholly-owned subsidiaries in another pillar. The same would apply to a holding company. If the holding company is publicly traded to the extent of 35 per cent, its subsidiaries can be narrowly held. However, if the holding is narrowly held, all of its subsidiaries must have 35 per cent of their shares publicly traded.

Schedule A banks are, of course, widely held. We deem mutual life companies and credit unions to be widely held as well. Hence any of these institutions would be able, under this provision, to hold wholly-owned subsidiaries in any pillar.

Where there is a difference between the percentage of shares publicly traded and the percentages of voting rights publicly traded, the 35 per cent rule applies to voting rights.

RECOMMENDATIONS AND OBSERVATIONS

43. Where one financial institution has a controlling interest in another financial institution operating in a different pillar, either the institution itself or its affiliate must have 35 per cent of its shares traded publicly. For financial conglomerates, if the holding company does not have 35 per cent of its shares traded publicly, all of its subsidiaries must be publicly traded to the extent of 35 per cent. Since schedule A banks, mutual companies and credit unions are, or are deemed to be, widely held they could, under these provisions, hold wholly-owned subsidiaries. The rationale for this provision is to enhance the role of corporate governance in monitoring self-dealing. A public share ownership of 35 per cent is probably sufficient to ensure that professional financial analysts will monitor the operations of the firm. This added scrutiny and increased public awareness will provide yet another incentive for institutions to ensure that their business conduct review committees function properly.

44. Where there is a difference between the percentage of shares publicly traded and the percentages of voting rights publicly traded, it is the latter that is the focus of our recommendation.

Financial and Non-Financial Activities

The issue relating to the commingling of financial and non-financial activities essentially relates to whether or not this occurs upstream or downstream. It seems appropriate that non-financial agents should be able to engage in financial activities provided they do this through a financial holding company structure. Either the financial holding company must have 35 per cent of its shares publicly traded or else all of its subsidiaries must have 35 per cent of their shares publicly traded.

What ought not to be permissible, however, is for institutions under a financial holding company to engage in non-financial activities. It is probably necessary to make some minor exceptions to this general prohibition in order to allow financial conglomerates to operate subsidiaries, such as data processing units, that are designed to service the needs of the

financial conglomerate or that derive from or are closely related to the principal operations of the financial conglomerate.

RECOMMENDATIONS AND OBSERVATIONS

45. Financial holding companies should be prohibited from engaging in non-financial activities. This general ban should not preclude allowing financial holding companies from operating subsidiaries, such as data processing units, which are designed to service the needs of the financial conglomerate or that derive from or are closely related to the principal operations of the financial conglomerate.

46. Non-financial institutions should be able to engage in financial activities provided they do so through a financial holding company structure. Either the financial holding company must have 35 per cent of its shares publicly traded or else all of its subsidiaries must have 35 per cent of their shares publicly traded.

G. CONFLICTS OF INTEREST

The very nature of a financial intermediary, interposed as it is between ultimate borrowers and ultimate lenders, involves potential conflicts of interest. Thus, the conflict-of-interest issue relates to preventing abuses of such conflicts since a complete removal of potential conflicts would require the elimination of financial intermediation. In the Canadian context, the concern over conflicts of interest tends to be focussed on the potential conflicts which result when institutions attempt to become involved in cross-pillar activities. We recognize these potential conflicts, but we also believe that the within-pillar conflicts are every bit as troublesome as cross-pillar conflicts. Through regulation and standards of professionalism, Canadians have long accepted that the brokerage and underwriting functions can be co-mingled within the same industry. Until very recently, however, the British have not allowed this combination. Similarly, the Americans appear to have no trouble accepting banking and trust activities in the same institution whereas Canadians have not allowed banks to engage in trust activities.

The Committee is of the view that the combination of enhanced disclosure, effective corporate governance and the establishment and monitoring of Chinese Walls represents an adequate approach to controlling conflicts of interest. This is particularly the case since many of the new cross-pillar activities will, as discussed in the next section, probably be undertaken through separate institutions which will be subject to the supervision of the respective primary regulators.

RECOMMENDATIONS AND OBSERVATIONS

47. The Committee is of the view that the combination of enhanced disclosure, effective corporate governance, and the establishment and monitoring of Chinese Walls represents an adequate approach to controlling abuses of conflicts of interest. This is particularly the case since many of the new cross-pillar activities will probably be undertaken through separate institutions which, in turn, will be subject to the supervision of the relevant primary regulator.

H. SUMMARY

Thus, the Committee proposes a balanced, multi-faceted approach to consumer protection, institution soundness and system stability. Each of the four players — the CDIC, the primary regulators, the auditors, and the institution itself via enhanced corporate governance — will have its role, power and responsibilities enhanced with respect to existing arrangements. This is especially the case for corporate governance. Discipline is introduced across all fronts with no single role pushed to an extreme. The Committee believes that the sorts of interactions we recommend for these roles will imply that the overall regulatory/supervisory system will be stronger than the mere sum of its components.

We are satisfied that we have put in place an effective supervisory and monitoring system so that we can with confidence now address some of the competition and efficiency issues related to the financial sector.

RECOMMENDATIONS AND OBSERVATIONS

48. The Committee is satisfied that the preceding recommendations will ensure an effective supervisory and monitoring system with respect to consumer protection, institution soundness and system stability.

Thus the Committee proposes a balanced, multi-faceted approach to consumer protection, institution soundness and system stability. Each of the five players — the CDIC, the primary regulators, the auditors, and the institution itself via enhanced corporate governance — will have its role, power and responsibility enhanced with respect to existing arrangements. The interaction of the various components ensures that there is a system of checks and balances with no single role player being overburdened. The Committee believes that the series of interlocking recommendations set out in this report ensures that the overall regulatory/supervisory system will be much strengthened and more conducive to achieving its objectives.

We are satisfied that we have put in place an effective supervisory and monitoring system, so that we can with confidence now address some of the competition and efficiency issues relating to the financial sector.

RECOMMENDATIONS AND OBSERVATIONS

46. **The Committee is satisfied that the preceding recommendations will ensure an effective supervisory and monitoring system with respect to consumer protection, institution soundness and system stability.**

PART II

ENHANCING COMPETITION

A. INTRODUCTION

Four of the nine principles enumerated in the Green Paper relate directly to competition and efficiency. These are:

- promoting competition, innovation and efficiency;
- enhancing the convenience and options available to customers in the market-place;
- broadening the sources of credit available to individuals and business; and
- promoting international competitiveness and domestic economic growth.

We endorse those principles, particularly in the context of the underlying competitive thrust of the Green Paper: "the challenge is to develop a regulatory approach that encourages, rather than inhibits, innovation and efficiency in our financial system while at the same time protecting the public." As the Green Paper further notes: "While regulation is needed to ensure soundness and consumer protection, market forces should have an important role in shaping the financial system because that will work in the direction of achieving the kind of dynamic and efficient financial system that our economy needs." We believe that our recommendations in Part I will "ensure soundness and consumer protection" so that we can with confidence now turn our attention toward enhancing the competitive and efficiency aspects of the financial sector. Hence, our goal in this section is to devise a set of arrangements that will allow the financial system to become more open, flexible and dynamic.

In pursuing these objectives, the Committee is working from a few additional principles or precepts. The first of these relates to the role of the financial sector. It is all too easy when discussing issues like the four pillars and the Canada Deposit Insurance Corporation to take the view that the object of the whole exercise is to create a set of structures within which financial institutions will prosper. But a sound and prosperous financial sector is of value to Canada only if it serves effectively its ultimate goal — to transfer funds efficiently from lenders to borrowers. Phrased differently, Canada's success as a trading nation will depend on its ability to compete internationally. In turn, this requires that the process of financial intermediation provide access to capital and credit for Canadian firms that, in terms of quality and price, are at least on a par with the opportunities available to our competitors in other nations. Thus, the critical issue is how well the Canadian financial sector is serving the

needs of Canadian savers and investors, not how well the financial sector is serving the needs or interests of the chartered banks, trust companies, insurance companies or securities firms. Relatedly, if policy-makers decide to maintain the four-pillar structure, it should not be because this makes life more comfortable for institutions and regulators; it must also be that this structure is deemed to be a highly effective and efficient way to transfer funds from ultimate lenders to ultimate borrowers. The role of financial intermediaries is to intermediate.

The second precept is that government policy in the financial area should avoid the imposition of a preconceived structure on the system. Technology is evolving too quickly and innovation is proceeding too rapidly for the policy authorities to attempt to straitjacket the system in any one direction. To be sure, policy in the financial area must ensure that certain priorities are maintained. Within such a legislative framework, however, the system should be free to evolve in response to market forces. In this observation we are fully in line with the views of the Green Paper.

Third, when the policy or regulatory authorities are presented with innovative types of institutions or products, the presumption ought to be that these innovations are acceptable unless they can be demonstrated to run contrary to the public interest. Unfortunately, it is all too often the case that innovators themselves are called upon, at considerable cost in terms of time and money, to demonstrate that their products or processes are in the public interest. This assigns a degree of optimality to the status quo that is clearly inappropriate in a fast-changing domestic and international financial environment. In other words, the overall policy framework for the financial system must, as the Green Paper stresses, encourage rather than inhibit innovation.

In general, Canadians have been well served by their financial institutions and many of these institutions are world class. Thus, the fourth observation in these times of rapid change in financial markets is that an overriding goal in redesigning the system must be to ensure that our successful institutions remain world class and that other institutions be permitted the flexibility to achieve this status. The final observation is related: when contemplating how to accommodate the changing needs of the financial market-place we ought to work from and build upon our existing strengths, whether these be institutional structures or time-tested processes. What this approach has to offer, in contrast to entirely new structures, is that monitoring is much easier, difficulties will be evident much earlier and, in the case of error, the process is more easily reversible.

Working from these and other considerations, the Committee offers the following analysis and recommendations relating to the structure of the Canadian financial sector. The discussion begins by focussing on the third of the Green Paper principles, namely how best to broaden the sources of credit available to individuals and business. In part, this is also related to the second principle, enhancing the convenience and options available to customers in the market-place. Our general conclusion is that, within an acceptable overall set of priorities, the system should be opened up to accommodate flexibility and diversity.

RECOMMENDATIONS AND OBSERVATIONS

49. The Committee endorses the principles relating to competition and efficiency enunciated in the Green Paper. However, in conducting the analysis the Committee was also influenced by the following concerns:

- **The ultimate role of the financial system is to transfer funds efficiently from lender to borrower;**
- **Government policy in the financial arena should avoid the imposition of a preconceived structure on the financial system;**

- **The policy framework for the financial sector must encourage rather than inhibit innovation;**
- **Any set of reforms must ensure that our successful institutions remain world class and that other institutions have the flexibility to achieve this status; and**
- **Where possible, the reform process ought to work from, and build upon, our existing strengths.**

B. BROADENING SOURCES OF CREDIT AND CUSTOMERS' OPTIONS

The Process of Financial Integration

The barriers separating the four pillars are rapidly eroding. Each pillar now offers products that have traditionally been the preserve of other pillars. Securities firms, for all intents and purposes, now accept deposits and, via networking, some now offer chequing privileges. Trust companies are increasingly involved in unsecured or commercial lending. Both banks and life insurance companies are engaging more and more in securities-related activities. The caisses populaires have diversification powers in terms of their assets somewhere between those of banks and trusts. Moreover, there now exists a range of specialty financial institutions that are difficult to classify in terms of the pillars and, as a result, sometimes go unregulated.

At the ownership or affiliated-company level the integration is even more pronounced. The high profile examples are of course the financial conglomerates which can incorporate insurance, trusts, commercial lending and leasing, and securities-related functions under their umbrella. But ownership integration across the pillars is not limited to these financial holding companies. Offshore, some of the chartered banks operate substantial and successful merchant banking (securities) operations. Indeed, in Australia for example, some of the chartered banks have subsidiaries in each of the pillars. Life insurance companies have long been able to own substantial portions of trust companies. In Quebec, this process of integration has been carried much further: mutual insurance companies can form downstream financial holding companies and can use this structure to branch into other pillars, the caisses populaires (or their *centrale*) own insurance and trust companies and most financial institutions can register with *la Commission des valeurs mobilières du Québec* as agents to manage individual securities accounts under the Quebec Stock Savings Plan. Quebec has even opened up ownership requirements as they pertain to securities firms.

An Approach to Institution Flexibility

Our view is that this integration will likely increase both in terms of range and complexity. In the face of consumer demands, technology and financial innovation, regulation will probably not be successful in stemming this tide. If by some means it does, it will likely be at the expense of the efficiency and competitiveness of the system.

The Green Paper's approach is to channel this thrust for integration through the avenue of federally regulated FHCs. As noted above, our concern is not with the concept of financial holding companies, but rather with the Green Paper's view that this represents the only acceptable avenue for integration or diversification.

From our perspective, the essential question is whether or not the regulatory system is capable of accommodating a more far-ranging approach to diversification. Not only do we believe that it is, but we are also of the view that greater diversification is consistent with one of the key aspects of the four-pillar approach, namely the assignment of primary regulators to particular types of institutions according to their core function. Phrased in a more positive manner this means that, from the vantage point of consumer protection and institution

stability, the financial sector is able to respond to market forces and that this response can encompass a variety of avenues.

Therefore, subject to certain criteria and priorities to be detailed later, the Committee welcomes all four general approaches to financial diversification:

- within-institution expansion of powers;
- subsidiaries;
- upstream and downstream holding companies; and
- networking.

In recommending this degree of structural flexibility, our position coincides with that of the House of Commons report.

RECOMMENDATIONS AND OBSERVATIONS

50. Subject to certain criteria and priorities to be detailed later, the Committee welcomes all four general approaches to financial diversification:

- **within-institution expansion of powers;**
- **subsidiaries;**
- **upstream and downstream holding companies; and**
- **networking.**

The following four sections will elaborate on these approaches in turn. While we shall address a wide range of issues as they apply to these alternative avenues for integration and to various financial sectors, we make no claim that the analysis is exhaustive.

C. EXPANDING IN-HOUSE POWERS

Commercial Lending

- **Trust Companies**

One of the expressed goals of the Green Paper was to accommodate the desire of trust and insurance companies to expand their commercial lending activities. After considering the possibility of an expansion of within-institution powers to allow greater commercial lending (but presenting no arguments against such a proposal), the Green Paper rejected this avenue in favour of the creation of a schedule C bank through which all additional commercial lending activity would be channelled. None of the representations we received from the institutions involved expressed support for this approach, although some welcomed it as an option along with expanded in-house powers. Among the many concerns was that some trust and insurance companies might not be able to become associated with a schedule C bank, so that as a result of the Green Paper proposals they might find their existing powers curtailed.

The Committee is of the view that a considerable expansion of in-house commercial lending powers is warranted. This conclusion is based on the following considerations.

First, trust companies in particular are currently faced with "matching" and diversification problems. Over the years the liabilities of banks and trusts have become more similar. Trust companies are more and more engaged in short-term deposit taking and they are in the forefront of many of the recent innovations relating to these transactions deposits. For their part, the banks moved aggressively in the direction of term deposits in the wake of the 1967 Bank Act, which introduced lower reserve ratios for these deposits.

The 1967 Bank Act also allowed banks to enter the mortgage market. And they were able to do this either through an expansion of in-house powers or via the creation of mortgage subsidiaries. That is, the Bank Act did not require that these increased mortgage activities be undertaken through a complex and mandatory set of new institutional arrangements.

With the banks now accounting for a significant share of the overall mortgage market, and with the demographics signalling a decline in the rate of growth of housing starts, the trust companies face growth constraints as well as diversification problems. It would appear that enhanced commercial lending represents an obvious solution to the dilemma facing trust companies. More commercial loans make eminent sense in terms both of matching the terms of assets with the terms of liabilities and of allowing greater portfolio diversification.

A second argument for an in-house expansion of commercial lending powers relates to the evolution of the financial sector. To be competitive in the 1980s requires that institutions be able to offer a wider range of services in order to cater to the needs of their customers. All financial institutions today offer a considerably broader range and variety of financial services than they did even a decade ago. This trend will surely continue, particularly since it is becoming progressively difficult in the face of financial innovation to draw a line between the instruments offered by the various pillars.

Third, it seems to us that an expansion of commercial lending powers will not present a serious problem for the trust company primary regulators. These regulators already oversee some commercial lending activities. Thus, commercial lending does not represent a cross-pillar activity in the important sense that it involves recourse to another primary regulator for monitoring.

Accordingly, we recommend that trust companies be allowed considerably enhanced powers to engage in commercial lending/leasing. Under the existing federal legislation as it pertains to federal insurance and trust legislation, commercial activities come under the "basket clause" which has an aggregate limit of seven per cent of assets. (A basket clause is a provision which allows financial institutions to undertake any investment or lending activities up to a specified percentage of total assets. The basket clause can be used to exceed the specified investment limits in any category or it can be utilized to invest in instruments not elsewhere specified. Since there is no category for commercial loans under the existing legislation, the basket clause allows trust companies to invest seven per cent of their assets in commercial loans.)

The House of Commons report recommends that trust companies have greater flexibility with respect to engaging in commercial loans. It does this not by specifying an asset limit with respect to commercial loans, but rather by broadening the basket clause to 15 per cent of assets.

The submission of the Trust Companies Association of Canada recommended that commercial lending and/or leasing activites be expanded up to a maximum of between 20 and 25 per cent of assets.

The Committee is of the opinion that the lower limits of the Trust Companies' recommendation would provide an appropriate degree of relaxation of the commercial lending limits at this time. The existing limits might be raised in stages, with permission to move to the upper end of the 20 per cent maximum requiring levels of capital above some minimum threshold.

- **Insurance Companies**

We believe that insurance companies also merit more flexibility in commercial lending/leasing. They already participate in the private placement market and the longer term nature of their liabilities allows them to enter the commercial lending/leasing market in a way that is not always readily open to banks or trust companies. In testimony before us, Mr.

Allen Lambert, Chairman of Trilon Financial Corporation, noted that London Life had that very day completed the purchase of a ship built at Sorel that would be leased on an 18-year basis. This is an activity where one might expect that insurance companies would be better positioned than would banks and trust companies, although some trust companies are already involved in these sorts of activities.

Thus, there are important niches of the commercial lending/leasing market which should be opened to insurance companies. The fact that the leverage ratios of life insurance companies are very low in comparison with those of trust companies and banks suggests to us that an expansion of in-house activities would be fully consistent with concerns relating to consumer protection and solvency and, of course, consistent with enhancing competition in these markets.

The Green Paper argues that the private placement activity of insurance companies be considered as part of their commercial loan activity for purposes of portfolio investment limits. We disagree with this: private placements should come under the designation of debt securities rather than commercial lending.

- **Credit Unions**

The caisses populaires in Quebec already enjoy substantial freedom to diversify their assets. The present Ontario legislation allows credit unions to engage in commercial lending up to seven per cent of unimpaired capital, deposits and surplus and, with the approval of the regulatory authorities, up to 15 per cent of this total. The Ontario Task Force Report reaffirms these regulations and recommends that credit unions be able to engage in commercial lending to non-members as well as members. In our view, credit unions should have the same commercial lending powers as trust companies, after the credit unions achieve some threshold value of capital.

These recommendations with respect to credit unions were influenced by the brief of the Canadian Federation of Independent Business which reported that its members in Quebec felt that the caisses populaires represented an important alternative source of finance. Appropriately regulated, the credit union movement in the rest of the country might also provide a similar alternative avenue for the financing of small business.

Our principal concern is that the regulation of credit unions needs to be enhanced in some provinces. However, if our recommendations with respect to deposit insurance are implemented, the reconstituted CDIC will have the authority to ensure that the credit unions and their primary regulators will have to meet the minimum CDIC standards in order to qualify for deposit insurance.

- **Summary**

The Committee is in favour of expanding the in-house commercial lending powers of financial institutions. To this end, the Committee supports the Green Paper view, expressed in the Technical Supplement to the Green Paper, that "it would be appropriate to shift the focus of the investment rules governing financial institutions away from the qualitative rules towards a quantitative or portfolio approach." As part of this approach, we recommend that each institution be required to strike an investment committee of the board of directors that in turn would establish prudent investment standards for the corporation. The characteristic of this portfolio approach is the establishment of limits with respect to the proportion of the portfolio that can be invested in each type of security.

As noted above, in terms of commercial lending/leasing, the Committee is willing to go somewhat further than the Ontario Task Force and the House of Commons report; including the basket clause, we recommend that these institutions be allowed to invest up to 20 per cent of assets in commercial lending or leasing. It is probably appropriate for regulators to establish certain stages, presumably based on capital thresholds or leverage ratios, by which

institutions would be able to achieve this maximum commercial lending flexibility. Our proposals are summarized in the following series of recommendations.

RECOMMENDATIONS AND OBSERVATIONS

51. The present qualitative approach to investment should be replaced by a quantitative or prudent portfolio approach that would be monitored by the investment committee of the board of directors. The essential features of this portfolio approach would be that quantitative limits would be established with respect to the proportion of the portfolio that can be invested in each type of security.

52. As far as the investment limits relating to commercial lending/leasing, the Committee is in favour of establishing an all-inclusive maximum of 20 per cent of assets for trust companies and insurance companies. It may be appropriate to have these limits escalate to the maximum levels in terms of a series of thresholds based, say, on the amount of capital.

53. Provided that the regulation of credit unions and caisses populaires outside Quebec satisfies the prudential standards established by the CDIC, the Committee is also in favour of expanding the commercial lending powers of credit unions, in phases again based on capital, up to a maximum of 20 per cent of assets. Since the regulations relating to credit unions are essentially in the domain of the provinces, this recommendation is directed principally to the CDIC in terms of the conditions on which it should be willing to accept credit unions for deposit insurance, other prudential considerations assumed to be in order.

Other Cross-Pillar Activities

There are other areas where integration across the pillars is being accomplished through within-institution diversification. This is particularly the case with respect to securities-related transactions. Virtually all of the other pillars are engaged to some degree in the brokerage or underwriting industry. Some of these activities relate to the so-called exempt market where, because of the nature either of the transaction or the securities themselves, certain participants and transactions are exempted from coming under the application of the provincial securities acts. Other financial institutions have been allowed to register with the provincial securities commissions as limited-service brokers — the chartered banks in respect of their discount brokerage services, and financial institutions in Quebec as agents to manage individual securities accounts under the Quebec Stock Savings Plan. The Committee recognizes that in the final analysis it is the provincial securities commissions that will determine the extent to which other financial institutions can undertake securities-related activities.

Nonetheless, we are in favour of a more open and flexible environment with respect to these activities. For example, as we have already argued, the life companies should be allowed to maintain and even expand their private-placement activities. However, it is essential that all such activities be monitored or registered with the respective securities commissions. In this sense, within-institution expansion of powers to allow greater participation in the securities sector will involve regulation by other primary regulators, unlike the earlier case for an expansion of commercial credit. We do not believe that this will pose a serious challenge to the regulatory process, since it essentially represents a modest expansion of the status quo in this regard.

Expanding the in-house ability of the other pillars to engage in trust activities is somewhat more problematical. In general, we would recommend that financial institutions, other than trust companies, wishing to engage in estate, trust and agency activities be

required to do so through affiliated institutions, whether these be subsidiaries or under the umbrella of a financial holding company. The rationale for this has to do with the existing scope and competence of the primary regulators. The trust company regulators already have to deal with commercial lending activities of trust companies under the provision of the basket clause. Expanding the commercial lending activities of trust companies represents only an extension of the present monitoring roles of these primary regulators.

The reverse is not the case, however. The other primary regulators do not, at present, monitor any estate, trust and agency activities. Hence, we prefer that if financial institutions desire to enter the trust business they do so via affiliated institutions which would then be subject to the trust company primary regulators.

However, even here it is difficult to draw a firm line. The House of Commons report recommended that the life insurance industry have trustee powers to administer funds payable on insurance contracts, registered pension plans and registered retirement savings plans. The House Committee based this recommendation on the fact that, given the diversification of powers for this industry recommended elsewhere in its report, these trustee powers seemed to represent a logical extension of the life insurance business. We concur.

RECOMMENDATIONS AND OBSERVATIONS

54. **There is probably scope for allowing greater in-house expansion of powers into other cross-pillar activities, provided that they are regulated or monitored by the responsible primary regulator. The Committee's approach is to be flexible unless a case can be made that such an expansion of in-house powers would run counter to the public interest.**

55. **The Committee concurs with the House of Commons report that life-insurance companies be allowed to act as trustee of funds payable on insurance contracts, registered pension plans and registered retirement savings plans. However, as a general rule, the Committee would prefer that institutions wishing to engage in the estate, trust and agency business do so through affiliated institutions rather than through an expansion of in-house powers.**

D. DIVERSIFICATION THROUGH SUBSIDIARIES

We have already signalled our support for financial intermediaries to diversify their financial activities through subsidiaries. However, following the recommendations of the House of Commons report, we also believe that the amount of equity investment in subsidiaries should be deducted from the base capital of the investing institution and that the equity level to trigger this treatment should be set at 20 per cent of the voting stock. The rationale for this is to avoid double leveraging, i.e. to preclude the investing institution from counting this investment as part of its own capital base as well as part of the capital base of the new institution. This will also ensure that only institutions with a strong financial base will be able to take advantage of diversifying through subsidiaries.

This recommendation is subject to the two constraints on ownership set forth in the preceding chapter. First, financial institutions should not be allowed to acquire non-financial subsidiaries, except to a minimal extent as outlined earlier. Second, if these subsidiaries fall within a different pillar from that of the investing institution, then either the investing institution or the subsidiary must have 35 per cent of its stock publicly traded.

For some parts of the financial sector, this recommendation amounts to supporting the existing legislation. For example, banks now hold mortgage subsidiaries. For other parts of the financial system, this recommendation would represent a fairly radical change. For

instance, without further qualification, it would allow a securities firm or a bank to acquire a trust company subsidiary.

Provincial authorities may not be willing to allow securities firms to diversify in this manner. Likewise, federal authorities may not give the green light to chartered banks to hold trust company subsidiaries. Our position on these issues is that the policy authorities should be required to make the case that such restrictions are in the public interest.

RECOMMENDATIONS AND OBSERVATIONS

56. Financial intermediaries should be allowed to diversify their financial activities through subsidiaries. However, subsidiaries of financial institutions should not be in the non-financial area, except to the limited extent referred to in the recommendations of the previous chapter. Moreover, the 35 per cent rule relating to publicly traded stocks will also apply: either the institution or the subsidiary must have 35 per cent of its stock publicly traded.

57. Equity investment in subsidiaries must be deducted from base capital in order to avoid double leveraging. A 20 per cent ownership stake in a subsidiary should be the threshold level for triggering this provision against double leveraging. This should ensure that only institutions with a strong financial base could take advantage of diversifying through subsidiaries.

E. HOLDING COMPANIES

The Committee recommends that diversification across the pillars also be allowed through both downstream and upstream holding companies. This recommendation is subject to the same sorts of restraints that apply to subsidiaries (e.g., no double leveraging, only related non-financial activities, and the ownership provisions as elaborated in the previous chapters). Since we are recommending a uniform approach to the disallowance of double counting of capital, there may be a case for special treatment of mutual-life companies and perhaps credit unions. The issue arises because mutual insurance companies and financial cooperatives are not able to readily raise outside capital. Thus, the Green Paper hints that the government might consider allowing double counting of capital by these institutions in respect of their investments in a downstream holding company. We disagree with this position. Our preference is to follow the House of Commons report in maintaining a uniform ban on double counting of capital, but allowing mutuals to issue preferred stocks and subordinated debentures.

These policy recommendations with respect to holding companies reflect, to a large degree, the status quo. The financial conglomerates already make extensive use of holding companies. Moreover, the caisses populaires in Quebec have utilized a downstream holding company route to acquire both a trust and insurance company.

We have already rejected the proposal that trust companies be required to conduct all additional commercial lending through a holding company and a schedule C bank. In large measure, this was because we believed that an expansion of in-house commercial lending powers was not only more appropriate but, as well, consistent with regulatory concerns. However, if institutions so desire, the Committee is in favour of allowing financial institutions to acquire the equivalent of a schedule B bank. Such banks could have a majority shareholder interest but they would be restricted in terms of asset size and branching. To go beyond these asset limits, the bank would have to follow the schedule A, widely-held route. Our rationale for this relates in part to the concern over regional banking. The schedule B route may provide an avenue for developing successful regional banks, particularly if they are offshoots of strong regional conglomerates. Moreover, they may represent an avenue whereby

an institution's overall asset portfolio may be diversified across regions. However, the likelihood is that there will not be too many takers for these schedule Bs.

RECOMMENDATIONS AND OBSERVATIONS

58. Diversification across the pillars by either upstream or downstream holding companies should be permitted.

59. Double counting of capital would not be permitted, even for mutual life companies and credit unions. However, these institutions should be allowed to issue preferred stocks and subordinated debentures.

60. For institutions desiring even greater commercial lending ability, a schedule B bank should be permitted as part of a holding company. Such banks would be restricted in terms of size. To exceed these limits would be possible only if they adopted the widely-held, schedule A route. The rationale for this approach is to encourage the development of regional banks as well as to allow regional institutions to use the schedule-B bank route to diversify their assets across regions.

F. NETWORKING

Networking is a term used to describe arrangements between financial institutions under which one of the institutions provides the public with access to products or services issued by the other. This type of arrangement can exist between affiliated or independent institutions. It provides an opportunity for independent and smaller institutions to offer a broader range of financial services than they could otherwise offer on their own account.

The Committee takes a very favourable view of networking. It is in the interest of consumers since it enhances product differentiation. This may be of particular importance in regions that have but one financial institution. Moreover, it allows an alternative form of diversification for financial institutions that desire to restrict their own operations to specialized areas.

We have two concerns relating to networking. The first is that tied selling be prohibited. Tied selling occurs when the sale of a good or service is conditional upon the purchase of other related goods or services. Suppose, for example, that a consumer wants to acquire a mortgage and also desires to have the mortgage insured in case of death. The institution providing the mortgage may have a networking arrangement with a particular life company that offers the package desired by the consumer. Tied selling would occur if the consumer could not obtain the mortgage unless he also took the specific life insurance contract offered by the mortgage lending institution, rather than an insurance contract that he/she had negotiated with an alternative insurance company.

The second, and related, concern is that the schedule of fees associated with networking be above board and be subject to monitoring by the relevant regulator.

RECOMMENDATIONS AND OBSERVATIONS

61. The Committee takes a very favourable view of networking, with two provisos. Tied selling must be prohibited and networking fees should be above board and subject to monitoring by the relevant regulator.

G. INTERNATIONAL ASPECTS

The Green Paper's proposal with respect to foreign ownership of life and trust institutions is to adhere to the existing arrangements, namely that transfer of ownership or control of existing Canadian financial institutions be restricted (or at least subject to ministerial approval) but that new entry be freely allowed. The Committee supports this approach.

The Green Paper's regulations relating the ownership of schedule C banks were of considerable concern to insurance companies. Under the proposed provisions, some insurance companies, because of their international linkages, would be precluded from the schedule C option. In turn this raised the possibility of reciprocal restrictions in other countries. This should no longer be a concern under our recommendations, since the option of schedule B banks would be open to all institutions just as the present schedule B route is open to foreign banks.

In general, the Committee believes that in areas where Canadian institutions have a substantial foreign presence (e.g. banking, securities and insurance), financial sector policy should ensure that we do not take actions on the domestic front that will jeopardize the freedom of our own institutions to act offshore. In some of these areas our institutions are clearly world class now and we must strive to preserve this. Moreover, for the chartered banks at least, foreign operations are likely to be one of the principal areas of expansion and growth.

Finally, the Committee endorses the view that mutual life companies incorporated in Canada be deemed Canadian institutions. The requirements that a majority of their directors be Canadian and that the head office be in Canada are redundant since these provisions are already part of the articles of incorporation.

RECOMMENDATIONS AND OBSERVATIONS

62. The Committee endorses the existing approach toward foreign ownership of Canadian trust and life companies; transfer of ownership or control of existing Canadian financial institutions to foreign interests should be restricted, or at least subject to ministerial approval, but new entry should be freely allowed.

63. Given the growing internationalization of the markets for credit and capital, Canadian regulatory policy should avoid initiatives which could result in our institutions being denied access to foreign markets.

64. Mutual life companies incorporated in Canada should be deemed Canadian institutions.

H. CAPITAL REQUIREMENTS

Many of the representations to our Committee argued for higher initial capital requirements for establishing financial institutions. We support such an increase in initial capital requirements. They would complement our provisions relating to consumer protection and institution stability. However, there is a clear trade-off here, since enhanced initial capital requirements will affect ease of entry. We would be concerned if these initial requirements were so high so as to unduly restrict entry.

RECOMMENDATIONS AND OBSERVATIONS

65. The Committee endorses the generally accepted view that higher initial capital requirements are required for financial institutions, but cautions against setting these requirements so high as to unduly restrict entry.

I. SECURITIES INDUSTRY

The Structure of the Securities Industry

Canada has one of the world's most efficient capital markets. This is a considerable achievement, given our population and geography. Some of our securities firms have important operations overseas and, in combination with the offshore merchant-banking activities of several of the chartered banks, Canada is developing a significant presence in international capital markets.

However, the structure of the securities industry in Canada is quite different from that of the rest of the financial sector. There are in effect two markets — the "registered market" or protected market which is open only to 100 or so Canadian securities firms and the "exempt market" which is open to the Canadian securities firms and to foreign securities dealers as well as to other financial institutions. Transactions can qualify for exempt-market status either because of the nature of the securities (e.g. government bonds) or because of the size of the transactions (generally those in excess of $100,000 are exempt).

In Ontario, registration for the protected market requires satisfying certain professional and prudential criteria (e.g. education standards, bonding requirements, capital requirements). In addition, registration carries with it ownership requirements. No single investor, financial intermediary, or group of investors not registered as industry participants can own more than ten per cent of the shares of a registered securities firm. Non-resident investors must also abide by these provisions and in addition they are restricted in aggregate to a 25 per cent ownership limit. Finally, membership in the Investment Dealers' Association and the exchanges other than the Montreal Stock Exchange requires that securities firms abide by these or very similar provisions.

In Quebec the regulations are far more liberal. In principle a securities firm could be wholly owned by a financial intermediary, although any ownership stake beyond ten per cent must receive the approval of *La Commission des valeurs mobilières du Québec*. Thus far, none of the Quebec-based full-service securities firms has more than ten per cent of its ownership held by a non-industry owner. Part of the reason for this is that a share larger than ten per cent held by an outside owner would mean that the securities firm would no longer be able to trade as a member of the Toronto Stock Exchange. Most of the other provinces have no specific ownership rules, in large measure again because if these firms want to trade on the Toronto Stock Exchange they must conform to Ontario rules.

The Increasing Foreign Penetration

The result of this structure has been an increasing foreign presence in the Canadian securities business. Compared to a decade ago, foreign securities firms now account for a very large proportion of the exempt market activities. In certain areas, such as government and corporate issues in the Eurodollar market, foreign dealers dominate Canadian securities firms. So do the offshore merchant-banking subsidiaries of some of the chartered banks (e.g. Orion Royal and CIBC Limited). Indeed, some of the schedule B banks, such as Citibank, are also beginning to enter the exempt markets in a major way.

Several Canadian securities firms have responded to this situation by arguing for a much freer operating environment. Basically, they want flexibility (in terms of ownership) and powers similar to those of securities firms in other jurisdictions. Their fear is that

without this flexibility they will continue to lose Canadian clients to foreign firms. With the growing internationalization of the markets for credit and capital, these concerns are viewed as progressively more acute.

However, the majority of Canadian securities firms appear to be reacting to this foreign penetration by calling for increased protection. Specifically, the industry position as reflected in the 1984 report of the Joint Securities Industry Committee (*Regulation and Ownership of Market Intermediaries in Canada*) recommended that the registered market be expanded significantly to encompass much of the present exempt market. In effect, under this proposal the 10 per cent ownership limits would become binding across a much wider range of activities than at present.

This was followed by the 1985 Ontario Securities Commission report (*A Regulatory Framework for Entry and Ownership of the Ontario Securities Industry*) which argued for an opening up of ownership restrictions and for a new category of registrant — the foreign dealer registrant. These foreign dealers would be full service brokers but would be limited, individually and in the aggregate, in terms of the amounts of capital they could put in place in Canada. Essentially, this would be equivalent to the schedule B bank solution applied to the securities industry.

Thus far, the government of Ontario has not introduced any legislation in this regard.

The Approach of the Official Reports

We recognize fully that in expressing views in this area we are treading upon the legislative domain of the provinces. Yet the securities industry plays such a pivotal role in Canadian capital markets that no overview of the regulation of the Canadian financial system can be complete without some reference to the operations of securities markets. An efficient securities industry is essential to Canada's competitive position. In these times of on-going economic restructuring, both at home and abroad, it is paramount that Canadian firms, regardless of size, have access to equity capital on terms that are at least as favourable as those available to competing firms abroad. Following from the first principle enunciated in the introduction to this chapter, the regulatory role as it applies to the entire financial system, including the securities industry, is to ensure that Canada achieves allocative and operational efficiency in the provision of capital. The Ontario Securities Commission in its 1985 report made this point more forcefully: "Our task is not to exercise our powers to protect any particular group of participants in the capital markets. Our responsibility is to create a structure which encourages the efficient operation of the capital markets." We concur.

Prior to making our own suggestions with respect to the securities industry, it is instructive to review the recommendations of the other official reports. The Green Paper's approach to the securities industry was one of enhancing flexibility subject to provincial approval: "The federal government does not want to interfere with provincial policies in respect of the ownership of securities dealers and, therefore, proposes to allow investment in securities dealers' equity by financial holding companies, to the extent permitted by the various provincial jurisdictions".

The House of Commons report devotes only two paragraphs to the securities industry, largely because it deems this sector to be the regulatory preserve of the provinces. Nonetheless, in principle, it believes that the overall emphasis in its report on opening up the financial sector should also apply to the securities industry.

Not surprisingly, the Ontario Task Force report feels more at home in addressing the regulation of the securities industry. Its recommends that non-industry investors, including financial intermediaries, be permitted to own, in aggregate, up to 49 per cent of a securities firm with no one single non-industry investor allowed more than 20 per cent of the voting rights. This represents a modest increase in integration at the ownership level. Along with this enhanced ownership the Ontario Task Force recommends that a securities firm be

prohibited from underwriting any securities of institutions that hold more than 10 per cent of voting rights of the firm. This concern relates to self dealing and we would support such a provision in the event of the opening up of the securities industry.

The Committee's View

Hence, the thrust of all of these reports is toward some increased flexibility for the securities sector. Not only do we support these initiatives but we are willing to go somewhat further. We recommend that the federal government, in its consultations with the provinces, raise the issue of allowing even greater ownership participation in securities firms by other financial intermediaries, group investors and individuals. In particular, we see no reason why a securities firm could not be part of a financial holding company or a subsidiary of a financial institution operating in a different pillar. Although this would imply greater integration at the ownership level, it would be fully consistent with the four-pillar approach since the primary regulators, that is the respective provincial securities commissions, would still have exclusive regulatory control over the core function of the industry.

In other words, while there may be some concerns relating to the intermingling at the ownership level of financial intermediaries and market intermediaries, these have little to do with the preservation of the four pillars. Indeed, one of the arguments that the Green Paper made to buttress its proposal for federally-regulated financial holding companies was that this type of ownership integration would be fully consistent with the four-pillar approach. We believe that the same is true in the securities industry: ownership restrictions may well be desirable, but they have nothing in principle to do with the preservation of the pillars and the concept of core-activity primary regulators.

We also believe that securities firms should have the flexibility that we have given to other financial intermediaries. This would include the ability to acquire ownership of trust companies and/or insurance companies either as subsidiaries or via downstream holding companies. It may be appropriate to stipulate lower leverage ratios for such subsidiaries over some phase-in period. The march of technology is such that securities firms now have the ability to provide services to their customers that exceed by a wide margin their traditional role. Maintaining their competitive position vis-à-vis other financial institutions and their foreign counterparts will likely result in continuing demands on the various provincial securities commissions for greater flexibility in their operations.

Finally, in terms of foreign ownership and foreign entry, the Ontario Task Force felt that this area was beyond its mandate, since the Government of Ontario already has a declared policy position on this issue. Without taking sides on this issue, the Ontario Task Force recommends that the Ontario government review its policy toward both foreign entry and ownership in the larger context of bilateral and multilateral trade negotiations as they relate to services. Our Committee welcomes this call by the Ontario Task Force for a review by Ontario of this policy.

RECOMMENDATIONS AND OBSERVATIONS

66. The Committee recognizes that policy with respect to the securities industry falls under the legislative domain of the provinces. Nonetheless, the securities industry plays such a pivotal role in Canadian capital markets that no overview of the regulation of the Canadian financial system can be complete without some reference to the operations of securities markets.

67. The Committee also recognizes that the Green Paper and the House of Commons report appear in principle to be willing to include the securities industry as an integral part of their overall designs for reform. In particular, should the provinces be willing, these reports would allow securities firms to come under the umbrella of a financial holding company (the Green Paper and

the House of Commons report) or become a subsidiary of a financial institution operating in a different pillar (the House of Commons report).

68. Consistent with the general approach we have taken to the opening up of the financial system, the Committee recommends, for consideration by the provinces:

- **that securities firms be treated like any other financial institution in terms of being able to be part of an upstream or downstream holding company or subsidiaries of a financial institution operating in another pillar; and**
- **that securities firms themselves be given powers similar to those of other financial institutions in terms of being able to acquire subsidiaries and to form downstream holding companies.**

69. The Committee welcomes the call by the Ontario Task Force that the province of Ontario review its policy with respect to foreign ownership of securities firms.

J. CHARTERED BANKS

The focus of the Green Paper is basically on the financial structure as it relates to institutions other than chartered banks. Presumably the federal government's detailed proposals with respect to banking powers will arise in connection with the decennial review of the various banking acts. However, there are a few issues relating to the chartered banks that merit attention in connection with the reform of the rest of the system. Indeed, some of these were addressed, albeit briefly, in the Green Paper.

The first issue relates to the statutory reserve requirements imposed on chartered banks. The second issue has to do with the scheduling of the decennial Bank Act revision in relation to the updating of the legislation for trust and insurance companies. Finally, we feel that it is appropriate to make a few observations with respect to the powers of chartered banks.

Reserve Requirements and the Level Playing Field

Our recommendations would allow trust companies, insurance companies and credit unions expanded commercial lending powers. However, under present arrangements, trust companies, for example, would not be subject to the requirement of holding non-interest-bearing reserves that applies to the chartered banks. In this sense, the playing field is not level.

This issue is not as straightforward as it might initially appear. First, since the chartered banks carry out the bulk of their mortgage lending through subsidiaries and since the deposits of these subsidiaries are not subject to reserve requirements, the banks and trust companies are on an equal footing here. Second, other institutions also hold reserves, but a substantial portion of these normally earn interest. For example, in addition to their currency on hand, trust companies usually hold liquid deposits with chartered banks on which they receive interest. Hence, the extent of the inequity is related to a) the interest foregone by virtue of the fact that chartered bank reserves at the Bank of Canada pay no interest and b) the fact that the reserve requirement provision may force the banks to hold more in reserves than they would voluntarily hold.

The Green Paper recommended that statutory reserves should be required only against deposits that have a term to maturity of less than one year. This may well be an appropriate

recommendation in terms of reducing the "tax" on chartered banks. However, it would serve only to alleviate the inequity vis-à-vis trust companies, not to remove it.

An alternative approach, mentioned by some of the witnesses who appeared before us, would be to subject all members of the Canadian Payments Association to reserve requirements. This would indeed level the playing field, but at the likely cost of a federal-provincial confrontation. A similar recommendation was introduced in the context of the parliamentary discussions relating to the formation of the Canadian Payments Association (CPA). The provision was rescinded, in part because of the strenuous objection by some provinces that the CPA was being utilized to subject provincial institutions to federal regulation. In part, also, the measure was rescinded because the Governor of the Bank of Canada argued that, for purposes of monetary control, restricting reserve requirements only to the chartered banks posed no problem.

There is, however, an obvious solution. The Bank of Canada should pay interest on that portion of chartered bank required reserves that the banks hold on deposit with the Bank of Canada. This interest rate could be somewhat below market rates because the banks do get some *quid pro quo* from this arrangement. Since trust companies tend to hold their reserves in excess of currency needs in the form of chartered bank demand deposits, the Bank of Canada might look to the interest rate on these demand deposits in setting the interest rate on the chartered bank reserves on deposit with the Bank of Canada.

In order that this alteration be consistent with the maintenance of Bank of Canada monetary control, it is essential that the interest be paid only on the portion of chartered bank deposits at the Bank of Canada that they are required to hold. Interest must not be paid on any excess reserves held with the Bank of Canada. This will ensure that the Bank of Canada's ability to exercise its monetary control function will not be impaired.

RECOMMENDATIONS AND OBSERVATIONS

70. The fact that the chartered banks are required to hold part of their reserves in the form of non-interest-bearing deposits with the Bank of Canada serves, in effect, to levy a tax on banks relative to other financial institutions. The preferred solution is for the Bank of Canada to pay interest on these reserves. Since trust companies, for example, typically hold some of their reserves with chartered banks, the Bank of Canada might look to the interest rate paid on these deposits when determining the appropriate interest rate to pay on chartered-bank deposits with the Bank of Canada.

71. Interest should not be paid on any chartered-bank excess reserves (i.e. reserves beyond those required) held on deposit with the Bank of Canada. Together, these two provisions — interest on required reserves and no interest on excess reserves — will ensure that the Bank of Canada's ability to exercise its monetary control function will not be impaired.

Extending Bank Powers

We have viewed the Green Paper as addressing the range of issues associated with the updating of the legislative frameworks for trust and insurance companies and not as a document that would form the basis for the decennial revision of the banking legislation. Hence, to this point we have refrained from making specific recommendations with respect to the powers that ought or ought not to be conferred on the banks.

Our general position is rather clear, however. We have put in place a set of policies and procedures with respect to consumer protection and institution/system stability that has allowed us to recommend that the financial system become more flexible and responsive to consumer demand and technology. In principle, there is no reason why these avenues for

flexibility should not also be extended fully to the banking sector. This is particularly the case since the widely held nature of the chartered banks ensures that there will be no concern that financial power will fall into the hands of a few "families".

When the discussions relating to the decennial revision of the banking legislation begin in earnest, we would hope that the presumption would be that the banks will be granted the full range of powers accorded to other financial institutions. In particular, we would like to endorse the Green Paper's suggestion to the effect that chartered banks along with other institutions should, the provinces willing, be able to expand into the securities area. It is hard to imagine that the substantial chartered-bank expertise associated with their offshore merchant-banking operations could not be put to valuable use in the domestic context. It would not make sense to allow Salomon Bros., Goldman Sachs and Citibank to set up domestic operations while denying this opportunity to the chartered banks, either directly or through their merchant-banking operations.

Finally, we see no reason for altering the ownership limits applicable to schedule A banks.

RECOMMENDATIONS AND OBSERVATIONS

72. In principle, there is no reason why the flexible approach which the Committee has outlined for the financial system should not apply to the chartered banks. Those who would wish to constrain the chartered banks in their sphere of operations should be required to demonstrate that an extension of bank powers would be contrary to the public interest.

73. This is particularly the case for the securities industry. If the provinces move to allow foreign securities firms and merchant bankers to establish domestic operations, then the Committee believes it is essential that the chartered banks, or at least their offshore merchant-banking subsidiaries, be allowed equivalent privileges.

74. The Committee recommends that the ownership restrictions applicable to schedule A banks remain in place.

The Legislative Timetable

The Committee's view is that priority must be assigned to the updating of the legislation for trust companies and life-insurance companies. The last major revisions were in 1913 and 1932 respectively. Thus, while it is only six years since the last Bank Act update, it has been, on average, 60 years for these other institutions. The legislative schedule may be such that, in opening up the system, the trusts and insurance companies will enjoy a head start on the banks for a year or two. However, it will probably take at least this long for the various provincial laws and regulations to fall in line with any new federal legislation, presuming that they will wish to mirror many of the changes. But our principal concern is not that the rest of the system get a head start on the chartered banks. Rather, it is that the new Bank Act legislation not become law before the trust and insurance legislation is updated.

RECOMMENDATIONS AND OBSERVATIONS

75. The Committee recommends that the updating of the trust company and life insurance company legislation take priority over the 1990 Bank Act revisions.

K. CONCENTRATION

The final issue we wish to address is the concentration of market and financial power.

The Green Paper is silent on this issue, although by its recommendation for FHCs it appears to be accepting the recent trends in the financial sector. For its part, the House of Commons report recommends that ownership become more widely held as the size of the financial institution or holding company increases. Specifically, domestic financial institutions with assets of less than $10 billion can be wholly owned. When assets exceed $10 billion, institutions will have to become more widely held until the $40 billion level is reached, at which point the House of Commons report argues for 10 per cent ownership limits.

The Ontario Task Force is in favour of widely held institutions. It offers no specific formulas for ownership, but it does argue that Ontario government policy should favour widely held institutions.

In Part I of this report, we argued that if a financial institution or a holding company controlled institutions operating in different pillars, then either the financial institution or the subsidiary must have 35 per cent of its stock publicly traded. For holding companies, either the holding company must have 35 per cent of its shares publicly traded or else all of its subsidiaries must have 35 per cent of their shares publicly traded.

The rationale underlying this recommendation had more to do with enhancing disclosure and public monitoring as a disincentive to self-dealing in financial conglomerates. But it also goes some way toward preventing wholly owned financial conglomerates and it does give Canadians an opportunity for equity ownership in the financial sector.

However, the question at issue is whether or not the Canadian financial sector is too concentrated. There are two quite separate issues here. The first has to do with whether there is a concentration of power in individual markets. We think that the answer here is "no". Consider the market for commercial lending. Trust companies, life insurance companies, chartered banks, credit unions, venture capital companies and foreign financial institutions (e.g. schedule B banks) all operate in the commercial lending market. It would be extremely difficult to make a case that there is a concentration of market power here. Much the same would apply to the other financial markets.

What is of potential concern, therefore, is the second issue, namely the concentration of financial power in the hands of a few holding companies or families. To address this issue the Committee will have to look into some or all of the following questions:

- Will the current trend toward financial conglomerates continue?
- Is concentration of ownership necessary for Canadian financial institutions to compete successfully in world capital markets?
- Is concentration of ownership of financial institutions likely to be self-perpetuating? Or is it likely that the power base will shift over time in the financial sector as it has in the non-financial sector?
- Does concentration of ownership mean that financial markets have become less contestable? The corollary to this is that as long as markets do remain contestable, then financial concentration will continue only to the extent that such concentration has the consumers' interests uppermost.

Moreover, the concerns with respect to concentration extend beyond the financial sector. One witness appearing before the Committee argued that concentration posed a greater problem in the non-financial sector than it did in the financial sector.

Therefore, apart from our 35 per cent provision, the Committee, like the authors of the Green Paper, remains silent on the issue of financial concentration. However, we take this opportunity to signal our intention to undertake a more thorough review of the concentration issue (both financial and non-financial) and its impact on the Canadian economy.

RECOMMENDATIONS AND OBSERVATIONS

76. The Committee is concerned about the degree of concentration in the financial sector. We take this opportunity to signal our intention to undertake a thorough review of the concentration issue as it relates to both the financial and non-financial sectors, including the issues raised by the commingling of financial and non-financial activities.

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PART III

FEDERAL-PROVINCIAL CONSIDERATIONS

A. FEDERAL-PROVINCIAL RELATIONS AND FINANCIAL SECTOR REFORM

In testimony before the Committee, trust companies and insurance companies were unanimous in expressing concern that the long-awaited updating of their legislative frameworks could founder on the shoals of constitutional or jurisdictional disputes between the federal and provincial governments. We believe that one of the distinguishing features of our report, in contrast to the Green Paper, the Wyman Report and the House of Commons report, is that our recommendations complement fully the existing federal-provincial allocation of powers and responsibilities in the Canadian financial sector. While we were cognizant at all times of the federal-provincial implications arising from these recommendations, the principal reason for working within the existing structure, rather than engaging in a process of constitutional or jurisdictional re-design, is our belief that the existing structure has served Canadians well. Although some of our recommendations with respect to consumer protection and institution stability will impose new attitudes and procedures, they essentially have the impact of ensuring that the time-tested arrangements in the financial sector are re-oriented to cope with the challenges of the 1980s and beyond.

Thus, we believe that the federal government can act on our recommendations now, confident that they respect the historical and judicial evolution of powers and responsibilities in the Canadian financial system.

This said, however, it is nonetheless critical to the efficiency of any set of arrangements that the system take steps to achieve harmonization and coordination among and between jurisdictions, policy makers and regulators. The purpose of this section is to address these harmonization and coordination issues, beginning with jurisdictional harmonization.

RECOMMENDATIONS AND OBSERVATIONS

77. **The Committee believes that the federal government can act now upon the foregoing recommendations, confident that they respect the historical and judicial evolution of powers and responsibilities in the Canadian financial system.**

B. JURISDICTIONAL HARMONIZATION

The Jurisdictional Mosaic

The federal-provincial jurisdictional labyrinth as it relates to the financial sector is probably more complex and layered than that of any other aspect of our federation. Some of the pillars are under the exclusive jurisdiction of either the federal government or the provinces. For example, banks are in the federal domain whereas the securities industry comes under provincial control. However, exclusive jurisdiction at the provincial level typically involves horizontal harmonization and coordination issues since there are multiple horizontal (provincial) jurisdictions.

For other pillars such as trusts and insurance, there is divided jurisdiction. Here, the harmonization and coordination problems typically involve both vertical and horizontal dimensions. For still other aspects of the system, one can find instances where jurisdiction is divided but the harmonization problems only have a vertical dimension; the existing deposit-insurance arrangements for trust companies would fall into this category, with Quebec-based trust companies coming under Quebec deposit insurance and with trust companies in the rest of Canada, whether chartered federally or provincially, coming under the CDIC. And so on.

Jurisdictional Harmonization and the Legislative Process

If history is any guide, it would appear that exclusive jurisdiction facilitates the legislative process. The legislation for both banks and the securities industry has been updated on a more or less continuing basis over the years. This has not been the case for the trust and insurance pillars. Divided jurisdiction, with its vertical and horizontal harmonization problems, would appear to be a recipe for legislative paralysis. In large measure, this is why we have placed such a premium on ensuring that the legislative framework for both federal trust companies and insurance companies be updated as soon as possible, including provisions for decennial review along the lines of the Bank Act.

It is important to point out that legislative paralysis need not imply a similar paralysis on the part of institutions caught up in the problem of out-of-date legislation. As the House of Commons report aptly notes: "Money knows no boundary. It is fungible and mobile. Technology only accentuates these qualities of financial assets." Hence, in the absence of legislative frameworks that run with the times, the institutions will simply innovate in creative ways in order to maintain their competitive position. The trust companies of the 1980s are very different creatures than were the trust companies of the 1930s. Yet the underlying legislation at the federal level has not been altered substantially over this period. Financial holding companies provide an even better example of the evolution of the financial sector in the face of outdated or, more precisely, no legislation.

However, while institutions will probably innovate on their own, an outdated regulatory framework may impose costs on this innovation, either because it has to occur through more inefficient channels than otherwise would have been the case or because of the uncertainty associated with the fact that legislative updating may render some of their existing operations illegal or inappropriate. In this sense, there can also be a cost to divided jurisdiction, at least to the extent that the requirement of both vertical and horizontal harmonization can lead to legislative stalemate.

Prior to addressing some of the advantages that can arise from divided jurisdiction, it is useful to focus on the concern most often raised by those who are in favour of centralizing the regulation of the financial system.

Jurisdictional Havens and Competitive Deregulation

One consequence of divided regulation, and in particular of provincial regulation, is the presence of multiple jurisdictions which, in the words of the House of Commons report, can

result in "varying enforcement of standards and the potential for institutions to seek shelter in jurisdictions of least regulation and supervision, which ultimately could threaten the solvency of financial institutions and overall confidence in the economy". Relatedly, and again from the House of Commons report, there exists the "potential for competitive deregulation which could distort the free flow of capital in the national context". We agree that these concerns are warranted and are also potentially very serious. One need only note that it probably was not accidental that IOS Limited chose to operate under a federal charter with a head office in New Brunswick.

However, centralization of regulation within a single federal agency also has potential drawbacks. Economic theory and practice have indicated that on many occasions regulation tends to be in the interest of those being regulated rather than in the public interest. Via regulation, institutions may earn excess profits at the expense of consumers of financial services. The existence of competing jurisdictions will help ensure that these excess profits are transferred to the consumers of financial services. There are many examples of this that can be drawn from recent Canadian experience. The Toronto Stock Exchange has added services to respond to the recent innovations undertaken by the Montreal Stock Exchange. The range of services offered by chartered banks has increased dramatically over the last decade, thanks in large measure to the aggressive behaviour of trust companies.

There may be a further advantage stemming from a decentralized approach to regulation. Trust companies in British Columbia can now engage in rather extensive commercial leasing. To the extent that this experiment proves successful, it paves the way for all jurisdictions to allow trust companies greater flexibility in this direction. In other words, multiple jurisdictions may be conducive to greater experimentation and innovation. The costs of an inappropriate expansion of powers may still be serious, but these costs would be localized and thus minimized in comparison to a situation where such an experiment were conducted nation wide.

It is not our desire to downplay the problems associated with divided or multiple jurisdictions. They exist and will continue to exist. What we want to emphasize, however, is that there are also advantages associated with multiple jurisdictions. And as our recommendations imply, we are not of the opinion that the Canadian financial sector regulatory framework for the 1980s requires any substantive alteration in the allocation of the jurisdictional authority over financial institutions.

We conclude this discussion of jurisdictional harmonization by focusing on two recent developments that respect, and indeed have entrenched, the existing jurisdictional approach to the financial sector.

CDIC, CPA, and Financial-Institution Jurisdiction

Prior to the last Bank Act revision the Canadian Bankers' Association was responsible for overseeing the cheque-clearing system in Canada. Only banks were allowed direct access to the clearing system. Near-banks were required to clear through a chartered bank. The new Canadian Payments Association (CPA) allows direct clearing for banks, trust companies and credit unions, although the latter have typically joined the system through their various centrals. The essential point for present purposes is that provincially incorporated and regulated institutions are now allowed direct access to the clearing system. Phrased somewhat differently, the clearing system has ceased to be a central institution and has become a "national" institution where access is not restricted to institutions that are federally chartered or regulated. This represents a significant step in the evolution of the Canadian financial system, particularly since it recognizes and entrenches the existing jurisdictional framework.

The Canada Deposit Insurance Corporation, established in 1967, also lends legitimacy to the existing jurisdictional allocation of powers in the financial sector. Our own proposals with respect to CDIC would move it even more in the direction of a national institution. By

inviting credit unions and caisses populaires outside Quebec to be members of the CDIC, albeit subject to overall CDIC regulation, by recommending provincial participation on the board of directors, and by establishing procedures whereby the CDIC can co-exist with the existing range of primary regulators, we are carrying one stage further this tendency to incorporate multiple and divided jurisdictions within an overall approach to the regulation of the financial sector.

RECOMMENDATIONS AND OBSERVATIONS

78. The Committee recognizes that the existence of multiple jurisdictions can and does complicate the operations of the Canadian financial sector. However, there may also be substantial benefits in terms of flexibility, innovation, experimentation and healthy competition. Moreover, the two most recent substantive alterations of the financial system, namely the advent of deposit insurance and the Canadian Payments Association, have been introduced in such a manner that they have served to endorse and even entrench the existing institutional and federal-provincial operating environment.

There is no question, however, that divided jurisdiction places substantial emphasis on regulatory coordination. To this we now turn.

C. REGULATORY COORDINATION

Exclusive Jurisdiction

Concerns relating to regulatory harmonization will likely be heightened when the coordination must take place between provincial and federal regulators. However, in many instances this harmonization or coordination has proceeded quite smoothly. For example, consider the interaction that occurs between the Inspector General of Banks and the provincial securities commissions with respect to new equity issues by chartered banks. While the IGB maintains jurisdiction over such equity issues, the securities regulators have not exempted the banks from prospectus requirements. Thus, both primary regulators oversee the issue of new equity issues, but for different reasons — the IGB from the vantage point of insuring the institutional integrity of the banks and the securities commissions from the vantage point of such things as disclosure in order to maintain the efficiency and integrity of the capital market. This co-existence of dual regulatory oversight has led to the adoption of procedures that are fully compatible and, in several aspects, identical. This example is instructive because it illustrates how regulation by function or activity (in this case the issue of securities) can complement regulation by institution or pillar in harmonizing regulatory procedures across jurisdictions and, more generally, across pillars.

Needless to say, not all cross-pillar regulatory overlaps, whether the regulatory overlap is vertical or horizontal, are resolved in as efficient a manner. The challenges to the overall regulatory system are two-fold. The first is to guard against situations where activities go unregulated because they fall into "gaps" between two regulatory regimes. The second is to ensure that where regulators overlap, any duplication is kept to a minimum. An important corollary of this second concern is that, where several types of institutions are engaged in the same activity, care should be exercised to ensure that a "level playing field" prevails. In an earlier chapter, we have commented upon the chartered banks' complaint that the existence of reserve requirements places them at a competitive disadvantage with respect to other institutions that provide a similar range of financial services. No doubt other such situations exist, so that the task facing the regulatory authorities is to strive for equitable as well as compatible procedures.

Multiple Horizontal Jurisdictions

The regulatory coordination problems when there is jurisdictional overlap or multiple provincial jurisdictions are somewhat different. The challenge here is to accommodate the interprovincial mobility of an institution's services without the need for incorporating in all provinces and, at the same time, to respect the provinces' rights to establish their own standards with respect to financial institutions chartered in their jurisdiction. Not surprisingly, perhaps, the degree of coordination is the highest where the market is clearly a national one, namely the securities market. The Canadian Securities Administrators, the association of provincial securities regulators, has effectively adopted the slogan "compatibility if not uniformity", with the result that the requirements for preparing prospectuses anywhere in Canada are not more onerous than is the case in the USA where control over the capital markets resides with the federal government.

In general, therefore, it is our view that there are mechanisms in place which, if utilized to the fullest, could go a long way towards coordinating regulations across jurisdictions. Obviously the ultimate goal would be to have a structure where regulations are sufficiently compatible that markets can become national. However, regulatory coordination can only do so much in terms of ensuring this compatibility. Regulators are subject to the overall policies of their respective jurisdictions. In the final analysis it is at the policy level where the system must strive for harmonization.

RECOMMENDATIONS AND OBSERVATIONS

79. The ultimate objective of regulatory coordination should be to create a structure where regulations are sufficiently compatible across jurisdictions that the markets can in effect become national markets. Some pillars are more advanced in achieving this goal than others. Frequently, however, the stumbling block is not that coordinating mechanisms are not in place, but rather that there is a lack of policy harmonization across jurisdictions.

D. POLICY HARMONIZATION

Harmonization at the policy level is at the same time the most important and the most difficult to achieve. The recommendations in our report would require substantial policy coordination across jurisdictions. For example, the proposals to require common reporting and auditing standards and the development of a computerized data base to facilitate the operation of an early-warning system cannot be left solely to the regulators for implementation. In these and in many other areas, regulators take their marching orders from their respective ministers, so that the policy authorities must be part of the overall coordination and harmonization process.

Moreover, even if there were full coordination across the various jurisdictions within each pillar, this might still generate problems for some cross-pillar activities which would have to be sorted out at the policy level. For example, the securities industry may have fully compatible regulations across the provinces in terms of how to deal with registration of limited-service brokers. Suppose the regulatory authorities for banks, for trust companies and for insurance companies also had provisions for this activity such that, for each of these pillars, regulations were compatible across jurisdictions. It might nonetheless be the case that the regulations applicable to banks when conducting such activities were more onerous than those for trust companies, even though all trust companies were treated equally, as were all banks. These level-playing-field problems are not likely to be resolved at the regulatory level. They require policy coordination.

Unfortunately, it appears to us that there is no mechanism or institution in place designed to harmonize and coordinate the financial environment at the policy level.

Accordingly, our final recommendation is that the federal government take the initiative to establish, with the provincial governments, a Permanent Committee of Ministers Responsible for Financial Institutions. Among other roles, this permanent committee would be responsible for adopting a national perspective on the markets in which financial institutions operate. There is now no one regulator or no one jurisdiction that is able to provide such a perspective, largely because the Canadian financial market is much more encompassing than the domain of any single regulator or jurisdictional responsibility. If policy can be harmonized at this ministerial level, the implementation then becomes a matter of ensuring that appropriate mechanisms and processes exist. In other words, for regulators to coordinate, legislators must harmonize.

RECOMMENDATIONS AND OBSERVATIONS

80. The Committee perceives that the institutional infrastructure designed to harmonize the financial environment at the policy level is, at present, inadequate. Accordingly, the Committee recommends that the federal government take the initiative to establish, with the provincial governments, a Permanent Committee of Ministers Responsible for Financial Institutions. This body would be responsible for achieving policy harmonization. In particular, it would be responsible for adopting a national perspective with respect to the markets in which financial institutions now operate. This global overview is essential since the Canadian financial market is much more encompassing than the domain of any one regulator or jurisdiction.

E. CONCLUSION

Harmonization and coordination are always more difficult in federations than they are in unitary states. That there are likely to be federal-provincial implications of policy decisions has long been a fact of life for Canadians. We understand the point of view that argues that Canada needs to move in a centralizing direction in the regulation of financial institutions. However, we have come to the conclusion that the existing federal-provincial allocation of powers and responsibilities in the financial sector has served Canada exceedingly well over the years. More importantly, we believe that the range of needed reforms in the areas of consumer protection, institution and system stability, and the enhancement of efficiency and competition can be achieved without any substantive alteration in jurisdictional responsibilities. What is required is not a redesign of the underlying structures or responsibilities in the financial sector, but rather a re-orientation of the existing structures in order to address the challenges of the 1980s and beyond. In this sense, the federal-provincial implications arising from our recommendations call primarily for renewed and creative efforts in reiterating the perennial problems of harmonization and coordination.

RECOMMENDATIONS AND OBSERVATIONS

81. The Committee concludes by reiterating its view that what is required on the federal-provincial front is not a re-design of the underlying structures or responsibilities in the financial sector, but rather a re-orientation of existing structures in order to address the challenges of the 1980s and beyond. In this sense, the federal-provincial implications arising from the preceding recommendations call primarily for renewed and creative efforts in addressing the perennial problems of harmonization and coordination.

APPENDIX A

WITNESSES

Issue No.	Date	Organizations and Witnesses
First Session, Thirty-third Parliament		
9	Sept. 25, 1985	**From the Canadian Bankers' Association:** Mr. Allan R. Taylor, Chairman of the Executive Council; President and Chief Operating Officer of the Royal Bank of Canada; Mr. Robert M. MacIntosh, President; Mr. Gilles Mercure, Vice-Chairman of the Executive Council; President and Chief Operating Officer of the National Bank of Canada; Mr. John Altenau, Chairman of the Schedule "B" Foreign Banks Executive Committee; President and Chief Executive Officer of Manufacturers Hanover Bank of Canada.
		From the National Bank of Canada: Mr. Gilles Mercure, President and Chief Operating Officer.
10	Sept. 30, 1985	**From the Toronto-Dominion Bank:** Mr. Richard M. Thomson, Chairman and Chief Executive Officer; Mr. A. Charles Baillie, Executive Vice-President, Investments; Mr. Robert J. McGavin, Vice-President, Public Affairs.
		From the Canadian Imperial Bank of Commerce: Mr. R. Donald Fullerton, Chairman, President and Chief Executive Officer; Mr. G.S. Cantor, Executive Vice-President; Mr. Clifford J. Shirley, Executive Vice- President.
11	Oct. 2, 1985	**From the Bank of Montreal:** Mr. W.D. Mulholland, Chairman and Chief Executive Officer; Mr. Lloyd Atkinson, Senior Vice-President and Chief Economist; Mr. Glenn R. Rourke, Senior Vice-President, Corporate and Government Banking.

Issue No.	Date	Organizations and Witnesses
		From the Bank of Nova Scotia: Mr. Cedric E. Ritchie, Chairman and Chief Executive Officer; Mr. J.A.G. Bell, President; Mr. R.L. Brookes, Executive Vice-President; Mr. Ramsay R. Holmes, Senior Vice-President, Planning and Legislation; Mr. Peter Nicholson, Executive Assistant to the Senior Executive.
		From the Royal Bank of Canada: Mr. Rowland C. Frazee, Chairman and Chief Executive Officer; Mr. Allan R. Taylor, President and Chief Operating Officer; Mr. Alex Thomson, Deputy Chief Economist.
12	Oct. 9, 1985	**From the Securities Industry Capital Markets Committee:** Mr. James B. Pitblado, Chairman; Chairman, Dominion Securities Pitfield Ltd.; Mr. Andrew J. Kniewasser, Member; President, Investment Dealers Association of Canada; Mr. F. Warren Hurst, Senior Policy Advisor, Investment Dealers Association of Canada.
16	Oct. 16, 1985	**From the Trust Companies Association of Canada:** Mr. William H. Somerville, Chairman; Chairman and Chief Executive Officer, National Trust Company; Mr. William W. Potter, President; Mr. John A.C. Hilliker, First Vice-Chairman; Chairman, President and Chief Executive Officer, Canada Permanent Trust Company; Mr. Michael A. Cornelissen, Second Vice- Chairman; President and Chief Executive Officer, Royal Trustco Limited; Mr. Alan R. Marchment, Immediate Past Chairman; President and Chief Executive Officer, Guaranty Trust Company of Canada.
		From Royal Trustco Limited: Mr. Hartland M. McDougall, Chairman of the Board; Mr. Michael A. Cornelissen, President and Chief Executive Officer; Mr. William J. Inwood, General Counsel and Secretary.
		From First City Trust Company: Mr. V. Edward Daughney, President.
19	Oct. 21, 1985	**From the Canadian Life and Health Insurance Association:** Mr. John S. Acheson, Chairman; President, Dominion Life Assurance Company; Mr. E. Sydney Jackson, Vice-Chairman of the CLHIA Task Force on Legislative Review; Chairman and Chief Executive Officer, Manufacturers Life Insurance Company;

Issue No.	Date	Organizations and Witnesses
		Mr. Gordon N. Farquhar, Representative of the CLHIA Task Force on Consumer Protection; Chairman and Chief Executive Officer, Aetna Canada;
		Mr. David Johnston, Member; Senior Vice- President and Actuary, Crown Life Insurance Company;
		Mr. John H. Watson, Member; Senior Vice- President, Investments, Confederation Life Insurance Company;
		Mr. Gerald M. Devlin, Q.C., Executive Vice- President, Staff Head;
		Mr. Jean-Pierre Bernier, Vice-President and General Counsel.
		From Canada Life Assurance Company:
		Mr. Edward H. Crawford, President;
		Mr. David Nield, Vice-President;
		Mr. Dan Needles, Director, Public Relations.
		From Metropolitan Insurance Companies:
		Mr. Charles Armstrong, President, Canadian Operations, Metropolitan Life Insurance Company;
		Mr. Claude Garcia, Senior Vice-President and Actuary, Standard Life Assurance Company; Mr. James Lewis, President, Canadian Operations, Prudential Insurance Co. of America.
		From Manufacturers Life Insurance Company:
		Mr. E. Sydney Jackson, Chairman and Chief Executive Officer;
		Mr. Thomas DiGiacomo, President and Chief Operating Officer;
		Mr. Yves Fortier, Director; Partner, Ogilvy Renault;
		Mr. Joseph J. Pietroski, Vice-President and Secretary;
		Ms. Jalynn Bennett, Vice-President, Corporate Development.
		From Household Trust Company:
		Mr. F.E. Silk, President;
		Mr. G.H. Archambault, Executive Vice- President;
		Mr. R.W. Stevens, General Counsel;
		Mr. N.W. MacLeod, Vice-President;
		Mr. D.J. Mickey, Controller.
21	Oct. 23, 1985	**From Mutual Life Assurance Company of Canada:**
		Mr. Jack V. Masterman, President and Chief Executive Officer;
		Mr. John H. Panabaker, Chairman;
		Mr. Duncan R. Winhold, Executive Vice- President;
		Mr. Claude Gingras, Vice-President and Chief Legal Counsel.
		From Sun Life Assurance Company of Canada:
		Mr. Thomas M. Galt, Chairman and Chief Executive Officer;
		Mr. John R. Gardner, Senior Vice-President and Executive Officer;
		Mr. Steven B. Browne, Vice-President, Investments.
23	Oct. 28, 1985	**From the Canadian Co-operative Credit Society:**
		Mr. Edward Grad, Chief Financial Officer, Ontario Central;

Issue No.	Date	Organizations and Witnesses
		Mr. Jonathan Guss, General Counsel and Vice- President;
		Mr. Paul Renaud, General Counsel, Cumis Insurance Company;
		Ms. Mary Lou Spence, Government Relations.
		From "La Confédération des caisses populaires et d'économie Desjardins du Québec":
		Mr. Hervé Hébert, President, "Fiducie du Québec";
		Mr. Georges-Octave Langlois, President, "Corporation de fonds de sécurité de la Confédération Desjardins";
		Mr. François Richard, Senior Vice-President and Chief Executive Officer, "Fédération des caisses populaires Desjardins de Montréal et de l'Ouest du Québec";
		Mr. Bruno Riverin, President and Chief Operating Officer, "La Caisse centrale Desjardins du Québec,";
		Mr. Yves Morency, Advisor;
		Mr. André Morin, Advisor.
25	Oct. 30, 1985	**Representatives from the Working Committee on the Canada Deposit Insurance Corporation:**
		Mr. Hugh M. Brown, Director, Burns Fry Limited;
		Mr. J.L.A. Colhoun.
28	Nov. 6, 1985	**From E-L Financial Corporation Limited:**
		Mr. Henry N.R. Jackman, Chairman and President.
		From Crownx Inc.:
		Mr. H. Michael Burns, President;
		Mr. R.W. Luba, President, Crown Financial Services; Chairman, Coronet Trust;
		Mr. Robert N. Granger, Vice-President and General Counsel.
32	Nov. 20, 1985	**From the Economic Council of Canada:**
		Dr. David W. Slater, Former Chairman;
		Mr. André Ryba, Director, 23rd Annual Review;
		Mr. Keith Patterson, Economist.
33	Nov. 26, 1985	**From the Canadian Institute of Actuaries:**
		Mr. Kenneth T. Clark, President Elect;
		Mr. Robin B. Leckie, Past President;
		Mr. Robert C. Dowsett, Past President;
		Mr. Brian Wooding, Executive Director.
		From the Canadian Institute of Chartered Accountants:
		Mr. A.M. Dilworth, FCA, Chairman, CICA Task Force to review the accounting and auditing implications of "The Regulation of Canadian Financial Institutions: Proposals for Discussion";
		Mr. D.H. Atkins, FCA, Member, CICA Task Force to review the accounting and auditing implications of "The Regulation of Canadian Financial Institutions: Proposals for Discussion";
		Mr. W.W. Buchanan, FCA, General Director of Research;
		Mr. John A. Carchrae, CA, Senior Research Manager.

Issue No.	Date	Organizations and Witnesses
34	Nov. 28, 1985	**From Trilon Financial Corporation:** Mr. Allen T. Lambert, Chairman; Mr. Melvin M. Hawkrigg, President and Chief Executive Officer; Mr. George B. Soteroff, Consultant.
45	May 1, 1986	**From the Department of Consumer and Corporate Affairs** Mr. M.S. Cappe, Acting Assistant Deputy Minister, Bureau of Competition Policy; Dr. R.S. Khemani, Chief, Special Studies and Contract Research; Mr. R.C. Atkinson, Former Director, Regulated Sector Branch. **From Fraser & Beatty:** Mr. Lawson Hunter, Q.C. **From Goodman & Carr:** Mr. Wolf D. Goodman, Q.C.

APPENDIX B

List of Submissioners who were not Witnesses

ALLENVEST GROUP LIMITED
BELL CANADA ENTERPRISES INC.
CANADA TRUSTCO MORTGAGE COMPANY AND THE CANADA TRUST COMPANY
CHAMBRE DE COMMERCE DU QUÉBEC
INSURANCE BUREAU OF CANADA
THE INVESTORS GROUP
MR. HENRY J. KNOWLES, Q.C. LLM, MBA
LAURENTIAN GROUP
MR. K.R. McGREGOR
SODARCAN INC.
TORONTO STOCK EXCHANGE

Respectfully submitted,

Lowell Murray, Chairman

MINUTES OF PROCEEDINGS

WEDNESDAY, FEBRUARY 5, 1986
(51)

The Standing Senate Committee on Banking, Trade and Commerce met at 3:30 p.m. this day *in camera*, the Chairman, the Honourable Senator Lowell Murray, presiding.

Members of the Committee present: The Honourable Senators Anderson, Barrow, Godfrey, Kelly, Kirby, MacDonald (Halifax) and Murray. (7)

In attendance: From the Department of Economics, University of Western Ontario: Professor Thomas J. Courchene, Advisor.

The Committee, in compliance with the Order of Reference dated June 25, 1985, resumed consideration of:

(i) the document entitled: "The Regulation of Canadian Financial Institutions: Proposals for Discussion", tabled in the Senate on 23rd April, 1985;

(ii) the document entitled: "Final Report of the Working Committee on the Canada Deposit Insurance Corporation (CDIC)", tabled in the Senate on 18th June, 1985; and

(iii) the subject-matter of bills, in advance of their coming before the Senate, and other matters relating to these documents.

It was—
Ordered, that the Committee meet *in camera*.

At 4:53 p.m., the Committee adjourned to the call of the Chair.

WEDNESDAY, FEBRUARY 12, 1986
(52)

The Standing Senate Committee on Banking, Trade and Commerce met at 3:30 p.m. this day *in camera*, the Chairman, the Honourable Senator Lowell Murray, presiding.

Members of the Committee present: The Honourable Senators Anderson, Barrow, Buckwold, Godfrey, Kelly, Kirby, MacDonald (Halifax), Murray and Perrault. (9)

In attendance: From the Department of Economics, University of Western Ontario: Prof. Thomas J. Courchene, Advisor; *From the Library of Parliament, Research Branch, Economics Division:* Mr. Basil Zafiriou, Chief.

The Committee, in compliance with the Order of Reference dated June 25, 1985, resumed consideration of:

(i) the document entitled: "The Regulation of Canadian Financial Institutions: Proposals for Discussion", tabled in the Senate on 23rd April, 1985;

(ii) the document entitled: "Final Report of the Working Committee on the Canada Deposit Insurance Corporation (CDIC)", tabled in the Senate on 18th June, 1985; and

(iii) the subject-matter of bills, in advance of their coming before the Senate, and other matters relating to these documents.

It was—
Ordered, that the Committee meet *in camera*.

At 4:59 p.m., the Committee adjourned to the call of the Chair.

WEDNESDAY, MARCH 5, 1986
(53)

The Standing Senate Committee on Banking, Trade and Commerce met at 3:30 p.m. this day *in camera*, the Chairman, the Honourable Senator Lowell Murray, presiding.

Members of the Committee present: The Honourable Senators Anderson, Buckwold, Flynn, Godfrey, MacDonald (Halifax), Murray, Perrault and Roblin. (8)

Other Senators present: The Honourable Senator Sinclair.

In attendance: From the Department of Economics, University of Western Ontario: Professor Thomas J. Courchene, Advisor; *From Martineau Walker, Montreal*: Mr. Gérald A. Lacoste, Counsel; *From the Library of Parliament, Research Branch, Economics Division*: Mr. Basil Zafiriou, Chief.

Witnesses:

From the Department of Consumer and Corporate Affairs:
Mr. M.S. Cappe, Acting Assistant Deputy Minister, Bureau of Competiton Policy;
Dr. R.S. Khemani, Chief, Special Studies and Contract Research;
Mr. R.C. Atkinson, Former Director, Regulated Sector Branch.

From Fraser & Beatty:
Mr. Lawson Hunter, Q.C.

From Goodman & Carr:
Mr. Wolf D. Goodman, Q.C.

The Committee, in compliance with the Order of Reference dated June 25, 1985, resumed consideration of:

(i) the document entitled: "The Regulation of Canadian Financial Institutions: Proposals for Discussion", tabled in the Senate on 23rd April, 1985;

(ii) the document entitled: "Final Report of the Working Committee on the Canada Deposit Insurance Corporation (CDIC)", tabled in the Senate on 18th June, 1985; and

(iii) the subject-matter of bills, in advance of their coming before the Senate, and other matters relating to these documents.

It was—
Ordered, that the Committee meet *in camera*.

The witnesses made a statement and answered questions.

The Honourable Senator Godfrey moved that, pursuant to the Order of Reference from the Senate dated Wednesday, February 6, 1985 the following budget application for the period 1st February 1986 to 31st March 1986 be concurred in; and

That the Chairman submit same to the Standing Senate Committee on Internal Economy, Budgets and Administration for approval:

Professional and Other Services (including salaries)	$35,000
TOTAL	$35,000

The question being put on the motion, it was—
Resolved in the affirmative.

At 5:24 p.m., the Committee adjourned to the call of the Chair.

WEDNESDAY, MARCH 12, 1986
(54)

The Standing Senate Committee on Banking, Trade and Commerce met at 3:30 p.m. this day *in camera*, the Chairman, the Honourable Senator Lowell Murray, presiding.

Members of the Committee present: The Honourable Senators Anderson, Flynn, Godfrey, Kelly, Kirby, MacDonald (Halifax), Murray, Perrault and Roblin. (9)

Other Senators present: The Honourable Senator Sinclair.

In attendance: From the Department of Economics, University of Western Ontario: Professor Thomas J. Courchene, Advisor; *From Martineau Walker, Montreal*: Mr. Gérald A. Lacoste, Counsel; *From the Library of Parliament, Research Branch, Economics Division*: Mr. Basil Zafiriou, Chief.

The Committee, in compliance with the Order of Reference dated June 25, 1985, resumed consideration of:

(i) the document entitled: "The Regulation of Canadian Financial Institutions: Proposals for Discussion", tabled in the Senate on 23rd April, 1985;

(ii) the document entitled: "Final Report of the Working Committee on the Canada Deposit Insurance Corporation (CDIC)", tabled in the Senate on 18th June, 1985; and

(iii) the subject-matter of bills, in advance of their coming before the Senate, and other matters relating to these documents.

It was—
Ordered, that the Committee meet *in camera*.

The Honourable Senator Kirby moved that, pursuant to the Order of Reference from the Senate dated Wednesday, February 6, 1985 the following budget application for the period 1st April 1986 to 31st March 1987 be concurred in; and

That the Chairman submit same to the Standing Senate Committee on Internal Economy, Budgets and Administration for approval:

Professional and Other Services (including salaries)	$143,000
Transportation and Communications	3,000
All other expenditures	4,000
TOTAL	$150,000

The question being put on the motion, it was—
Resolved in the affirmative.

At 5:57 p.m., the Committee adjourned to the call of the Chair.

WEDNESDAY, MARCH 19, 1986
(55)

The Standing Senate Committee on Banking, Trade and Commerce met at 3:30 p.m. this day *in camera*, the Chairman, the Honourable Senator Lowell Murray, presiding.

Members of the Committee present: The Honourable Senators Anderson, Flynn, Godfrey, Kirby and Murray. (5)

Other Senator present: The Honourable Senator Sinclair.

In attendance: From the Department of Economics, University of Western Ontario: Professor Thomas J. Courchene, Advisor; *From Martineau Walker, Montreal*: Mr. Gérald A. Lacoste, Counsel; *From the Library of Parliament, Research Branch, Economics Division*: Mr. Basil Zafiriou, Chief.

The Committee, in compliance with the Order of Reference dated June 25, 1985, resumed consideration of:

(i) the document entitled: "The Regulation of Canadian Financial Institutions: Proposals for Discussion", tabled in the Senate on 23rd April, 1985;

(ii) the document entitled: "Final Report of the Working Committee on the Canada Deposit Insurance Corporation (CDIC)", tabled in the Senate on 18th June, 1985; and

(iii) the subject-matter of bills, in advance of their coming before the Senate, and other matters relating to these documents.

It was—
Ordered, that the Committee meet *in camera*.

At 5:49 p.m., the Committee adjourned to the call of the Chair.

WEDNESDAY, APRIL 16, 1986
(56)

The Standing Senate Committee on Banking, Trade and Commerce met at 3:30 p.m. this day *in camera*, the Chairman, the Honourable Senator Lowell Murray, presiding.

Members of the Committee present: The Honourable Senators Anderson, Buckwold, Flynn, Godfrey, MacDonald (Halifax), Murray, Perrault, Roblin and Simard. (9)

Other Senator present: The Honourable Senator Sinclair.

In attendance:From the Department of Economics, University of Western Ontario: Professor Thomas J. Courchene, Advisor; *From Martineau Walker, Montreal*: Mr. Gérald A. Lacoste, Counsel; *From the Library of Parliament, Research Branch, Economics Division*: Mr. Basil Zafiriou, Chief.

The Committee, in compliance with the Order of Reference dated June 25, 1985, resumed consideration of:

(i) the document entitled: "The Regulation of Canadian Financial Institutions: Proposals for Discussion", tabled in the Senate on 23rd April, 1985;

(ii) the document entitled: "Final Report of the Working Committee on the Canada Deposit Insurance Corporation (CDIC)", tabled in the Senate on 18th June, 1985; and

(iii) the subject-matter of bills, in advance of their coming before the Senate, and other matters relating to these documents.

It was—
Ordered, that the Committee meet *in camera*.

At 5:14 p.m., the Committee adjourned to the call of the Chair.

WEDNESDAY, APRIL 23, 1986
(58)

The Standing Senate Committee on Banking, Trade and Commerce met at 4:00 p.m. this day *in camera*, the Chairman, the Honourable Senator Lowell Murray, presiding.

Members of the Committee present: The Honourable Senators Anderson, Flynn, Godfrey, Kelly, MacDonald (Halifax), Murray and Roblin. (7)

Other Senator present: The Honourable Senator Sinclair.

In attendance: From the Department of Economics, University of Western Ontario: Professor Thomas J. Courchene, Advisor;*From Martineau Walker, Montreal*: Mr. Gérald A. Lacoste, Counsel;*From the Library of Parliament, Research Branch, Economics Division*: Mr. Basil Zafiriou, Chief.

Also in attendance: The Official Reporters of the Senate.

The Committee, in compliance with the Order of Reference dated June 25, 1985, resumed consideration of:

(i) the document entitled: "The Regulation of Canadian Financial Institutions: Proposals for Discussion", tabled in the Senate on 23rd April, 1985;

(ii) the document entitled: "Final Report of the Working Committee on the Canada Deposit Insurance Corporation (CDIC)", tabled in the Senate on 18th June, 1985; and

(iii) the subject-matter of bills, in advance of their coming before the Senate, and other matters relating to these documents.

It was—
Ordered, that the Committee meet *in camera*.

The Honourable Senator Kelly moved that the Draft Report as amended be adopted as the Sixteenth Report of the Committee and that pursuant to Rule 78(1), the Report be tabled in the Senate.

The question being put on the motion, it was—
Resolved in the affirmative.

The Honourable Senator MacDonald moved that the Committee print 4,000 copies in both official languages of the Sixteenth Report as a regular issue of proceedings with a special cover.

The question being put on the motion, it was—
Resolved in the affirmative.

The Honourable Senator Godfrey moved that the Committee authorize the printing of 2,000 additional copies of Issue No. 37 dated December 11, 1985 which includes the Tenth Report.

The question being put on the motion, it was—
Resolved in the affirmative.

At 4:29 p.m., the Committee adjourned to the call of the Chair.

ATTEST:

Timothy Ross Wilson
Clerk of the Committee