CANADA

CANADIAN FINANCIAL INSTITUTIONS

REPORT OF THE STANDING COMMITTEE ON

FINANCE, TRADE AND ECONOMIC AFFAIRS

NOVEMBER 1985

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HOUSE OF COMMONS

CHAMBRE DES COMMUNES

Issue No. 74

Fascicule nº 74

Thursday, July 11, 1985
Monday, September 30, 1985
Wednesday, October 2, 1985
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Friday, October 4, 1985
Wednesday, October 16, 1985
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Wednesday, October 23, 1985
Tuesday, October 29, 1985

Le jeudi 11 juillet 1985
Le lundi 30 septembre 1985
Le mercredi 2 octobre 1985
Le jeudi 3 octobre 1985
Le vendredi 4 octobre 1985
Le mercredi 16 octobre 1985
Le jeudi 17 octobre 1985
Le mardi 22 octobre 1985
Le mercredi 23 octobre 1985
Le mardi 29 octobre 1985

Chairman: Don Blenkarn

Président : Don Blenkarn

Minutes of Proceedings and Evidence of the Standing Committee on

Finance, Trade and Economic Affairs

Procès-verbaux et témoignages du Comité permanent des

Finances, du commerce et des questions économiques

RESPECTING:

Document entitled "The Regulation of Canadian Financial Institutions: Proposals for Discussion"

The Final Report of the Working Committee on the Canada Deposit Insurance Corporation

The Regulation of Canadian Financial Institutions: Proposals for Discussion (Technical Supplement)

CONCERNANT :

Document intitulé «La réglementation des institutions financières du Canada : Propositions à considérer»

Rapport final du Comité d'étude sur la Société d'assurance-dépôts du Canada

La réglementation des institutions financières : Propositions à considérer (Supplément technique)

INCLUDING:

The Eleventh Report to the House

First Session of the
Thirty-third Parliament, 1984-85

Y COMPRIS :

Le Onzième Rapport à la Chambre

Première session de la
trente-troisième législature, 1984-1985

STANDING COMMITTEE ON
FINANCE, TRADE AND
ECONOMIC AFFAIRS

Chairman: Don Blenkarn

Vice-Chairman: Louis Plamondon

Members who participated in the drafting of this Report

Bill Attewell
Simon de Jong
Murray Dorin
Raymond Garneau
Jim Jepson
Donald Johnston
Steven Langdon
Claude Lanthier
Nic Leblanc
Shirley Martin
Paul McCrossan
George Minaker
Aideen Nicholson
Nelson Riis
Robert Toupin
Bernard Valcourt
Norm Warner
Geoff Wilson

(Quorum 8)

Robert Vaive

Clerk of the Committee

ORDERS OF REFERENCE

Thursday, April 18, 1985

ORDERED,—That the document entitled "The Regulation of Canadian Financial Institutions: Proposals for Discussion", tabled earlier this day, be referred to the Standing Committee on Finance, Trade and Economic Affairs;

That the Committee examine and report on the proposals contained therein;

That the Committee be empowered to retain expert, clerical and secretarial staff as may be deemed necessary; and

That the Committee submit its final report to the House no later than September 30, 1985.

ATTEST

Monday, June 17, 1985

ORDERED,—That it be an Instruction to the Standing Committee on Finance, Trade and Economic Affairs that, in relation to the Committee's Order of Reference of April 18, 1985, the Committee consider the document entitled "Final Report of the Working Committee on the Canada Deposit Insurance Corporation", Tabled Monday, June 17, 1985, before making its final report and, that for the purposes of this study, the said document shall stand referred to the Committee.

ATTEST

Wednesday, June 26, 1985

ORDERED,—That it be an Instruction to the Standing Committee on Finance, Trade and Economic Affairs that, in relation to the Committee's Order of Reference of April 18, 1985, the Committee consider the document entitled "The Regulation of Financial Institutions: Proposals for Discussion", dated June 1985 (Sessional Paper No. 331-7/24), Tabled on Tuesday, June 25, 1985, before making its final report and, that for the purposes of this study, the said document shall stand referred to the Committee; and

That it be a further Instruction that the Committee be empowered to travel to Vancouver, Calgary and Winnipeg on September 3, 4 and 5 and to Halifax on September 30, 1985, and that the deadline for submitting the Committee's final report be extended to October 30, 1985.

ATTEST

Friday, September 27, 1985

ORDERED,—That, pursuant to its Order of Reference dated April 17, 1985, the Standing Committee on Finance, Trade and Economic Affairs be empowered to travel to Mont-Gabriel on October 2, 3 and 4, 1985, for the purpose of drafting their final report; and

That the necessary staff do accompany the Committee.

ATTEST

Tuesday, October 29, 1985

ORDERED, —That the deadline for submitting the report to the House of the Standing Committee on Finance, Trade and Economic Affairs, in accordance with its Orders of Reference dated Thursday, April 18, 1985, relating to the document entitled: "The Regulation of Canadian Financial Institutions: Proposals for Discussion", Monday, June 17, 1985, relating to the document entitled: "Final Report of the Working Committee on the Canada Deposit Insurance Corporation" and Wednesday, June 26, 1985, relating to the document entitled: "The Regulation of Canadian Financial Institutions: Proposals for Discussion", dated June 1985 (Technical Supplement), be extended to Wednesday, November 6, 1985.

ATTEST

C. B. Koester
The Clerk of the
House of Commons

THE STANDING COMMITTEE ON FINANCE, TRADE AND ECONOMIC AFFAIRS

has the honour to present its

ELEVENTH REPORT

In accordance with its Orders of Reference dated Thursday, April 18, 1985, Monday, June 17, 1985 and Wednesday, June 26, 1985, your Committee has examined the document entitled "The Regualtion of Canadian Financial Institutions: Proposals for Discussion", the document entitled "The Final Report of the Working Committee on the Canada Deposit Insurance Corporation" and the document entitled "The Regulation of Canadian Financial Institutions: Proposals for Discussion (Technical Supplement)".

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I. Acknowledgement

This Report would be remiss if it did not acknowledge the exceptional dedication and hard work brought in the organization of the Committee's deliberations by H. Dennis Madden, Dr. E. Wayne Clendenning, Brian D. Carter, Alain Thibault, Actuary, and by Mr. Randall Chan who is presently associated with the Library of Parliament, but who is in fact this Committee's permanent research coordinator.

The consulting group worked exceptionally long hours with utmost dedication. They painstakingly researched briefs and presented them to the Committee and on their own examined the regulatory concerns not only of federal regulators but also of provincial regulators and regulators in the United States.

Without their extensive background work it would have been impossible for the Committee to deal with the very broad and complex issues dealt within this Report.

The Committee on Finance, Trade and Economic Affairs in this Parliament has within its membership Members of Parliament who have extensive business experience, particularly in financial affairs.

In that respect, it is important to make special mention of the Honourable Donald Johnston, from the Liberal Party, probably one of Canada's foremost lawyers specializing in income tax; Mr. Raymond Garneau, former Minister of Finance for the Province of Quebec and past President and Chief Executive Officer of the Montreal City and District Savings Bank; and Aideen Nicholson, Member of Parliament for the riding of Trinity in Toronto, a respected economist in her own right.

From the New Democratic Party, Nelson Riis, Member of Parliament for Kamloops-Shuswap and Simon de Jong, Member of Parliament for Regina East, were exceptionally dedicated in their work on the Committee and travelled with the Committee to Vancouver, Calgary and Winnipeg and to Halifax and spent the total three-day period doing the intense work required in Mont-Gabriel working out the details of this Report.

From the Progressive Conservative Party, the Committee had the help of the Parliamentary Secretary to the Minister of Finance, Claude Lanthier, who has extensive business interests, particularly in insurance in the Province of Quebec and Louis Plamondon, Member of Parliament for Richelieu, Vice-Chairman of the Committee, who made many contributions to the Committee's deliberations.

The Committee was exceptionally fortunate to have as a Member Paul McCrossan, Member of Parliament for York-Scarborough, who brought to the Committee his exceptional expertise as a leading actuary and specialist in the management of financial intermediaries in general; William Attewell, Member of Parliament for Don Valley East, and a former Vice-President, Corporate Planning of the Guaranty Trust Company; Norman Warner, Member of Parliament for Stormont-Dundas, who has had extensive experience in the general insurance and real estate business.

From Western Canada, the Committee had assistance from Murray Dorin, Member of Parliament for Edmonton West, a chartered accountant with extensive business experience; Geoff Wilson, Member of Parliament from Swift Current-Maple Creek, who brought to the Committee a knowledge of the particular problems of rural Canada; George Minaker, former Minister with the Government of Manitoba and Member of Parliament for Winnipeg-St. James.

Shirley Martin, Member of Parliament for Lincoln, Jim Jepson, Member of Parliament for London East, Bernard Valcourt, Member of Parliament for Madawaska-Victoria, Robert Toupin, Member of Parliament for Terrebonne, and Nic Leblanc, Member of Parliament for Longueuil all made very valid contributions.

I also must particularly acknowledge the dedication of Robert Vaive, the Clerk of the Committee, and the Assistant Clerk, Marie Carrière.

The work of the Committee involved rather difficult arrangements for witnesses and very comprehensive arrangements needed for the trips away from Ottawa. The Clerk and his staff organized trips, accommodation, translation of briefs and documents, distribution of materials, arrangements for witnesses and a whole host of other matters for and on behalf of the Committee and its members in the most exemplary fashion.

Don Blenkarn, M.P.
Mississauga
Chairman

II. Preamble

On Thursday April 18, 1985, the government's discussion paper on *The Regulation of Canadian Financial Institutions: Proposals for Discussion* (Green Paper), was referred by the House of Commons to the Standing Committee on Finance, Trade and Economic Affairs for study and consultation, with a deadline to report to the House not later than September 30. On Monday June 17 and Wednesday June 26, the *Final Report of the Working Committee on the Canada Deposit Insurance Corporation* and the *Technical Supplement* to the discussion paper were released and referred respectively to this Committee for consideration in conjunction with the Green Paper. The deadline for reporting by the Committee on all three orders of reference was extended to October 30.

Prior to the conclusion of the Committee's investigation on the circumstances leading up to the support package provided to the Canadian Commercial Bank on June 12, the steering committee of this Committee met on several occasions to discuss its work plans and staffing requirements. In addition to the normal staff, the Committee engaged in late May the services of three outside consultants. This number was later augmented to five to ensure adequate expert advice in the various areas under consideration. Hearings held by the Committee were divided into two categories: those with supervisory authorities, government officials and academics; and those with industry and the public at large.

Briefing sessions by the research staff for members of the Committee began on June 10. These were followed by hearings and information sessions with various federal and provincial supervisory bodies as well as academics. Given that the Green Paper and the *Technical Supplement* had sought public response up till August 15, the Committee could not effectively begin its hearings with industries, businesses and consumers until September.

It was generally recognized that the task and responsibility delegated by this mandate was of significant importance. The potentially far-reaching implications for the financial services industry in Canada and its economy as a whole arising from this study compelled the Committee to hold hearings in several major cities across the country. These included Vancouver, Calgary, Winnipeg, Halifax and Ottawa.

In total, the Committee received 137 submissions and received testimony from 9 governmental bodies, 79 industry, business and consumer groups, 7 academics and 6 individuals.

The end of the hearings on September 30, was followed by three consecutive days of deliberation in Mont-Gabriel, Québec where this report was prepared.

DIAGRAMMATIC OUTLINE OF PUBLIC POLICY

OBJECTIVES AND REGULATORY STRUCTURE OF THE CANADIAN FINANCIAL SYSTEM

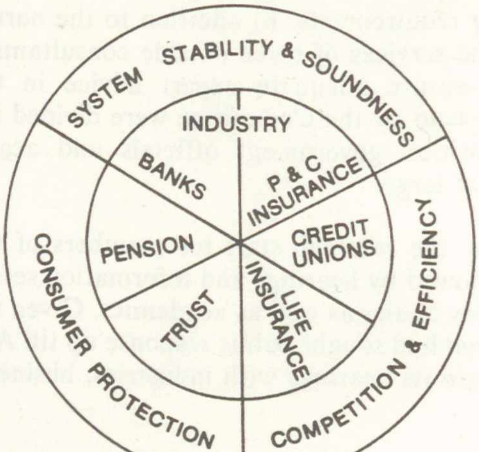
CORPORATE GOVERNANCE

- Standard of Care and Supervision
- Board Committees
- Board Size
- Independent Directors
- Interlocking Directors

SUPERVISION

- Functional versus Institutional
- Structure
- Methods
- Remedies
- Penalties

OBJECTIVES



STRUCTURAL POLICIES

- Corporate Ownership
- Industry Concentration
- Financial/Non-Financial Relationships
- Corporate Structure
- Regulatory Review Process

OPERATING RULES

- Investment and Lending Powers
- Capital and Leverage
- Double Counting of Capital
- Self-Dealing and Conflicts
- Institutional Disclosure

III. Introduction

Since 1980, Canada's financial services industry can be characterized by both a remarkable expansion in terms of institutions and products, and a considerable degree of instability. Almost 60 chartered banks have been incorporated since the last revision of the *Bank Act*. Credit cards, deposit accounts, annuities, life insurance policies, mortgage and consumer loans bearing features that were unknown only a few years earlier have proliferated. Examples of these include weekly payment plans on mortgages, buy-back option on car loans, short term deferred annuities, life insurance policies without non-forfeiture options and personal lines of credit on credit cards and so forth. Parallel to the rapid developments in financial innovation and the inevitable blurring of distinctions among chartered banks, trust companies, life insurance companies, securities dealers, credit unions and caisse populaires, there has also been a significant number of failures of financial institutions. The Green Paper cited 15 cases of insolvencies since 1981 involving 4 property and casualty insurance companies and eleven trust and mortgage loan companies. Since the Committee began studying the Green Paper proposals in late May, London Loan has been placed under liquidation, Northumberland Insurance Company has failed, Continental Trust is being wound up, the Canadian Commercial Bank and the Northland Bank are undergoing curatorship or liquidation, CCB Mortgage Investment Corporation has been given 45 days to determine its viability, and Heritage Savings and Trust has recently signed an agreement with a provincial government to receive liquidity support for a period of six months. The Canadian financial system is sound but shaken. Recent financial institution failures have reinforced the need for immediate and substantial regulatory change. The central question facing the Government is not whether regulatory change is needed, but, rather what means should be used and how soon.

While these insolvencies generally reflect the difficult economic conditions of the recent past and the outdated laws and regulations governing these institutions, they also serve to reinforce the number one public policy objective in respect of financial institutions, notably solvency and stability. This is of particular relevance to deposit-taking institutions which are custodians of the public's money and whose operations are highly leveraged to an extent unknown in any other business. As a consequence, it is a prerequisite that the smooth functioning of financial institutions must entail trust, confidence and integrity. Solvency and stability both foster and reflect the development of these qualities. Recognizing that liabilities are generally more liquid than assets in deposit-taking institutions, confidence in the system becomes paramount for the survival of these institutions. Without confidence, problems of an isolated instance could rapidly translate into systemic proportions. The recent liquidity problem of the Mercantile Bank is a case in point. Moreover, financial intermediation is the lubricant of the engine of economic growth. It is the instrument by which scarce financial resources are allocated to productive use. For these reasons, financial institutions impose a responsibility of prudence on their management and warrant close regulation and supervision by public authorities. Lastly, it must be recognized that implicitly embodied in the public policy objective of stability and solvency is the principle of consumer protection.

However, the number of recent failures and the need for adequate regulation and supervision must not unduly overshadow the need for competition as a public policy objective. Canada is a country of diversity with varying regional and local needs. It is also a major player in world financial markets. Therefore, it is imperative that legislation governing financial institutions and the system of regulation and supervision should provide a framework for new institutions to be created and small regional ones to be viable. This is because regionally based institutions may often be more sensitive to local community needs. The growth of the credit union movement in Western Canada and that of the caisses populaires in Quebec is proof that small and regional institutions can be viable.

The financial institution failures and the rapid development of financial innovations precipitated by technology have pointed to the need for re-regulation and deregulation. Straddled between the two seemingly opposing trends are the public policy objectives of stability and competition. While most observers acknowledge that trade-offs are inevitable between these two policy objectives, it is the view of the Committee that re-regulation and deregulation are not incompatible goals. The Committee believes its conclusions and recommendations contained in this Report reflect this attempt to strike a balance between the two public policy objectives while concomitantly improving prudential safeguards (re-regulation) and providing greater diversification of corporate powers to non-bank institutions (deregulation).

In outlining the thrust of the Committee's approach to the legislative revision for non-bank financial institutions, the Committee wishes to stress that discussions on a new financial order should not be solely preoccupied with the failures of a few but with a framework which assures the soundness and efficiency of the vast majority of Canadian financial institutions. A broad perspective is needed, one which responds to the concerns of the moment while also focussing on developing a regulatory structure which would assure a wide range of sound and competitive financial institutions both at home and in the increasingly important international markets. By global standards, most experts agree that Canada has a strong, stable and competitive financial services industry, with banking and life insurance being the two most often cited examples. Canada is a net exporter of these two services to the world. The employment and income resulting from the international operations of Canadian financial institutions abroad would by any measure be considered significant. As technological development gradually transforms the world into one integrated capital market where Canadian institutions have become increasingly successful, regulations based on nationality are generally viewed as an impediment to trade. As a result, reciprocity has become a yardstick which national governments use to enhance trade.

Operations of foreign banks and subsidiaries and branches of foreign-owned life insurance companies in Canada have historically been subjected to somewhat different regulations than domestic institutions, on account of their foreign ownership. The Committee believes that conditions are now suitable for the dismantling of these measures. The proposal on ownership limits detailed in the section on ownership would establish one single standard for all financial institutions irrespective of the nationality of the controlling shareholder.

This ownership proposal represents a concrete measure of deregulation on foreign ownership. It also affirms and extends the principle of widely-held ownership of financial institutions as a desirable objective by providing a practical approach to broad-based ownership. It would not adversely affect the operations and ownership patterns of existing closely-held institutions but rather allow them to accomplish an orderly broad-base ownership structure as they grow.

The proposed ownership limits based on domestic assets also safeguard against the potential increase of abuses in self-dealing as institutions grow larger. This balances the needs of small institutions for capital and leadership from a controlling shareholder, particularly in their formative years and the safeguards required for large institutions against abuses where they can be least tolerated. This approach to ownership coupled with the Committee's recommended greater reliance on self-regulation through higher standards of corporate governance and strengthened prudential standards would in the Committee's opinion represent a more flexible and accommodating way of addressing potential conflicts of interest and self-dealing problems.

To meet the needs of non-bank institutions to remain competitive in a rapidly changing environment, the Committee has accepted the desire of these institutions to have extended powers with a flexible approach towards corporate structure subject to limitations on non-financial activities except those specified by the regulatory authority as ancillary business. It has also proposed that these institutions be allowed to issue different forms of capital as is now permitted to banks. Not only would this achieve a uniform standard of capital for all financial institutions in Canada but would also enable these institutions to raise much needed capital in light of the broadened powers. While these constitute initiatives of deregulation, the Committee also calls for a considerable tightening of prudential rules regarding double leveraging, real estate investments, allowable leverage, and minimum capitalization requirements, recognizing that different forms of capital justify different leveraging ability.

In the area of consumer protection, the Committee believes that on balance there is not sufficient justification for changing the coverage on deposit insurance. However, a cash maintenance program is proposed to address the needs of uninsured depositors and the spin-off effects of financial institution failures. A system of protection for insurance policyholders also needs to be established. Insofar as regulation and supervision are concerned, the Committee proposes to alter the system further than that proposed by the Wyman Committee. The National Financial Administration Agency (NFAA) would be a tripartite body composed of representatives from all financial institutions by industry and federal and provincial governments. It is the hope of the Committee that such a forum would not only achieve the much needed uniform standards for prudential regulation across the country but would also promote the harmonization of federal and provincial policies on the financial services industry.

The deliberations and recommendations by the Committee on the wide range of issues have been guided by the procedure of: an examination of the problem, an assessment of the adequacy of present regulations and supervision, the costs and benefits of proposals, and the feasibility of different proposals within a federal-provincial context.

The proposed ownership rules based on domestic assets also mitigate against the potential overuse of closely held financial institutions grow larger. This balances the needs of such institutions for capital and leadership by a controlling shareholder, particularly in their formative years, and the safeguards required for large institutions against abuses where they can be least tolerated. This approach to ownership coupled with the Committee's recommended greater reliance on self-regulation through higher standards of corporate governance and strengthened prudential standards would in the Committee's opinion represent a more flexible and accommodating way of addressing potential conflict of interest and self-dealing problems.

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IV. Summary of Recommendations

Regulation, Supervision and Consumer Protection

Supervisory Structure

1. **That a National Financial Administration Agency (NFAA) be created to administer all consumer protection plans and act as the regulatory and supervisory agency for all federally incorporated financial institutions and for provincially incorporated institutions where appropriate;**

2. **That NFAA have a Board of Directors consisting of federal, provincial and industry representatives and appoint an Inspector General of Financial Institutions as its chief executive officer;**

3. **That there be an appropriate transition period for organizing NFAA after which the responsibilities, functions and staff of the Office of the Inspector General of Banks, the Superintendent of Insurance and the Canada Deposit Insurance Corporation would be transferred to NFAA;**

4. **That NFAA establish conditions for membership with respect to all consumer protection plans under it and administer separate funds for each type of financial institution and act as direct provider of deposit insurance, as administrator of insurance policyholder compensation plans and as lender of last resort to provincial stabilization funds for financial co-operatives;**

5. **That NFAA operate through regional offices across Canada, an inspection and supervisory system with broad powers structured into separate branches for the chartered banks, trust and loan companies, life insurance companies, property and casualty insurance companies and pension funds;**

6. **That the cost of operating NFAA's regulatory functions be charged back to each supervised institution through user assessments.**

7. **That NFAA in connection with its future administration of deposit insurance, not borrow funds at interest rates above those normally charged to the government of Canada.**

Supervisory Methods

Inspection System

8. **That NFAA develop the necessary capability to perform on-site inspections of chartered banks for assessing the solvency of these institutions.**

Audit Appointment

9. **That one of the two auditors of a bank be appointed by and report to NFAA and be required to carry out its examination in accordance with the instructions from NFAA.**

Monitoring and Communication

10. **That NFAA conduct a meeting with the shareholders' auditors and the audit committee of a bank as part of its annual inspection procedure or whenever such a meeting is deemed to be necessary.**

Liquidity Support

11. **That whenever a deposit-taking institution receives liquidity support in relation to its total liabilities in excess of limits pre-determined by the appropriate supervisory body, NFAA be required to perform on-site inspection to determine the reasons for the liquidity shortage and consider reviewing and revising the permitted leverage of the institution.**

Interest Accrual, Non-accrual Loans and Fee Income

12. **That NFAA be encouraged to develop the necessary procedure for all financial institutions to report regularly the amount of fee income related to restructured loans and that these amounts be required for public disclosure;**
13. **That all financial institutions be required to report to NFAA and disclose to the public the amount of non-accrual loans and the amount of interest accrued but not yet received.**

Transactions With Related Parties

14. **That all financial institutions be required to report related party transactions to NFAA on a quarterly basis.**

Post-resignation Interview

15. **That all letters of resignation by a director, auditor, valuation actuary or an officer of a financial institution be submitted to NFAA within 14 days of receipt by the institution and that NFAA be empowered to conduct a post-resignation interview with the individual if the reasons for the departure reflect upon the prudential management of the institution.**

Brokered Deposits

16. **That NFAA be encouraged to develop appropriate procedures to monitor brokered deposits.**

Inter-affiliated Dividends

17. **That a 30-day pre-notification to NFAA be required of any company declaring a special or extraordinary dividend in addition to regular quarterly or annual dividends, and other dividends whose amounts substantially exceed those paid out in preceding years.**

Chapter XI

18. **That for the purposes of rehabilitating a financial institution in difficulty, any curator appointed by NFAA be empowered to reorganize, restructure and recapitalize the institution, without the encumbrance of creditors and shareholders alike, in the same manner as provided for under Chapter XI of the *U.S. Bankruptcy Code*.**

Actuaries, Auditors and Appraisers

19. **That any actuary, auditor or appraiser to be engaged in his/her respective professional capacity, by a financial institution under the supervision of NFAA be required to obtain the prior approval of NFAA and that NFAA establish a list of certified individuals for this purpose;**

20. **That NFAA in conjunction with the Canadian Institute of Actuaries, the Canadian Institute of Chartered Accountants and the Appraisal Institute of Canada be encouraged to develop guidelines and standards for the financial reporting of the solvency of financial institutions;**

21. **That NFAA require these professional bodies to establish a review committee on the adequacy of solvency standards as applicable to actuaries, accountants and appraisers;**

22. **That severe disciplinary measures be instituted against those professional advisors who fail to observe the established standards and code of conduct.**

Enforcement Powers

Suspension and Removal Powers

23. **That NFAA have the power to appoint a curator, together with grounds to take immediate control of troubled financial institutions;**

24. **That NFAA have the power to issue cease and desist orders;**

25. **That NFAA have the power to suspend or remove directors and executive officers;**

26. That NFAA have the power to obtain information with respect to the ownership of financial holding companies and their group of institutions;

27. That NFAA have the power to require the declaration of interests of substantial shareholders;

28. That NFAA have the discretionary power to deem specific transactions to be non-arm's-length;

29. That NFAA have the power to force divestiture of prohibited investments or loans;

30. That NFAA have the power to require the restoration of assets illegally paid out of an institution;

31. That NFAA have the power to specify asset values;

32. That the statute creating financial intermediaries, where administrative penalties are provided, be amended to substantially increase the penalties and where provisions exist making a matter illegal and providing for penalties to be imposed by a court, be substantially increased, particularly for improper self-dealing and breach of the statute and regulations thereunder;

33. That the government amend the Criminal Code to impose a criminal penalty for directors, officers, and professional agents, employed by financial institutions, where the person acts in such a fashion as to be grossly negligent in performing his duties for and on behalf of the institution, and where those persons make reports, which the public or NFAA rely on, which are of such a nature as to create gross misunderstanding.

Deposit Insurance

Coverage

34. That the present deposit insurance coverage of up to $60,000 be retained;

35. That deposits subject to coverage as presently defined be broadened to include those deposits irrespective of their term to maturity;

36. That NFAA develop a set of uniform prudential standards particularly regarding leverage to be observed by all deposit-taking institutions as a condition for the provision of insurance and also establish policies, procedures and penalties to ensure compliance with such standards.

Funding

37. That the existing CDIC deficit not be refinanced immediately by means of a preferred share issue;

38. That the deposit insurance premium be raised immediately to 1/10th of 1 per cent of insured deposits from 1/30th of 1 per cent presently, on an interim basis until December 31st, 1986;

39. That future premiums be established by NFAA on the basis of an appropriate ongoing premium for CDIF plus an amount, as a surcharge, that would retire the current CDIC deficit in not less than 10 years but not more than 25 years;

40. That the Deposit Insurance Fund under NFAA be granted tax-free status.

Uninsured Depositors

41. That government stop bailing-out uninsured depositors in the event of financial institution failure;

42. That NFAA develop and implement an uninsured depositor cash advance program based upon anticipated liquidation values after a thorough assessment of alternatives and consultation with the financial community.

Insurance Policyholder Compensation Plans

43. That two separate tax free funds be established for life insurance and property and casualty insurance, and that accident and sickness insurance be covered under the life insurance fund;

44. That participation in the funds be mandatory for all companies under federal jurisdiction and provincial companies be eligible for protection on an optional basis provided that they meet the solvency and prudential standards established by NFAA;

45. That each fund be self-supporting and entirely financed by each of the two industries respectively, and that contributions be required on a pre-assessment basis until the funds have reached a level sufficient to prevent severe liquidity or financing problems in case of an insolvency;

46. That the funds be administered by the National Financial Administration Agency;

47. That the level of coverage be established by NFAA at a level which will ensure that the large majority of policyholders be adequately protected against the possibility of severe hardship resulting from the insolvency of an insurance company;

48. That the property and casualty insurance fund be limited to outstanding claims and exclude unearned premiums, and that coverage be extended to all new claims arising in the 45-day period following the winding-up order;

49. That appropriate legislation be amended so that outstanding claims be assigned a higher priority than unearned premiums in the event of liquidation of a property and casualty insurance company.

Ownership

Domestic Ownership

50. **That domestic ownership limits for all Canadian incorporated financial institutions and holding companies controlling affiliated financial institutions be established on the basis of domestic asset size as follows:**

Domestic Asset Size		*Ownership Limits*
under $10 billion	**—**	**100%**
$10-$20 billion	**—**	**75%**
$20-$30 billion	**—**	**50%**
$30-$40 billion	**—**	**25%**
over $40 billion	**—**	**10%**

51. **That Canadian incorporated financial institutions be required to maintain domestic assets greater than or equal to domestic liabilities;**

52. **That the definition of domestic assets for determining these limits exclude the Estate, Trust and Agency assets of trust companies and the segregated funds assets of life insurance companies;**

53. **That domestic asset size for holding companies and multiple holding companies under the same ownership control be determined by aggregating the total domestic assets of all affiliated financial institutions in which a 30 per cent or greater ownership interest is held by the holding companies and related interests on a consolidated basis;**

54. **That for purposes of these limits, the ownership test be applied at the first ownership level where there is a non-financial ownership interest except for those non-financial activities permitted as ancillary activities of financial institutions;**

55. **That a period of 5 years be provided to meet these ownership limits;**

56. **That for holding companies these limits be met either by broadening ownership at the holding company level or by reducing their ownership interests in financial subsidiaries below the control level;**

57. **That the Minister of Finance be empowered to review and prohibit the merger with or acquisition of an existing institution and that explicit criteria be developed by NFAA for the application of such review procedure;**

58. **That the Minister of Finance not approve any merger between Canada Trust and Canada Permanent Trust until an ownership policy for financial institutions has been developed and implemented.**

Foreign Ownership

59. That foreign-owned Canadian financial institutions be made subject to similar ownership limits based upon Canadian domestic asset size as domestic institutions;

60. That the chartering, acquisition or merger of a financial institution involving a foreign-owned entity be considered for approval by the Minister of Finance on the principle of reciprocity;

61. That consequential amendments to the *Bank Act* be made to eliminate the requirement that a foreign-owned financial institution connected to a banking operation abroad be restricted to establishing a bank in Canada;

62. That the foreign-owned Schedule 'B' bank classification, along with the aggregate asset ceiling of 16 per cent of total domestic assets imposed on these banks, be eliminated;

63. That Canadian investments made on behalf of Canadian depositors or policyholders be deemed to be Canadian-owned assets for purposes of any foreign ownership provisions, including those under the *Investment Canada Act*.

Financial Holding Company

64. That the mandatory form of a financial holding company as proposed in the Green Paper be rejected;

65. That non-bank financial institutions be allowed to diversify flexibly through upstream holding companies and affiliated institutions, downstream holding companies and subsidiaries, together with some limited expansion of in-house powers and networking arrangements;

66. That double counting of capital in respect of investments in downstream holding companies and subsidiaries, except for real estate subsidiaries, not be allowed but that such investments not be limited to a specified percentage of assets or capital of the parent institution.

Schedule 'C' Bank

67. That the Schedule 'C' bank concept be rejected;

68. That non-bank financial institutions be permitted a limited in-house expansion of commercial lending powers;

69. That non-bank financial institutions be required to expand their commercial lending activities beyond their limited in-house powers through a chartered bank subsidiary or affiliate;

70. That the Schedule 'A', and Schedule 'B' classifications for chartered banks be eliminated and all banks be allowed to operate under the same rules regardless of their ownership structures.

Networking

71. That tied-selling be prohibited;

72. That trust and loan companies, insurance companies and co-operative credit associations be allowed to participate in networking arrangements;

73. That due consideration be given to networking participation by the chartered banks in the 1990 *Bank Act* revision;

74. That policies with respect to privacy controls over computer-based information and trans-border data flows appropriate to the confidence, stability and efficient operation of the Canadian financial system be developed not later than December 31st, 1986;

75. That financial institutions not be allowed to share confidential information pertaining to any client without the written consent of the client.

Self-Dealing

76. That financial institutions be permitted to engage in non-arm's-length transactions except those that are likely to have a significant impact on the institutions' solvency, and requests for exemptions to prohibited transactions be considered by NFAA in special cases;

77. That the prohibited transactions be set forth in regulations governing each of the major sectors of the financial services industry;

78. That professional associations including accountants, lawyers, appraisers, actuaries and representatives from financial institutions and trade organizations be consulted in drawing up a list of prohibited transactions;

79. That NFAA prepare and circulate new guidelines and rules with respect to prohibited transactions and the parties affected by them;

80. That limits on the size of individual transactions and aggregate limits on such transactions be imposed by NFAA where necessary;

81. That NFAA approval be required for all non-arm's-length transactions for a specified period of time after the establishment of a new financial institution or upon a change in the control of the institution;

82. That NFAA be given an overriding discretion to prohibit an institution from engaging in prohibited transactions, if it determines that allowing the institution to engage in such transactions would be contrary to public interest;

83. That NFAA be entitled, in appropriate circumstances, to reverse transactions or to require institutions to dispose of property acquired in a related party transaction;

84. That NFAA be empowered to cause an institution, in the appropriate circumstances, to eliminate the assets so acquired from its borrowing base;

85. That all financial institutions be required to pass a bylaw establishing a committee of the board with responsibility for reviewing and approving all non-arm's-length transactions and that such committees consist of not less than three independent outside members chosen from the Board of Directors of the financial institution;

86. That the responsibilities of the reviewing committee be reinforced by imposing an obligation upon directors, management, auditors, valuation actuaries, solicitors, and appraisers of financial institutions to report immediately all non-arm's-length transactions of which they become aware.

Conflicts of Interest

Chinese Wall

87. That financial institutions be required to create and maintain Chinese Walls to prevent the flow of information between certain departments within an institution or affiliated institutions in situations where the flow of information between them might give rise to a conflict either: (i) between the interests of customers of the institution; or (ii) between the interests of a customer and that of the institution;

88. That specific rules and procedures required for each sector of the financial services industry be left to the discretion of NFAA;

89. That procedures be implemented by institutions and NFAA to ensure effective maintenance and operation of the Chinese Wall on an ongoing basis;

90. That institutions be exempt from liability in certain situations where they would otherwise have been liable, if they can establish that a Chinese Wall prevented the flow of information between two departments.

Increased Institutional Disclosure

91. That government consult with trade associations, professional groups, financial institutions and consumer groups in developing guidelines for increased institutional disclosure of information to enhance the ability of consumers to make informed choices in view of the increased possibility of conflicts of interest resulting from product bundling, corporate affiliations and networking.

Financial Conflicts of Interest Office

92. That the proposed Financial Conflicts of Interest Office not be established.

Corporate Governance

Special Act Corporations

93. That amendments be made to the legislation governing trust, loan and insurance companies to give them the capacity of a natural person, and similarly modifications, as appropriate, be made to the legislative powers of financial co-operatives and mutual insurance companies.

Standards of Care

94. That the standard of care of the board of directors be increased from that of a prudent person to that of a prudent director.

Registry of Directors

95. That no person shall be a director of a financial institution unless the person is registered with NFAA and registration be granted only when the regulators are of the opinion that such person is suitable for registration.

Group Corporate Responsibility

96. That the legal concept of "corporate group responsibility" not be introduced in the governing legislation of federally incorporated financial institutions.

Standards of Attention and Supervision

97. That standards of supervision of directors be increased including, as appropriate, more extensive use of specialized oversight board committees aimed at limiting potential abuses arising from conflicts of interest and self-dealing situations and to generally prevent the misuse of corporate powers;

98. That no statutory requirement be introduced for board attendance, although, as in the case of the *Bank Act*, directors' attendance at board meetings be required to be made public.

Limits on Board Size

99. That the minimum number of directors for financial institutions be determined by present governing legislation and that no upper limits be imposed on the size of the board.

Outside Directors

100. That all members of board committees established to monitor, review and approve non-arm's-length transactions be independent members of the board with the criteria for independence to be established along the lines provided for the appointment of auditors in the *Canada Business Corporations Act* and the *Bank Act*.

Interlocking directors

101. That no restrictions be imposed on financial directorships with other non-bank financial institutions nor on the percentage of directors serving on one or more boards within a holding company group.

PRUDENTIAL STANDARDS AND CORPORATE POWERS

Initial Capitalization

102. That the Minister of Finance or the Minister of State (Finance) have the discretionary power to review and revise the minimum initial capitalization requirement, as deemed appropriate;

103. That life and trust companies be allowed a 5-year transition period to comply with the new initial capitalization requirements, and that existing property and casualty insurance companies, which do not meet such requirements be "grandfathered".

Capital

104. That NFAA be encouraged to adopt a two-tier structure for the definition of capital in respect of trust and insurance companies similar to that for the chartered banks;

105. That both stock and mutual insurance companies as well as their subsidiaries be allowed to issue preferred stock and subordinated debentures.

Leverage

106. That the range of permissible leverage for all deposit-taking institutions be reduced over some period to between 10 and 20 times and that NFAA be encouraged to establish comparable standards and criteria for granting any increase in leverage to all such institutions;

107. That institutions be allowed to operate with a leverage above the permissible limit only when solvency and market conditions are deemed to be appropriate by NFAA.

108. That all preferred shares and subordinated debentures having an outstanding maturity or retraction right exceeding 5 years and forming part of secondary capital of an institution be allowed to have the weight equalling one third of common equity in determining leverage, and that such instruments with a maturity or retraction right of less than 5 years be subject to a straight-line amortization for leverage purposes.

Double Leverage

109. That the amount of equity investment in subsidiaries except real estate subsidiaries created by all federally regulated financial institutions be deducted from the base capital of the investing institution.

110. That when share investments in any existing financial institution exceed 20 per cent of the voting stock of that institution, the entire amount of investment be deducted from the base capital of the investing institution.

Commercial Lending

111. That all investments for which no specific aggregate limits are imposed be considered as basket clause investments for non-bank financial institutions;

112. That the aggregate limit on basket clause investments for all non-bank financial institutions be established at 15 per cent of assets.

113. That the requirement for chartered banks to maintain non-interest bearing cash reserves with the Bank of Canada be eliminated;

114. That the Minister of Finance, if necessary, to make up this loss of revenue, consider the advisability of imposing a tax on the total deposits of all deposit-taking institutions.

Quality Mortgage

115. That the definition of a quality mortgage with respect to owner-occupied residential property include first and junior mortgages provided the following conditions are met:

- a single financial institution provided both the first and the junior mortgage loans;
- no third party claim on the property in question;
- the total value of the first and junior mortgage not exceed the 75 per cent loan to value ratio;
- no single mortgage loan exceeding 15 per cent of shareholders' equity of the lending institution.

Trust Companies

116.

A.	MINIMUM INITIAL CAPITALIZATION	$5 million
B.	BORROWING MULTIPLE (trust companies only)	10x – 20x on a consolidated basis
C.	ASSET MIX	PER CENT OF ASSETS
	Debt securities and quality mortgages	Minimum 60%
	Preferred shares	Maximum 10%
	Non-quality mortgages	Maximum 5%
	Real estate and real estate subsidiaries	Maximum 5%
	Subsidiaries:	
	Financial	No statutory limit
	Non-financial	Aggregate Maximum 5% Each individual subsidiary, Maximum 2%
	Basket clause(except real estate)	Maximum 15%
D.	MAXIMUM EXPOSURE TO 1 INDIVIDUAL OR GROUP OF RELATED ENTITIES	20% of shareholders' equity
E.	PORTFOLIO INVESTMENT	Maximum 20% of voting stock

Life Insurance Companies

117.

A.	MINIMUM INITIAL CAPITALIZATION	$6 million
B.	LEVERAGE	To be determined pending introduction of a minimum continuing capital and surplus requirement which varies by the nature of liabilities
C.	ASSET MIX	LIMITS
	Debt securities and quality mortgages	No statutory limit
	Preferred shares	Maximum of 10% of assets
	Non-quality mortgages	Maximum of 5% of assets
	Real estate for investment, including real estate subsidiaries	35% of equity & 25% of par liabilities & 15% of non-par liabilities

Real estate for own use, including real estate subsidiaries	**35% of equity**
Common stocks	**35% of equity & 25% of par liabilities & 15% of non-par liabilities**
Common stocks of venture capital corporations	**10% of equity**
Total common shares and real estate combined	**100% of equity & 40% of par liabilities & 20% of non-par liabilities**
Subsidiaries:	
Financial	**No statutory limit aggregate maximum 5% of assets and 2% of assets on each individual subsidiary**
Non-financial	
Basket clause (except real estate)	**Maximum 15% of assets**
D. PORTFOLIO INVESTMENT	**Maximum 20% of voting stock**

118. That life insurance companies be allowed to act as trustees of funds payable on insurance contracts, registered pension plans and registered retirement savings plans.

Valuation Actuary

119. That NFAA review the present role of the valuation actuary in consultation with the Canadian Institute of Actuaries and broaden this role to include an appropriate responsibility for the continuing financial condition of the company along the lines of the Appointed Actuary in the United Kingdom.

Property and Casualty Insurance Companies

Investments

120.

A. MINIMUM INITIAL CAPITALIZATION	**$5 million**
B. MINIMUM ON-GOING CAPITALIZATION	**Maintain Test 103 of current insurance legislation. Introduce new test proposed by Superintendent of Insurance based on 15% of premiums and 22% of claims.**

C. ASSET MIX

Debt securities and quality mortgages	no statutory limit
Real estate for investment, including real estate subsidiaries	35% of equity
Real estate for own use, including real estate subsidiaries	35% of equity
Common stocks	100% of equity
Common stocks of venture capital corporations	10% of equity
Total common stocks, preferred shares and real estate combined	150% of equity
Subsidiaries	
Financial	No statutory limit
Non-financial	5% of assets aggregate maximum 2% of assets on each individual subsidiary
Basket clause(except real estate)	Maximum 15% of assets

D. PORTFOLIO INVESTMENT	Maximum 20% of voting stock

Reinsurance

121. That the amount of premiums that a company, other than a reinsurance company, can cede to a non-registered reinsurer be limited to the amount of premiums ceded to a registered company.

Valuation Actuary

122. That property and casualty insurance companies be required as soon as possible to appoint a valuation actuary and include with their financial statements a report by the actuary certifying that the provisions for unearned premiums and unpaid claims are adequate;

123. That a transition period of five years be allowed during which a company could appoint a person other than a fully-qualified actuary if it could demonstrate to NFAA that it was not reasonably able to secure the services of a fully-qualified actuary;

124. That the review of the role of the valuation actuary recommended by the Committee for life insurance companies also be applicable to property and casualty insurance companies.

Pension Funds

Diversification

125. That the existing limit of 10 per cent of assets on the investment in a single corporation or group of related corporations be retained.

Portfolio Investment Limit

126. **That investments in a single corporation be limited to 20 per cent of voting stock.**

Securities in Default

127. **That a basket clause of 15 per cent of assets for investment in ineligible assets be established;**

128. **That the proposed prohibition of investment in securities "in default" be rescinded and that such prohibition be determined within the investment rules and objectives of individual pension funds.**

Chartered Banks

129. **That the requirement for chartered banks to maintain non-interest bearing cash reserves with the Bank of Canada be eliminated.**

Co-operative Credit Institutions

130. **That the Canadian Co-operative Credit Society be given the same powers of diversification as those contemplated for non-bank financial institutions;**

131. **That NFAA be encouraged to develop ways and means to enable CCCS to establish a bank should the provincial centrals so desire.**

Securities Dealers

132. **That a position on the Board of NFAA be reserved for the securities industry if and when provincial governments permit ownership rules allowed other financial institutions to have ownership interest in securities firms.**

Federal-Provincial Relations

133. **That federal and provincial governments pursue discussions to harmonize legislation, regulation, supervision and enforcement of the Canadian financial system within the framework of NFAA.**

Conclusion

134. **That all federal legislation governing financial institutions be reviewed and revised on a decennial basis.**

V. Regulation, Supervision and Consumer Protection

The Green Paper indicated that the government will review the system of regulatory supervision and deposit insurance, and will introduce changes to the supervisory structure, including the consolidation of the Office of the Inspector General of Banks and the Department of Insurance. Supervisory methods would be updated, including stricter standards for granting or renewing licences and the requirement for ministerial approval for mergers and significant transfers. Several new enforcement powers for all institutions will be introduced, including cease and desist order, curatorships, increased grounds for taking control of the assets of endangered institutions, and increased powers to control self-dealing. The Wyman Report recommended extensive changes with respect to deposit insurance.

Supervisory responsibility for the incorporation and ongoing supervision of financial institutions is divided between federal and provincial governments. As Table 1 indicates, federal regulatory agencies are responsible for the supervision of the majority of assets of banks, life, property and casualty and trust companies.

Responsibility for incorporation and ongoing supervision of federally incorporated institutions is divided between the Office of the Inspector General of Banks (OIGB), whose responsibility is limited to the chartered banks and the Department of Insurance (DOI) whose responsibility relates to life insurance, property and casualty insurance, trust and loan companies, investment corporations and six credit union centrals under the *Credit Union Associations Act*.

The Canada Deposit Insurance Corporation (CDIC) supervises, with the assistance of the Inspector General of Banks and the Department of Insurance, federally incorporated deposit-taking institutions and some provincially insured institutions.

There has been little change in these supervisory arrangements over the years with the exception of the creation of CDIC in 1967 and the added responsibility to the Department of Insurance for supervising companies coming under the *Investment Companies Act* of 1972 and for credit unions under the *Federal Co-operative Credit Associations Act*.

Given the national and international scope of Canadian financial institutions, federal officials maintain ongoing contacts with provincial and foreign supervisory authorities.

The Inspector General of Banks is appointed by Governor-in-Council and remains in office at the pleasure of the Governor-in-Council. He reports to the Minister of Finance. The principal, and only, office is located in Ottawa. Its current budget is $2.5 million dollars a year, of which almost 100 per cent is recovered from the institutions under his supervision. It has an authorized staff of 42. This compares to a staff of 2 in 1945 and 5 in 1975. It is currently responsible for supervising 13 Schedule

Table 1

Scope of Federal Regulation

Major industry segments	No. of Institutions[1]	Percentage of total assets held by federally regulated companies[2]
Chartered banks	72	100
Trust and mortgage loan companies		66
CDIC-insured federal[3]	59	
CDIC-insured provincial	63	
Non-CDIC-insured provincial	1	
Insurance companies		
Life and health[4]		91
—federal	199	
—provincial	58	
Property/casualty		71
—federal	244	
—provincial	70	
Registered investment dealers	70	0
Co-operative credit institutions		
Canadian Co-operative Credit Society	1	100
Provincial centrals[5]	12	0
Credit unions and caisses populaires[6]	1,781	0
Desjardins Group[7]		
—federations	11	0
—locals	1,419	0

[1] As of December 31, 1984. Numbers include both federally and provincially incorporated institutions.
[2] As of December 31, 1983.
[3] Not including chartered bank mortgage loan subsidiaries.
[4] Includes 71 fraternal benefit societies.
[5] Six of the 12 non-Quebec provincial centrals are registered under the Co-operative Credit Associations Act and are supervised in part by the federal Department of Insurance.
[6] Outside Quebec.
[7] Mainly Quebec.

Source: Department of Finance, *The Regulation of Canadian Financial Institutions*, April 1985.

'A' banks (including the Canadian Commercial Bank and the Northland Bank) and 58 Schedule 'B' banks, of which 57 are foreign-owned.

The Superintendent of Insurance is also appointed in the same manner. He reports to the Minister of Finance. The Department of Insurance has its head office in Ottawa as well as smaller regional offices in Vancouver, Winnipeg, Toronto, Montreal and Halifax. It has a budget of $11.7 million, approximately 80 per cent of which is recovered by supervisory fees. It has a total authorized staff of 226. This compares to 37 staff in 1945 and 193 in 1975. It is currently responsible for supervising 192 life insurance companies (which include 39 fraternal benefit societies and 19 companies that also transact property and casualty insurance), 263 property and casualty insurance companies (included 19 companies that also transact life insurance), 69 trust and loan companies, 26 investment companies, and 7 central credit unions. The Department also supervises, by agreement with certain provinces, 1 fraternal benefit society, 4 property and casualty insurance companies and 19 trust and loan companies incorporated under the laws of those provinces. It also provides examination and other technical services to CDIC with respect to 40 provincially incorporated trust and loan companies that are members of CDIC.

The Chairman of CDIC is appointed for a fixed term by the Minister of Finance and reports to him. In addition, he reports to the board of directors made up of the Governor of the Bank of Canada, the Deputy or Associate Deputy Minister of Finance, the Inspector General of Banks and the Superintendent of Insurance. The principal office is located in Ottawa. There is an additional office in Toronto. The corporation had an annual budget of approximately $3 million in 1984 and has a current staff of 22, compared with 3 in 1967. By agreement, the Office of the Inspector General of Banks and the Department of Insurance, together with Quebec and Ontario supervisory officials, carry out all annual insurance inspections of CDIC insured institutions. In 1984 the corporation incurred expenses of approximately $1.6 million for inspection and other supervisory activities, the bulk of which covered inspections carried out by the Department of Insurance.

A. The Need for Supervisory Reform

Recent trends and problems in the Canadian financial system have highlighted the need to improve the federal supervisory system. The failure of seven federally supervised financial institutions during 1985 – two chartered banks, three trust companies and two property and casualty insurance companies - raises serious doubts about the adequacy of the supervisory system. Failures of provincial institutions, while not the direct responsibility of federal supervisory authorities also underline the need for improved supervisory standards across all jurisdictions.

In his testimony before the Committee, the Superintendent of Insurance cited the numerous reasons for the failures of seven federal trust and mortgage loan companies and four property and casualty companies. These include: inadequate capital, overexposure in real estate, low quality mortgages with questionable appraisals, mismatching between assets and liabilities, abusive self-dealing, the use of unlicensed reinsurers, and the poor quality of management.

In its study of the circumstances leading up to the support package provided to the CCB in March 1985 this Committee also identified a number of serious shortcomings such as lax regulatory supervision, questionable accounting practices, inadequate disclosure, inadequate performance by outside auditors and their lack of communication with the Office of the Inspector General of Banks.

Technology accounts for another reason for supervisory reform. Computers and communications technology have enabled the financial institutions to effectively leap over traditional domestic and international supervisory boundaries. No longer is it sufficient to limit supervision to the activities of an institution in a limited geographic area. Technology, coupled with increased product de-regulation and the blurring of industry boundaries, requires a new approach to supervision, one which recognizes the national and international dimensions of many financial institutions and the need to utilize up to date computer-based technology and modernized supervisory approaches to deal with the dramatically different financial scene of the 1980's.

A third area of reform relates to the adequacy of the supervisor's power to deal with problem situations. There is evidence, from recent financial institution failures, that federal regulators require additional remedial powers to perform more effectively. Also it would appear that they have not fully utilized their existing powers nor done so in a timely manner. Recent events would indicate that the traditional "gentlemen's approach" to financial supervision is no longer appropriate in an environment of increased risks, frequent and significant economic shifts and intense competition. A more assertive supervisory approach is required, together with the requisite enforcement powers to get the job done. The traditional "reactive" mode of supervision must give way to a "pro-active" mode.

The supervisory process of Canadian banks has been patterned on the British system which relies heavily on institutional self-regulation and the use of outside auditors. Until 1975 the OIGB had under five employees. In contrast to the American supervisory system, which employs hundreds of government examiners to perform detailed on-site examinations, the Canadian approach relies on the work of internal inspections and external audits and generally limits its own reviews to an examination of the adequacy of bank management and the controls it has introduced to comply with prudential policies and regulations. In contrast the supervision of trust and insurance companies involves detailed on-site examinations by federal supervisors and is much closer to the American banking system.

Both the adequacy of bank supervisory methods and the responsibility of outside advisors to all financial institutions, including auditors, appraisers, actuaries and lawyers are in need of review and revision.

The internationalization of the Canadian financial system and in particular the growing importance of foreign markets to Canadian chartered banks, life insurance companies and some of the larger trust companies points to the need for careful re-examination of the adequacy of present supervisory practices in the international area.

Finally, the increased blurring of differences between financial industries, particularly among the deposit-taking institutions, and the pressure from all financial industry groups for further product deregulation, reinforces the need to re-examine the suitability and effectiveness of two separate federal supervisory bodies and a separate deposit insurance entity. The shortcomings of the present organization structure were recognized in both the Green Paper and the Wyman Report.

B. Supervisory Structure

The two major structural reform issues concern the desirability of consolidating the Office of the Inspector General of Banks and the Department of Insurance, and combining supervision and the administration of deposit insurance.

The issue of a centralized federal supervisory body was examined in the Green Paper, which recommended that in view of the increased complexity of the financial system and the probability of closer ties between institutions, consideration be given to incorporating responsibility for the regulation of all federally regulated financial institutions and financial holding companies into one body. The 1964 Porter Royal Commission on Banking and Finance recommended that supervisory responsibility for all deposit-taking institutions be centralized in one federal body. The report of the Economic Council of Canada in 1976 entitled *Efficiency and Regulation – A Study of Deposit Institutions* recommended that the functions of the Canada Deposit Insurance Corporation, be combined with those of the Office of the Inspector General of Banks and the Department of Insurance.

The proposal to consolidate the federal supervisory agencies into a single regulatory body met with a mixed response in evidence presented to the Committee. Most institutional groups had reservations about this approach and preferred to have primary supervisory bodies dealing with each of the major financial industries at the federal level. It was argued that each of the industries is unique and has specific regulatory concerns and requirements and thus requires supervisory staff specialized in their respective businesses. Some witnesses, however, accepted that there could be improved co-ordination and greater efficiencies in supervision if the separate specialized groups operated as separate but related branches of an overall single agency. It was also suggested by a number of witnesses that if this consolidated approach were to be adopted there should be an adequate transition period during which the new structure could be put into place.

The Canadian Life and Health Insurance Association did not object to the consolidation of supervisory authority into one body provided life insurers are supervised directly by an individual knowledgeable in the business and the primary supervisor's mandate does not exceed a period of five years. The Trust Companies Association did not support the view that regulatory bodies at the federal level should be brought under one regime. However, wherever possible regulatory and supervisory provisions relating to one industry sector should be made consistent with those relating to the others. The Insurance Bureau of Canada questioned the proposal to consider consolidating the functions of the Office of the Inspector General of Banks with that of the Superintendent of Insurance in one body responsible for supervising all federally regulated financial institutions and financial holding companies. The Canadian Bankers' Association felt that the case for merging the Offices of the Inspector General of Banks and Superintendent of Banks was unconvincing. Instead, the present supervisory structure should remain. This approach would be consistent with the CBA view that the banking and trust sectors should also be treated separately for insurance purposes through a system of claims based on assessments to reflect the insurance claims experience of different classes of member institutions.

The Committee is of the view that there are several administrative advantages to be gained in consolidating the activities of the two major supervisory offices which could lead to much-needed improvements in federal supervision. It will, of course, be necessary to develop a transition plan, in close consultation with the Office of the Inspector General of Banks, the Department of Insurance, regulated financial institutions and provincial and other supervisory officials to assure a smooth transfer.

The proposal for a national body incorporating both supervision and insurance functions was not examined in the Green Paper or the Wyman Report. Nor was it commented on by witnesses during the Committee hearings. The Committee has however examined in some detail the arguments for and against combining supervisory responsibility and the administration of insurance into one body.

Federal supervisors and insurance underwriters share the ongoing need to be assured of the continuing safety and soundness of the institutions which they regulate and insure. As the Wyman Report pointed out, in the case of the CDIC, it is essential that it be able, in certain cases, to directly exercise selected enforcement powers. Many of the present administrative problems under the existing arrangements between the CDIC, the OIGB and the DOI would be eliminated through consolidation. There are also several administrative advantages resulting from the combination of both functions: common administrative leadership and control; improved staff communications; broadened personnel career paths; use of common administrative support systems including data processing and regional office structures; and a larger pool of highly skilled professional staff. Finally, the supervision of financial institutions which are characterized by a relatively small number of players, and very high concentration ratios requires a federal regulatory system of sufficient scale to attract staff of the caliber required to deal with increasingly large, complex and sophisticated financial institutions and transactions. Most importantly, consolidation would instill some measure of market discipline into the supervisory system because the body responsible for deposit insurance has an incentive to minimize loss.

The arguments against consolidation can be summarized by the following concerns. Insurance underwriting is significantly different from ongoing regulatory supervision and therefore should be kept separate. Weaknesses in the present supervision of financial institutions can and should be improved without the need for major organization changes through staffing improvements, stepped-up examinations and improved enforcement powers. A separate and independent insurance agency would be in a position to establish standards for its own underwriting as well as prudential standards to be imposed by all primary regulators, of insured institutions. Conflicts are likely to arise in one agency which combines the roles of policy and standard setting with supervisory responsibility for their observance.

Little public testimony was heard with respect to possible structural changes affecting CDIC. The Canadian Bankers' Association was one of the few witnesses to address some aspects of this issue. It argued that, while it was generally supportive of a strengthened supervisory role for the CDIC, it was against what it termed "regulatory overlap" and "super" regulatory responsibilities and instead recommended that CDIC work through the primary regulators for ongoing supervision and on-site inspections.

The Committee has examined the arguments for and against combining the supervisory and insurance agencies into one federal body and is convinced that there are a number of advantages in doing so. In addition to internal administrative advantages, there should also be advantages to provincial governments and their regulatory officials, and the financial institutions themselves in dealing with only one agency combining supervision and insurance.

The Committee agrees that regulatory duplication should be avoided in any new regulatory framework but also feels strongly that there is a need for greater integration of the consumer protection system and the regulatory and supervisory systems for financial institutions. Consequently, the Committee proposes the creation of a National Financial Administration Agency (NFAA) which would be an autonomous Crown corporation involving representatives of the provinces, the financial industries and the federal government on its Board of Directors. The Committee suggests that there be four provincially appointed directors (from the Atlantic provinces, Quebec, Ontario and the Western Provinces); eight industry appointed directors (two from the chartered banks and one each representing the trust companies, the life insurance companies, the property and casualty insurance companies, the financial co-operatives, pension funds and securities firms, if provincial ownership rules were charged to allow them to be closely-held by federally incorporated financial institutions); and five federal government directors (one appointed by each of the Bank of Canada and the Department of Consumer and Corporate Affairs and three by the Department of Finance). In addition, the Board would hire an Inspector General of Financial Institutions as chief executive officer of NFAA and who would also sit on the Board to give a total board membership of eighteen. The Chairman of the Board of Directors would be appointed by the Minister of Finance.

This agency would act as the regulatory and supervisory agency for all federally incorporated financial institutions and for any provincially incorporated institutions if the provinces so desired. It would also establish conditions for membership of institutions in the various consumer protection plans under its administration. Provincial institutions would have to comply with these conditions in order to obtain coverage under these plans. The agency would administer separate funds for each type of financial activity that would act either as direct providers of consumer protection plans or as back-up resources to industry operated protection plans. In the case of deposit insurance, it would administer the Canada Deposit Insurance Fund which would be funded by premium assessments on the member institutions and would take over the existing financial obligations of the current Canada Deposit Insurance Corporation. For the insurance industries the agency would act as an administrator of two separate insurance policyholder compensation plans proposed by the life insurance and property and casualty insurance industries. In the case of financial co-operatives, it would act as a lender of last resort to the current provincial stabilization funds.

NFAA would operate an inspection and supervisory system which would have broad powers to inspect institutions without notice, to appraise asset values, to issue cease and desist orders, and to initiate prosecutions for conflicts of interest and self-dealing offenses. It would take a hands on approach to supervision along the lines outlined in the section on supervisory methods. This would include a much more assertive approach to preventing and dealing with problem situations and would include increases in the number, and particularly the quality of supervisory staff; a decentralized system of regional offices, more extensive use of computer-based reporting and ranking systems; more frequent and thorough supervisory examination; improved use of outside experts and broadened enforcement powers. All of this will be coupled with much higher standards of institutional care and self-regulation.

The system would be operated through a number of regional operating offices in much the same way as is currently done by the Department of Insurance. The supervisory system would be structured into separate branches for chartered banks, trust and loan companies, life insurance companies, and property and casualty companies, and pension funds each of which would have specialized staff appropriate for supervising the activities of each type of institution. However, staff could be interchanged between branches as required by the supervisory process. In cases where institutions felt that they were not being treated fairly by the inspection and supervisory system there would be provisions for appeals to an administrative review committee of the Board of Directors made up of industry directors, provincial directors and representatives of the Bank of Canada and Department of Finance and additionally civil and criminal appeals could also be conducted through the judicial process.

Therefore, the Committee recommends:

1. **That a National Financial Administration Agency (NFAA) be created to administer all consumer protection plans and act as the regulatory and supervisory agency for all federally incorporated financial institutions and for provincially incorporated institutions where appropriate;**

2. **That NFAA have a Board of Directors consisting of federal, provincial and industry representatives and appoint an Inspector General of Financial Institutions as its chief executive officer;**

3. **That there be an appropriate transition period for organizing NFAA after which the responsibilities, functions and staff of the Office of the Inspector General of Banks, the Superintendent of Insurance and the Canada Deposit Insurance Corporation would be transferred to NFAA;**

4. **That NFAA establish conditions for membership with respect to all consumer protection plans under it and administer separate funds for each type of financial institution and act as direct provider of deposit insurance, as administrator of insurance policyholder compensation plans and as lender of last resort to provincial stabilization funds for financial co-operatives;**

5. **That NFAA operate through regional offices across Canada, an inspection and supervisory system with broad powers structured into separate branches for the chartered banks, trust and loan companies, life insurance companies, property and casualty insurance companies and pension funds;**

6. **That the cost of operating NFAA's regulatory functions be charged back to each supervised institution through user assessments.**

In considering changes to the future operations of deposit insurance, the Committee has been made aware of a curious practice used by CDIC in recent years as part of its process to wind up failed institutions. This practice related to the use of so-called agency agreements which were entered into between CDIC and other deposit-taking institutions that had been selected by CDIC to run-off the assets and pay off the liabilities of the failed institution. While the selection of institutions for the agency run-off was based on a bidding process, presumably with cost minimization being one of the major criterion, numerous agreements called for the borrowing of funds at 25 basis points above the commercial bank prime rate by CDIC from the agent institution to meet the needs and liabilities of the failed institution as they became due. Admittedly, the borrowing authority of CDIC from the Consolidated Revenue Fund was limited to $500 million up to early 1983 when its financial requirements might have exceeded this line of credit. But this borrowing authority was increased to $1.5 billion in March 1983. There has been at least one agency agreement since then that contains a borrowing provision by CDIC at prime plus a quarter point from the agent institution as part of the run-off arrangement. The Committee calls into question this practice by a crown corporation to borrow funds at a considerably higher rate than normal government borrowing.

Therefore, the Committee recommends:

7. That NFAA in connection with its future administration of deposit insurance, not borrow funds at interest rates above those normally charged to the government of Canada.

C. Supervisory Methods

In general terms, regulation can be defined as the imposition of rules, backed by sanctions for non-compliance, to change the behaviour of individuals or corporations. Supervision, on the other hand, is the actual process of implementation of regulation, and supervisory methods are the ways and means of supervision. Under the present system of supervision, the variety of methods used can be broadly categorized in the following areas: monitoring functions such as regular reporting requirements, preventive measures such as liquidity and capital adequacy guidelines, rehabilitative or remedial procedures such as cease and desist orders and lastly termination of an institution by way of liquidation. Of the wide range of supervisory methods at the disposal of authorities, it is the monitoring and preventive measures that preoccupy most of the supervisor's time under normal conditions. Recent failures have pointed to certain gaps in these two areas of supervisory methods and some of these inadequacies are addressed in this section. The more drastic remedial procedures supervisory authorities may use are discussed in the following section on enforcement powers.

Inspection System

In contrast to the United States, the Canadian inspection system of banks is not founded upon on-site inspection by inspectors from the Office of the Inspector General of Banks. Instead, it is based on a combination of reporting by the shareholders' auditors, regular information returns and management interviews. While this system has operated reasonably economically and effectively until recently, the failures of the Canadian Commercial Bank and the Northland Bank have revealed a serious inadequacy in the system. The difficulty arises when communication between the supervisor and the shareholders' auditors is less than complete, the supervisory body finds itself in a position of having to asses the solvency of an institution, which it seems to be incapable of doing. In both recent failures, audit teams assembled from the major chartered banks were required to perform asset quality reviews and solvency assessments. The erosion of confidence in small regional banks following these two failures led three other regional banks to request the major banks to audit their books. To have one's fiercest competitors audit one's accounts in order to reassure the market about one's own soundness is peculiar to say the least. It may also leave the public with an impression that could affect the future ability of the supervisory body to play a meaningful role in any crisis management. While it may not necessarily be feasible or desirable for Canada's banking supervisory system be modelled after the U.S. system, the Office of the Inspector General of Banks under the proposed NFAA will need to develop the capability and be given the necessary manpower to perform solvency assessments in emergency cases.

Therefore, the Committee recommends:

8. That NFAA develop the necessary capability to perform on-site inspections of chartered banks for assessing the solvency of these institutions.

Audit Appointment

The *Bank Act* currently requires shareholders of a bank to appoint two firms of auditors, one of which must be replaced every other year. This Committee has already recommended in its report on the Canadian Commercial Bank earlier this year that the dual audit system be modified to the extent that one of the two firms would be appointed by and report to the Office of the Inspector General of Banks. Having an officially designated auditor would result in several advantages. One of the two auditors would have a direct responsibility to report any concerns or problems to the supervisor. The latter would be better able to verify compliance with guidelines and regulations through the officially designated auditor. Annual audits would focus more adequately on the prudential concerns of the supervisor. Admittedly, modifying the existing dual audit system is not a substitute for timely preventive or rehabilitative action by the supervisory body, but it does nevertheless constitute an improvement in the ongoing monitoring of institutions.

Therefore, the Committee reiterates its recommendation:

9. That one of the two auditors of a bank be appointed by and report to NFAA and be required to carry out its examination in accordance with the instructions from NFAA.

Monitoring and Communication

Based on its hearings on the provision of a support package to the Canadian Commercial Bank, this Committee concluded that communication between the shareholders' auditors and the Inspector General of Banks were not always timely or complete. To improve monitoring and communication, the Committee recommends:

10. That NFAA conduct a meeting with the shareholders' auditors and the audit committee of a bank as part of its annual inspection procedure or whenever such a meeting is deemed to be necessary.

The quality of judgement is vital when determining the kind of information institutions ought to be required to disclose. The information has to reflect the increasing complexities of today's financial transactions and be sufficiently transparent for the supervisory authority to monitor the solvency of an institution. Most industry observers have commented on the necessity of "street smarts" to exercise the kind of judgment that would result in meaningful and transparent disclosure.

Liquidity Support

Recent developments have demonstrated that the market may react precipitously and adversely to any bank receiving liquidity support from the Bank of Canada. Liquidity support has tended to erode public confidence in an institution. Justifiably or not, the Committee believes that when public confidence in a deposit-taking institution becomes visible shaken, the supervisor should take remedial action to rectify any weaknesses there may be or restore public confidence.

Therefore, the Committee recommends:

11. That whenever a deposit-taking institution receives liquidity support in relation to its total liabilities in excess of limits pre-determined by the

appropriate supervisory body, NFAA be required to perform on-site inspection to determine the reasons for the liquidity shortage and consider reviewing and revising the permitted leverage of the institution.

Interest Accrual, Non-accrual Loans and Fee Income

Effective fiscal year 1985, chartered banks in Canada are required to report the amount of non-accrual loans and the amount of interest accrued but not yet received. Any loan where interest payment is contractually in arrears for 90 days or more is automatically classified as non-accrual except when management judges that there is no reasonable doubt about the collectibility of both principal and interest. When a loan becomes non-accrual, any interest accrued would be reversed against other interest income. While this type of disclosure would have alerted the supervisor about the magnitude of this type of questionable accounting practice in the case of the Canadian Commercial Bank, the Committee has been made aware of another method used to deal with problem loans. The so-called "fancy deals" converted bad loans into good ones by simply changing the name of the loan file and showing as profits, the fee income which has been capitalized into the principal of the loan.

Therefore, the Committee recommends:

12. That NFAA be encouraged to develop the necessary procedure for all financial institutions to report regularly the amount of fee income related to restructured loans and that these amounts be required for public disclosure;

13. That all financial institutions be required to report to NFAA and disclose to the public the amount of non-accrual loans and the amount of interest accrued but not yet received.

Transactions With Related Parties

The question of non-arm's-length transactions is addressed in this report under the section on self-dealing. However, since the *Bank Act* does allow certain related party transactions such as loans to officers of a bank and to companies associated with directors of a bank. In light that there is now some evidence that related party transactions were involved in the failures of the two western based banks. The ability of the supervisory body to ascertain such knowledge in advance would be important as part of the ongoing monitoring process.

Therefore, the Committee recommends:

14. That all financial institutions be required to report related party transactions to NFAA on a quarterly basis.

Post-resignation Interview

The Committee has learned during its hearings that most of the reasons outlined by a former director of Pioneer Management Company for his resignation in fact turned out two years later to be the causes of the collapse of Pioneer Trust. However, this letter of resignation was not brought to the attention of the supervisory body in due time to prevent the failure. While "character and fitness" test serves as a precautionary device for screening individuals wishing to start a new or acquire an existing financial institution, it seems equally meaningful as a complementary device for the supervisory body to inquire about the reasons for the departure of a director or an officer of an institution.

Therefore, the Committee recommends:

15. That all letters of resignation by a director, auditor, valuation actuary or an officer of a financial institution be submitted to NFAA within 14 days of receipt by the institution and that NFAA be empowered to conduct a post-resignation interview with the individual if the reasons for the departure reflect upon the prudential management of the institution.

Brokered Deposits

Smaller deposit-taking institutions often pay a commission to a variety of agents to have deposits placed with them rather than developing a costly large branch structure. Insurance and real estate brokers, lawyers, and investment dealers have all been known to be brokers for deposits. On the one hand, the emergence of deposit brokers has resulted in a trend towards deposit-parcelling for the purpose of maximizing deposit insurance coverage. Since it is often the perceived weaker institutions that pay higher rates of interest to depositors and higher fees or commissions to brokers, the growth of a deposit brokerage network would undermine market discipline among depositors. In this context, the growth of brokered deposits would tend to undermine the stability of the whole system. Several failures of trust companies have revealed the extent to which brokered deposits had been used to support questionable lending activities. On the other hand, it would be questionable whether small regional deposit-taking institutions could remain viable and competitive without brokered deposits. Notwithstanding the recent failures of institutions that relied heavily on these deposits, it is a source of funding being used successfully by many other institutions across the country. Indeed, it is often not the fact that deposits were gathered by a brokerage network that is a source of difficulty but rather the relatively short-term maturity attached to some of these deposits. The Wyman Committee acknowledged that to impose a requirement for all deposit brokers to be registered would be unacceptable to some. It also recognized that to require brokers to forfeit to CDIC all commissions earned on deposits in a failed institution would be difficult to enforce.

On balance, the Committee does recognize that brokered deposits can be used to sustain institutions with substantial questionable assets, the Committee therefore recommends:

16. That NFAA be encouraged to develop appropriate procedures to monitor brokered deposits.

Inter-affiliated Dividends

In reviewing the failures of financial institutions in recent years, the Committee has noted that inter-affiliated dividend payments have often been used to accomplish the so-called "back-to-back" transactions as a device to disguise abusive self-dealing transactions. These often involved extraordinary dividend payments both in terms of amount and frequency of payment. While legitimate inter-affiliate transactions necessarily entail inter-affiliated dividend payment, it is the view of the Committee that inter-affiliated dividend payments of an extraordinary nature must be strictly controlled.

Therefore the Committee recommends:

17. That a 30-day pre-notification to NFAA be required of any company declaring a special or extraordinary dividend in addition to regular quarterly or annual dividends, and other dividends whose amounts substantially exceed those paid out in preceding years.

Chapter XI

The experience with the attempts to save the two recently failed chartered banks pointed to the need for powers to be vested in the curator of a financial institution similar to that provided to any company under Chapter XI of the *U.S. Bankruptcy Code*. The purpose of Chapter XI is to allow any company in financial difficulty to recapitalize itself and restructure its organization within a pre-determined period, usually 180 days. During the intervening period of reorganization, the company is not required to meet the obligations of its creditors. At the same time, it is protected against any liquidation proceedings. But it has to demonstrate to the satisfaction of the appropriate bankruptcy court that its reorganization and recapitalization would restore it to a viable ongoing concern. Failing this, creditors would be able to initiate bankruptcy proceedings against the company. It is the opinion on the Committee that a similar provision under the curatorship in respect of financial institutions might have avoided some of the confrontation between the authorities, shareholders and subordinated debenture holders in the case of the Canadian Commercial Bank and the Northland Bank. Therefore the Committee recommends:

18. That for the purposes of rehabilitating a financial institution in difficulty, any curator appointed by NFAA be empowered to reorganize, restructure and recapitalize the institution, without the encumbrance of creditors and shareholders alike, in the same manner as provided for under Chapter XI of the *U.S. Bankruptcy Code*.

Actuaries, Auditors and Appraisers

Another area of concern to the Committee is the role of the professional advisors to financial institutions. The specific areas of concern relate to the valuation of largely unoccupied buildings, the valuation of property in areas where there has been substantial fluctuation in value, and the amortization of goodwill. The Committee has learned that the Appraisal Institute of Canada had encountered over the years considerable resistance from its own members to raise the standards of the code of conduct by appraisers. The Institute also admitted that it had little power of effective sanction against wrongful behaviour. Moreover, unlike other professionals such as actuaries, lawyers and accountants, there is no minimum qualification requirement for someone to perform real estate valuation nor any requirement for someone actively involved in real estate valuation to be a member of the Appraisal Institute of Canada. It is the view of the Committee that these two factors have contributed to many questionable valuations used to support and justify questionable lending activities including non-arm's-length transactions.

As in the case of real estate valuation, the amortization of goodwill also involves the exercise of judgement by management and auditors. The Committee was surprised to learn that the shareholders' auditors of the Canadian Commercial Bank consented to amortizing the goodwill with respect to its acquisition of the Westlands Bank in California over the maximum period of 40 years allowed by generally accepted accounting principles (GAAP). This is particularly disturbing when the auditors acknowledged to the Committee that they had reservations about the length of the amortization period when the net worth of the Westlands Bank was questionable.

Therefore, the Committee recommends:

19. That any actuary, auditor or appraiser to be engaged in his/her respective professional capacity, by a financial institution under the supervision of NFAA be required to obtain the prior approval of NFAA and that NFAA establish a list of certified individuals for this purpose;

20. That NFAA in conjunction with the Canadian Institute of Actuaries, the Canadian Institute of Chartered Accountants and the Appraisal Institute of Canada be encouraged to develop guidelines and standards for the financial reporting of the solvency of financial institutions;

21. That NFAA require these professional bodies to establish a review committee on the adequacy of solvency standards as applicable to actuaries, accountants and appraisers;

22. That severe disciplinary measures be instituted against those professional advisors who fail to observe the established standards and code of conduct.

D. Enforcement Powers

Regulatory supervision is concerned with four broad areas - entry and transfer requirements; compliance with laws and regulations; safety soundness and consumer protection.

The responsibilities for compliance and consumer protection are shared between the supervisory bodies and three other departments, the Department of Consumer and Corporate Affairs for combines matters, and the Attorney General or Department of Justice for criminal prosecutions. Supervisory officials have traditionally played a major role in dealing with entry and transfer issues and conducting routine prudential reviews aimed at safety and soundness.

Financial Institution Failures

The supervisory system has generally worked well. This is illustrated in Table 2 by the relatively few failures. It has for the most part been conducted in an environment of economic growth and an atmosphere of congeniality in which governments, officials and financial institutions all seemed to understand and abide by the same rules. A high degree of trust prevailed in the system. Persuasion, rather than heavy-handed coercion, seemed to be sufficient in dealing with supervisory problems when they arose.

This traditional approach no longer seems appropriate in the changed conditions of today. The rate and speed of change in the financial industry, frequent and often adverse changes in the domestic and world economies together with the blurring of distinction between industry and regulatory boundaries requires new supervisory approaches and enforcement powers appropriate to the task.

Table 2

Failures of Federally Regulated
Financial Institutions
(1923-1985)

Chartered Banks

1923 The Home Bank
1985 Canadian Commercial Bank
1985 Northland Bank

Trust and Loan Companies

1980 Astra Trust Company
1983 The Fidelity Trust Company
1983 AMIC Mortgage Investment Corporation
1983 Greymac Mortgage Corporation
1983 Seaway Mortgage Corporation
1984 Northguard Mortgage Corporation
1985 Pioneer Trust Company
1985 Western Capital Trust Company
1985 Continental Trust Company

Property and Casualty Insurance Companies

1966 North American General Insurance Company
1976 Underwriters National Assurance Company
1977 American Reserve Insurance Company
1981 Pitts Insurance Company
1981 Strathcona General Insurance Company
1982 Cardinal Insurance Company
1985 Ideal Mutual Insurance Company
1985 Northumberland General Insurance Company

A broad mix of enforcement powers ranging from the routine to the more drastic is illustrated in Table 3. If, for whatever reasons, they are not used, used improperly or too late, they will not do the job they are designed for.

Table 3

Supervisory Enforcement Powers

Degree Of Seriousness

°Reports °Inspections °Audits °Disclosure	Limits on: —lending —borrowing —capital —leverage —asset valuations	°Administrative monetary penalties °Cease and Desist orders °Suspension or Removal	°Curatorship °Termination of licence °Termination of insurance °Liquidation	°Prosecution of Directors, or Officers for legislation, or regulations

Currently, Canadian supervisory officials have a broad mix of enforcement powers, ministerial authority in certain cases to seize assets; ministerial authority to impose limits on borrowings, leverage, interest rate, investments, branching etc.; in the case of banks, authority to appoint a curator; public disclosure of infractions; authority to apply for a winding-up order and liquidation; monetary penalties, although quite minimal; and civil and criminal penalties through the judicial process.

Notwithstanding these remedies the Green Paper and the Wyman Report, as well as supervisory officials, indicated that there are several additional remedies which could and should be available to the authorities.

Among the new enforcement powers recommended for all financial institutions by the Green Paper and the Wyman Reports are the following:

—authority to appoint a curator together with increased grounds to take immediate control of troubled financial institutions;
—power to issue cease and desist orders;
—power to remove directors and management;
—increased powers with respect to self-dealing, including information, divestiture and restitution of assets;
—discretionary authority to deem certain transactions as non-arm's-length;
—authority to prohibit changes in the control of institutions; and
—increased civil and criminal penalties for infractions.

Two remedies which has been recommended by both the Green Paper and the Wyman Report have been successfully used in the United States for a number of years. These are the power to issue cease and desist orders and the power of suspension and removal. Given their relative importance and their immediate relevance to current supervisory reform, a discussion of their uses in the United States is provided below.

Cease and Desist Orders

Cease and desist orders are an important tool of U.S. regulatory officials. They have been used effectively but infrequently. Enforcement statistics for 1982 indicate that final cease and desist orders were obtained by the Federal Deposit Insurance Corporation (FDIC), the Federal Reserve Bank System and the Office of the Comptroller of the Currency a total of 82 times. They have been used more extensively during the past three years.

Cease and desist orders are used with respect to insured banks and their subsidiaries (foreign or domestically-owned) against any director, officer, employee or agent and any person participating in the affairs of the company. They are usually directed to the bank, rather than to its officers or directors.

The proceedings start with a notice of charges issued by the supervisory authority, served on the organization or individual, stating the nature of the problems and a time and place for a hearing to determine if a cease and desist order should be issued. The bank then has twenty days to respond. If the order is consented to it is not made public. If, however, it is contested, a public hearing is held through the courts.

A temporary cease and desist order, effective immediately, may be issued to stop activities which might lead to insolvency, or cause a substantial disruption of assets or earnings, or severely weaken the condition of the organization or prejudice the interests of the depositors.

In the case of regular cease and desist orders, the bank or individual respondent has the right to a hearing before an administrative law judge. No such right exists with respect to the issuance of a temporary order. In both cases, there is a right to have a court review the order, and if successful, it can be set aside.

The FDIC has proposed that, effective January 1, 1986 all final cease and desist orders are to be made public. Even if a cease and desist order is not contested, it will normally be made public in a bank's annual statements.

An order can be removed by the regulator when he considers that the problem has been resolved and the institution restored to good condition.

Non-compliance with an order permits the supervisory authority to take possession of the bank, shut it down, sell it or arrange a merger with another institution. In addition, action can also be taken against its officers and directors.

Cease and desist orders have several advantages over the more drastic remedies of liquidation or insurance termination. Firstly, the order can be aimed at specific infractions and the institution concerned can be required to either cease and desist from a practice or violation or take affirmative action to correct a situation. Secondly, they can be carried out in a relatively short period. Thirdly they can involve administrative or court reviews, as well as appeals. Finally, if properly used, they can prevent situations arising which could lead to insolvency and the need for much harsher remedies.

Suspension and Removal Powers

The suspension and removal powers of U.S. supervisory agencies covers directors, officers and other individuals participating in the affairs of a financial institution. The agency must prove that there is violation of a law, rule, regulation or cease and desist order which could result in the organization suffering a substantial loss; and the interests of the depositors are threatened or the individual to be removed or suspended received financial gain by such conduct. Finally the practice or breach of duty must involve personal dishonesty or demonstrate a wilful or continuing disregard for the safety or soundness of the organization.

A temporary suspension order may be issued where an individual is charged with a crime involving dishonesty, or breach of trust and his continued service may pose a threat to depositors which could impair public confidence in the institution.

As in the case of cease and desist orders there is an evidentiary hearing held by an administrative law judge before an order can be issued. No such hearing is held for a temporary order. In both cases there is a judicial review procedure. Enforcement statistics for 1982 indicate that this remedy was used only twice, once each by the Federal Deposit Insurance Corporation and the Office of the Comptroller of the Currency.

In considering enforcement powers and penalties, the Green Paper focussed on breaches of duty by the Board of Directors, particularly in connection with related party transactions.

It proposed without spelling out the details a uniform set of penalties for wrongdoing by the Board of Directors of all federally incorporated financial institutions.

Infractions related to self-dealing transactions would be subject to a wide ranging set of sanctions available to professional bodies and supervisory authorities, together with civil and criminal penalties available through the courts.

The Committee agrees that there should be stiffer civil and criminal penalties for any wrongdoings by financial institutions or their controlling shareholders, management, directors and outside professional advisors.

The Committee is supportive of the recommendations in the Green Paper and the Wyman Committee Report for the granting of increased supervisory powers. However in recommending these powers, the Committee does so with the following observations:

- —existing enforcement powers can and should be used more effectively;
- —increased powers should be used with care recognizing there is a happy medium between over-zealousness and inaction;
- —where appropriate, an appeal system should be introduced to assure fair use of powers; and
- —civil and criminal penalties should be greatly stiffened in order to give a clear signal that abuses of the special role of trust given to financial institutions, their owners, and major shareholders will not be tolerated.

Therefore, the Committee recommends:

23. That NFAA have the power to appoint a curator, together with grounds to take immediate control of troubled financial institutions;

24. That NFAA have the power to issue cease and desist orders;

25. That NFAA have the power to suspend or remove directors and executive officers;

26. That NFAA have the power to obtain information with respect to the ownership of financial holding companies and their group of institutions;

27. That NFAA have the power to require the declaration of interests of substantial shareholders;

28. That NFAA have the discretionary power to deem specific transactions to be non-arm's-length;

29. That NFAA have the power to force divestiture of prohibited investments or loans;

30. That NFAA have the power to require the restoration of assets illegally paid out of an institution;

31. That NFAA have the power to specify asset values;

32. That the statute creating financial intermediaries, where administrative penalties are provided, be amended to substantially increase the penalties and where provisions exist making a matter illegal and providing for penalties to be imposed by a court, be substantially increased, particularly for improper self-dealing and breach of the statute and regulations thereunder;

33. That the government amend the Criminal Code to impose a criminal penalty for directors, officers, and professional agents, employed by financial institutions, where the person acts in such a fashion as to be grossly negligent in performing his duties for and on behalf of the institution, and where those persons make reports, which the public or NFAA rely on, which are of such a nature as to create gross misunderstanding.

E. Deposit Insurance

Coverage

The Wyman Report on the Canada Deposit Insurance Corporation proposed a 10 per cent co-insurance program from the first dollar of deposits. The basic premise behind co-insurance is that depositors must bear some exposure to potential loss as an incentive to monitor the risk status of deposit-taking institutions so that they would no longer favour with impunity those institutions which pay the highest interest rates on their deposits. In addition, deposit coverage was proposed to be increased to $100,000 from the present $60,000. A three year phase-in period was recommended on its implementation. The primary objective of CDIC was seen to be the protection of the unsophisticated depositor. Full or partial guarantees above the proposed coverage limit was deplored by the Wyman Committee. Its proposed insurance program was designed to introduce a measure of market discipline to risk-taking by financial institutions. It would also reduce the subsidization to risk-taking institutions by risk adverse institutions, and ultimately taxpayers at large.

The Committee views the objectives of the Wyman Report as worthy and desirable but the particular program proposed as fraught with difficulties. There are two rationales for the public provision of deposit insurance. The first is the need to protect small unsophisticated depositors who cannot reasonably be expected to choose among financial institutions on the basis of risk. The second is the need to prevent disruptive and costly runs on deposit-taking institutions. The former objective is tied to information costs faced by small depositors, while the latter reflects the so-called "contagion" effect resulting from an erosion of confidence in the financial system. Both cast doubt on the advisability of introducing co-insurance that starts from the first dollar of deposits. Small depositors cannot be expected to bear the information costs of monitoring the relative riskiness of financial institutions. Moreover, meaningful co-insurance would require among the general population a degree of financial education which has yet to be attained. It may also engender a greater likelihood of a run on financial institutions if numerous relatively unsophisticated depositors are exposed to risk. Hence, there seems to be a strong argument for a minimum coverage level beneath which deposits are fully insured. The evidence presented before the Committee variously defined such a level as $20,000 to $100,000, but there was no consensus on an appropriate level.

Yet another difficulty with the insurance program proposed by the Wyman Committee rested with disclosure rules. If it were desirable that the depositing public underwrite part of its own risk, then information would have to be publicly available defining the likely risks. Greater and more frequently reported information would be required by the man-on-the-street under a co-insurance program. The Committee has a number of reservations in this regard. To begin with, a trade-off must be struck between the rights to privacy for both the institution's clients and investors, and the required flow of information to the depositors. Additionally, disclosure implies a level of user education which can effectively employ such information in making a rational decision. The danger is one of information overload which may only confuse the user and potentially lead to wrong conclusions. Ultimately, the difficulty with disclosure is in finding the proper balance between effective scrutiny and public confidence. It is conceivable that enhanced public knowledge of alleged difficulties could touch off a "flight to quality" with ruinous effects on well operated but smaller, regional institutions. The underlying issue is that "bigness" both in terms of asset volume and distribution profile (e.g. number of branches) is often perceived as "quality".

Co-insurance from the first dollar may make it more difficult for new and smaller institutions to enter the deposit-taking business. The problem is again one of information. New and smaller institutions are perceived by most individuals to be uniformly riskier than large established firms. In fact, they may not be high risk ventures, but the mere perception of riskiness could harm deposit gathering and hence, effective competition. This perception of relative riskiness reduces the attractiveness of these institutions thereby inducing management to offer premium interest rates on deposits. A co-insurance program would only exacerbate this difficulty. Hence, the costs of entry into deposit-taking could rise significantly in the future.

The approach proposed by Wyman implies that the average depositor if partially exposed can effectively influence management's risk behaviour. The Committee is somewhat skeptical about this underlying assumption. Interest rate and credit risks are legitimate undertakings in the financial intermediation business. To management, the size of an individual depositor's funds at risk is small by comparison to the aggregate pool of deposit funds it commands and the gain to be derived from exercising leverage in its lending and investing activities. Furthermore, fraudulent practices can not be prevented by exposing depositors to risk.

This Committee agrees with the Wyman Committee that reform of deposit insurance does not require that risk-taking be eliminated or that financial institutions never fail. Rather, reform demands that management of insured institutions become totally accountable for the risks associated with their intermediary lending and investing decisions. Additionally, the Committee is concerned for the class of depositors that cannot defend itself from the adverse impact associated with financial institution failures. The Committee has reservations that co-insurance will be able to achieve the desired objective of market discipline. Yet, the Committee does not believe unlimited protection to all depositors is warranted. The Committee however, concurs with the view expressed by numerous witnesses that there should be some level of coverage where deposits are fully insured. But, to lower full coverage from the present level, which adequately protects unsophisticated depositors, would be destabilizing. The Committee, therefore, proposes that the Government reject the Wyman co-insurance program and maintain 100 per cent protection for deposits up to the $60,000 limit as presently defined. In addition, the Committee proposes that deposits subject to insurance coverage be extended beyond the current 5 year maturity limitation to include all deposits irrespective of their term to maturity.

The Committee concludes that risk control can be effectively exercised through the use of more stringent prudential standards, particularly regarding leverage, such as those described in the section on corporate powers. Consequently, the Committee proposes that policies and procedures be developed by NFAA to ensure compliance with prudential standards by all deposit-taking institutions. As such, deposit insurance would become a privilege only afforded to those who maintain the established regulatory standards.

Therefore, the Committee recommends:

34. That the present deposit insurance coverage of up to $60,000 be retained;

35. That deposits subject to coverage as presently defined be broadened to include those deposits irrespective of their term to maturity;

36. That NFAA develop a set of uniform prudential standards particularly regarding leverage to be observed by all deposit-taking institutions as a condition for the provision of insurance and also establish policies, procedures and penalties to ensure compliance with such standards.

Funding

The Wyman Report proposed that member institutions, not governments, directly refinance CDIC's existing deficit and that a target size for the Deposit Insurance Fund should be established at 0.75 per cent of insured deposits to be reached over approximately a 10 year period. This is in effect a refinancing of the existing deficit and establishment of a deposit insurance fund on a pre-assessment basis. In order to initiate the refinancing it was proposed that CDIC issue $1 billion in floating rate marketable preferred shares to member institutions on an obligatory pro rata basis on which dividends would be tax free. In addition, CDIC would increase its basic annual insurance premium from 1/30th of 1 per cent to 1/10th of 1 per cent of insured deposits in two stages over the next two years. Finally, it was proposed that CDIC be granted either tax-free status or the power to create a tax deductible insurance reserve fund equal to 0.75 per cent of insured deposits.

A number of views were expressed on this issue in evidence presented to this Committee. The Canadian Bankers' Association (CBA) suggested that funding of the ongoing operations of CDIC should be dealt with separately from the refinancing of the existing deficit. In addition, the CBA argued that member institutions should not be required to refinance the whole of the deficit but instead share this burden with both federal and provincial governments because the deficit stems in part from inadequate supervision and government decisions to reimburse uninsured deposits and increase insurance coverage retroactively from $20,000 to $60,000. They would accept the concept of a preferred share issue if it were made marketable through the provision of government guarantees and priced at market yields. If premiums were to be used to refinance the deficit they felt that this should take the form of a surcharge for this specific purpose. The CBA also agreed with the Wyman proposal to grant CDIC tax-free status. The Trust Companies Association also proposed the imposition of a temporary surcharge equivalent to 50 per cent of premiums at the current rate to deal with the deficit problem but that this should not be accompanied by any increase in the current ongoing premium rate. They opposed the concept of a preferred share issue and saw no need for an instant refunding of CDIC's deficit.

The Committee, having examined the financial projections for CDIC presented in the Wyman Report, concludes that recent financial failures have outdated these projections by substantially increasing the size of the CDIC deficit which would have to be refinanced. In addition, the Committee rejects the concept of an immediate refinancing of the deficit through such means as a preferred share issue which was an important element in these projections. Finally, all projections of this nature are subject to errors in interest rate assumptions and estimates of future failures. The Committee concludes that these uncertainties call into question the achievement of the refinancing and funding goals outlined in the Wyman Report within an appropriate time frame. This raises the prospect of an excessively long pay back period for advances to CDIC from the Consolidated Revenue Fund.

Although the Committee reiterates the view that the member institutions should be required to refinance the entire existing CDIC deficit, it proposes that the refinancing be undertaken separately from the ongoing funding of the new CDIF. To this end, the Committee proposes that the deposit insurance premium be raised immediately to 1/10th of 1 per cent of insured deposits from the current rate of 1/30th of 1 per cent on an interim basis until December 31st 1986. At that time, the Committee recommends that future premiums be established by NFAA on the basis of an appropriate ongoing premium for CDIF plus an amount, as a surcharge, that would retire the existing CDIC deficit in not less than 10 years but not more than 25 years.

Therefore, the Committee recommends:

37. That the existing CDIC deficit not be refinanced immediately by means of a preferred share issue;

38. That the deposit insurance premium be raised immediately to 1/10th of 1 per cent of insured deposits from 1/30th of 1 per cent presently, on an interim basis until December 31st, 1986;

39. That future premiums be established by NFAA on the basis of an appropriate ongoing premium for CDIF plus an amount, as a surcharge, that would retire the current CDIC deficit in not less than 10 years but not more than 25 years;

40. That the Deposit Insurance Fund under NFAA be granted tax-free status.

F. Uninsured Deposits

The reality of government is that those in power can never deny their obligation, directly or indirectly, to all depositors in the event of insolvencies. In fact, full protection against loss has been provided in almost every instance of failure in recent years. The uninsured depositor places government in a dilemma. Full investor protection cannot be provided to the financial sector any more than other sectors of the economy. Yet, the depositor no matter how sophisticated, inevitably puts faith and trust in a payments system which is critically dependent upon confidence. Additionally, government plays a crucial role in maintaining that confidence in the financial sector through its regulatory and supervisory responsibilities.

The Committee believes there are two categories of uninsured deposits that warrant discussion as matters of public policy. Municipalities, small business, co-operative associations, and colleges are but a few typical entities that utilize financial institutions primarily as a means of accessing the payments system. Their deposits are mainly used for current transactions such as payroll and operating expenses, and infrequently invest surplus funds in short term deposits. The intermediary function of bridging time receipts and expenditures is the primary consideration in such cases. Within the framework of the payments system, shutting down an institution and freezing deposits may put in jeopardy payments which become receipts to other persons or businesses in the community. This could precipitate a "domino" effect with respect to unemployment and bankruptcies outside the financial sector.

The other group relates to depositors who use deposits as a form of investment. They possess or have access to highly sophisticated investment knowledge, and hence, can generally be expected to be knowledgeable of the risks involved. However, knowledge is not perfect. Investment analysis is as much an art as a science. The financial system unlike other sectors of the economy is an information system, where assets are fungible and mobile and confidence is crucial to stability. Perception is as important as fact. False signals can be sent to the investment community by well intended or otherwise innocent statements or actions of governments and the private sector. Even when it becomes economically apparent that a financial institution should be closed, the decision to do so is one of timing which directly affects the losses incurred by the institution. These imperfections make it impossible for even sophisticated investors to protect themselves from all risks.

Clearly, the government cannot ignore the uninsured depositors in the above instances. But, a guarantee of any sort would not only be inequitable, it could lead to excessive risk-taking by depositors and financial institutions. A cross-subsidy for relatively unsound risk activities by the less well managed institutions would be provided by the more conservatively managed institutions. This cost would be borne by their depositors and shareholders, and eventually the taxpayer. The Committee is concerned and wants to arrest further taxpayer losses resulting from government bail-outs.

The Committee does however, recognize the economic difficulties that can occur with the failure of a financial institution and the need for immediate action in such cases. The Committee therefore proposes that NFAA develop and implement a cash maintenance program for depositors in the event of financial institution failure.

The uninsured depositor cash advance program would be based upon anticipated liquidation value from receivership. The Committee emphasizes that any such program is not to be construed as deposit insurance but is a cash maintenance program aimed at alleviating cash flow problems for depositors during the liquidation period. As such, the uninsured depositor remains exposed to losses subject to the values realized upon liquidation.

The Committee in considering how to structure such a program reviewed two basic options in terms of implementation. The first approach would be to advance a predetermined percentage of uninsured deposits based upon anticipated liquidation values that would constitute a final settlement with the depositor. A depositor would still have the right to decline the advance and wait for ultimate liquidation values if he so chooses. Any excess or deficiency in ultimate liquidation values relative to the fixed advances would be absorbed by NFAA. NFAA would also act as the liquidator and would bear all costs associated with the liquidation. As NFAA is funded directly by the institutions, this along with the absorption of any losses would provide an incentive for NFAA to undertake greater care in the regulation and supervision of financial institutions and in the process of liquidation.

The major difficulty with this approach is potential financial instability for NFAA that would arise if ultimate liquidation values were substantially below fixed advances, particularly in the case of a relatively large institutional failure. This makes the determination of the percentage of deposits paid out as a cash advance the critical element in this approach to a cash maintenance program. If this percentage is fixed at too high a level, NFAA could face large potential losses and hence the institutions would experience large and volatile increases in supervisory charges from the NFAA.

An alternate approach would be to make the same fixed advance to uninsured depositors subject to future adjustments reflecting ultimate liquidation value. Any excess or deficiency relative to the fixed advance would in this case be absorbed by the uninsured depositor. Again NFAA would act as the liquidator and absorb the related liquidation costs. These costs would be charged back to the institutions as part of the NFAA supervisory charges. Although any ultimate losses on liquidation would be absorbed by the uninsured depositors under this approach, the fact that NFAA absorbs liquidation costs, an incentive would still be provided for improved regulation, supervision and maximum efficiency in the liquidation process.

This second approach would involve the issuance of certificates that would document the obligations of both NFAA and the uninsured depositor to adjust the amount of the cash advance to reflect liquidation values. Although this may be more complex administratively, it limits the risk exposure of NFAA and provides the depositor the opportunity to realize liquidation values in excess of the advanced amount while still receiving an immediate advance for cash maintenance purposes.

The Committee recognizes that these approaches would be fully assessed by NFAA in consultation with the financial community before a choice is made between these two alternatives. Consequently, the Committee proposes that NFAA, subsequent to this assessment and consultation, develop and implement an uninsured depositor cash advance program based upon anticipated liquidation values.

The Committee concludes that a cash maintenance program is warranted in the financial sector because of the contingent impact on the economy from potential payment system difficulties arising from institutional failures. This would effectively remove the pressure on governments to bail out uninsured depositors at taxpayers' expense. Above all, economic dislocations would be minimized while market discipline is asserted.

Therefore, the Committee recommends:

41. That government stop bailing-out uninsured depositors in the event of financial institution failure;

42. That NFAA develop and implement an uninsured depositor cash advance program based upon anticipated liquidation values after a thorough assessment of alternatives and consultation with the financial community.

G. Insurance Policyholder Compensation Plans

The Green Paper has recognized the serious consequences for policyholders of a potential bankruptcy of any insurance company and has endorsed the concept of a policyholder compensation plan in the event of failures.

The protection of policyholders against the insolvency of an insurer is also of concern to the insurance industry. Both the Canadian Life and Health Insurance Association and the Insurance Bureau of Canada have informed the Committee of their proposals for developing a policyholder compensation fund for their respective industry.

It is recognized that a financially strong insurance industry remains the best form of protection for policyholders. Emphasis should be placed on preventing insolvencies by strengthening prudential regulation and standards and by giving the regulator the necessary powers to act early in problem situations. Policyholder compensation funds are necessary to ensure that public confidence in the insurance system is maintained and they represent the ultimate guarantee for policyholders.

The development of a policyholder compensation plan for either life or property and casualty insurance involves a great number of technical considerations and further consultation is necessary among the federal and provincial governments and the insurance industry before specific proposals can be adopted. The Committee envisages such consultation and agreement could take place within the framework of the National Financial Administration Agency.

For life insurance, the actual determination of the level of protection required is complex. In addition to the insurance protection, life insurance products often include a substantial element of savings that can be accumulated over extended periods of time. The level of coverage could therefore vary by product line. The industry has suggested a level of $200,000 per policyholder for life insurance and $60,000 for accumulation of earnings. In the interest of harmonizing federal and provincial policies, the Committee believes that the ultimate determination of coverage should be left to NFAA.

In the case of property and casualty insurance, the Committee believes that the primary objective of the fund would be to protect the policyholders who have an outstanding claim with an insolvent insurer, since they would be most adversely affected. The Insurance Bureau of Canada has proposed that the compensation plan be limited to outstanding claims and exclude unearned premiums and that the level of coverage be established at $200,000 per policyholder per occurrence for property and for liability insurance. The Committee agrees with the proposal to limit the coverage to outstanding claims. For property insurance, coverage of $200,000 would appear sufficient to fully protect the majority of policyholders. However, for liability insurance, the protection should be increased to a maximum of $1 million in order that a sufficient proportion of policyholders be adequately protected.

The Committee supports the proposal of the Insurance Bureau of Canada to deduct an amount of $500 from every outstanding claim in determining the amount recoverable from the fund.

The Committee recognizes that certain lines of insurance have distinctive characteristics which could require that they be excluded from the plan. Such would be the case of mortgage, credit, and title insurance, and possibly ocean marine and aircraft insurance.

To further reduce the possibility of severe hardship to those policyholders with an outstanding claim, the Committee believes that appropriate legislation should be amended so that outstanding claims be assigned a higher priority than unearned premiums in case of liquidation.

Therefore, the Committee recommends:

43. That two separate tax-free funds be established for life insurance and property and casualty insurance, and that accident and sickness insurance be covered under the life insurance fund;

44. That participation in the funds be mandatory for all companies under federal jurisdiction and provincial companies be eligible for protection on an optional basis provided that they meet the solvency and prudential standards established by NFAA;

45. That each fund be self-supporting and entirely financed by each of the two industries respectively, and that contributions be required on a pre-assessment basis until the funds have reached a level sufficient to prevent severe liquidity or financing problems in case of an insolvency;

46. That the funds be administered by the National Financial Administration Agency;

47. That the level of coverage be established by NFAA at a level which will ensure that the large majority of policyholders be adequately protected against the possibility of severe hardship resulting from the insolvency of an insurance company;

48. That the property and casualty insurance fund be limited to outstanding claims and exclude unearned premiums, and that coverage be extended to all new claims arising in the 45-day period following the winding-up order;

49. That appropriate legislation be amended so that outstanding claims be assigned a higher priority than unearned premiums in the event of liquidation of a property and casualty insurance company.

VI. Green Paper Proposals

A. Ownership

Ownership in the financial sector has long been a critical concern of policymakers in Canada. Historically, this concern was focussed on the threat of foreign take-overs of major Canadian financial institutions. For example, in the banking sector, this dates back to the Royal Commission on Canada's Economic Prospects in the late 1950's and the Royal Commission on Banking and Finance in the early 1960's, both of which recommended the maintenance of Canadian control in the financial sector. The first initiatives in this regard were the federal measures to permit and encourage the mutualization of major Canadian life insurance companies in the late 1950's. Nothing further was legislated in this area until the mid-1960's when a number of take-over events and threats induced political responses to this issue. As a result, legislative changes were made at the federal level (and subsequently at the provincial level) instituting a limit of 10 per cent for single non-resident and 25 per cent for aggregate non-resident ownership for all existing financial institutions except property and casualty insurance companies and investment dealers. In the early 1970's similar limits were placed on investment dealers by the Ontario Government in response to a specific take-over situation. In addition, a 10 per cent domestic ownership limit was also placed on the chartered banks in the 1967 amendments to the *Bank Act* in order to make foreign and domestic ownership limits in the banking sector consistent and non-discriminatory. However, similar domestic ownership limits were never placed on the non-bank financial institutions either at the federal or provincial level.

The economic and political rationales for the imposition of ownership limits have never been carefully articulated in Canada and these limits consequently have been accepted with very little public debate since their imposition. Some easing in foreign ownership limits occurred in the 1980 *Bank Act* revision when foreign banks were allowed to have wholly-owned subsidiaries in Canada subject to size and growth limitations. Some changes in foreign ownership limits have also recently been proposed and instituted for non-bank financial institutions at the provincial level. No changes have been made in the domestic ownership limits on banks since their imposition. In the 1982 proposed revisions to the federal trust and loan companies legislation, it was recommended that the 10 per cent domestic ownership limit be extended to federal trust and loan companies. These provisions were never proceeded with since closely-held ownership in the non-bank sector had become extensive by that time and consequently gave rise to serious reservations about the disruptive effects of ownership roll backs and retroactive legislation. The Green Paper proposed to permit unrestricted closely-held, cross ownership of non-bank financial institutions. Yet, it did not recommend any changes in foreign ownership limits and, in fact, virtually no discussion of these limits nor their rationale was included in the paper.

The Green Paper proposed that closely-held ownership of all types of financial institutions be allowed and that cross-ownership of these institutions be permitted through the mechanism of an upstream and inactive financial holding company. This proposal was a reversal of previous domestic ownership policy in the financial sector which favoured widely-held financial institutions. Under this proposal, trust and mortgage loan companies, life insurance companies, property and casualty insurance companies, and a new type of chartered bank (Schedule 'C') could be closely-held and cross-owned by a financial holding company. In addition, individual institutions, except Schedule 'C' banks, could simply be closely-held without the use of a financial holding company. It was also suggested that investment dealers could be included under the FHC ownership structure if the provinces concerned permitted this type of ownership for these institutions.

Moreover, the Green Paper proposed the retention of current foreign ownership limits of 10 per cent for a single non-resident and 25 per cent for aggregate non-resident ownership (10-25 rule) for existing non-bank financial institutions while continuing to exempt new institutions from any foreign ownership limits. Existing holding companies would also be covered by the 10-25 rule but new financial holding companies (FHC's) would be exempt from these limits. The suggested Schedule 'C' banks, however, could not be owned by foreign-owned financial holding companies and the existing 10-25 rule for Schedule 'A' banks would apply to Schedule 'C' banks. This latter proposal meant that foreign entities wishing to establish a bank in Canada would be allowed to do so only as Schedule 'B' banks. Essentially, these proposals would maintain the status quo as far as foreign ownership in the Canadian financial sector was concerned.

Domestic Ownership

Under the ownership structure proposed in the Green Paper, only Schedule 'A' banks would be required to continue as widely-held institutions but even in this case closely-held ownership of these institutions could be achieved by conversion of Schedule 'A' banks to Schedule 'C' banks. This could be accomplished if a financial holding company acquired more than 50 per cent of the outstanding shares of a Schedule 'A' bank. It is technically possible that if granted such powers all schedule 'A' banks could become closely-held and cross-owned. However, for practical purposes, the largest Schedule 'A' banks would probably never be taken-over in this manner nor would their conversion be approved by the regulatory authority. Under the Green Paper proposal, all institutions except the largest Schedule 'A' banks, mutual life insurance companies, and financial co-operatives could become closely-held with many also being cross-owned. Even in the case of mutual life insurance companies, there was a suggestion that they could be permitted to de-mutualize and become closely-held and cross-owned.

The Green Paper proposal was a reaction to the existing situation that had developed in the case of trust companies and life insurance companies whose governing legislation at both the federal and provincial levels did not impose any domestic ownership limitations on these institutions. As a result, with the takeover of Canada Trust by Genstar Financial Corporation, all major trust companies and a substantial number of stock life insurance companies are now closely-held with a significant number also being cross-owned through holding company structures. If the principle of widely-held ownership were to be retained and extended to non-bank institutions regardless of size, it would involve a major ownership roll-back and a large divestment of these ownership interests over the next decade. The Green Paper concluded that this would be very disruptive to the financial sector and would not be practical. It would seem that the ownership structure in the Green Paper was proposed to accommodate the existing ownership situation in the trust and life insurance industries. In addition, this ownership structure was extended to the banking sector through the proposal to allow Schedule 'C' banks to be closely-held and cross-owned through a financial holding company.

The extension of the closely-held and cross-owned structure to the banking system is a major departure from existing ownership policy for chartered banks. This essentially would create three types of domestic bank ownership provisions. Schedule 'A' banks would remain widely-held. Schedule 'B' banks could be closely-held for 10 years before divestment to widely-held ownership. Schedule 'C' banks would be closely-held and cross-owned. All of these banks would have the same powers and none would be subject to any size or growth limitations. Under these circumstances, the provision to allow the conversion of Schedule 'A' and domestically-owned Schedule 'B' banks to Schedule 'C' banks would likely result in these conversions occurring except for the largest Schedule 'A' banks. This could eventually result in a banking system consisting of a small number of widely-held Schedule 'A' banks, perhaps a similar number of closely-held and cross-owned Schedule 'C' banks, and the foreign-owned Schedule 'B' banks.

The fundamental issue surrounding the ownership of financial institutions is in effect, an assessment of the costs and benefits of closely-held versus widely-held ownership structures. One of the costs of permitting closely-held cross-ownership of financial institutions is the greater potential for self-dealing under such a structure. Widely-held ownership has traditionally been viewed in Canada as a deterrent for self-dealing transactions between financial institutions and the owners of these institutions. Under widely-held ownership, the potential for self-dealing with directors and their other non-financial interests remains, but to a much lesser degree than in the case of closely-held ownership where controlling shareholders could have undue influence on the financial institutions and abuse their privileged position. The Green Paper recognized this greater potential for self-dealing and proposed extensive self-dealing controls based on an outright ban of these transactions with limited exemptions. The Committee's proposals in this regard are presented in subsequent sections of this report on self-dealing and corporate governance.

This risk of self-dealing, however, has to be offset against the benefit of having a strong major shareholder that could provide financial support to a financial institution during its initial formative period and on an ongoing basis especially during periods of economic adversity. A widely-held ownership structure makes it difficult for new or small financial institutions to raise capital under these conditions. Perhaps less restrictive ownership limits in the banking sector could have alleviated the recent difficulties experienced by small regional banks in Canada. Indeed, evidence presented before the Committee favouring closely-held ownership cited the benefits of this type of ownership structure in the formation of "de novo" institutions and during the initial growth period for institutions when a widely-held ownership structure could otherwise make it difficult for a small and developing institution to raise additional capital for expansion. It was pointed out, for example by Atlantic Trust, that a major shareholder could have a greater interest and ability to provide additional capital for a fledgling institution especially during periods of adversity.

The closely-held cross-ownership structure for financial institutions creates a public policy concern by allowing extensive ownership of financial institutions by non-financial corporations either directly or through their ownership of financial holding companies. In the banking sector, this has traditionally been limited by the widely-held ownership provisions in the *Bank Act*, but under the Green Paper proposals, even non-financial ownership of Schedule 'C' banks could occur. In the trust and life insurance industries, existing legislation does not limit the degree of non-financial ownership in these institutions and as a result, a number of them have become part of holding company structures owned by non-financial interests. This spread of non-financial ownership of financial institutions would be inevitable under the Green Paper proposals for it would be impossible to limit or prohibit this type of ownership under such a framework.

The major costs regarding financial and non-financial ownership links is the impact of this on ownership concentration in the economy and the degree of economic and political power that would be concentrated within a few major ownership groups in Canadian society. These were outlined in evidence presented by The Cadillac Fairview Corporation before the Committee as follows:

> The concern for public policy is not simply that those with such power will earn excess profits. Rather the concern is that these large groups will have the ability to earn an acceptable level of profits (e.g., sufficient to prevent a takeover) and be able to use their power to achieve objectives other than increasing the shareholders' wealth. This power may be used to alter the behaviour of other firms involuntarily, e.g.,
>
> —by advancing the interests of some customers or suppliers and/or by penalizing others;
>
> —by undermining the position of rivals in ways inconsistent with maximizing the wealth of one's own shareholders;
>
> —by providing excess rewards, pecuniary or otherwise, to the top management coalition that effectively controls the corporation; or
>
> —by using economic power to influence public policy via the political process, i.e., expenditures on lobbying, advocacy advertising, public relations, campaign contributions and the ability to redirect corporate locational decisions.
>
> Corporate concentration with respect to financial institutions has potentially greater ramifications than in the non-financial or "real" side of the economy because of the particular characteristics of money and related near-money assets.

In addition, once this concentration of power has been permitted it would be very difficult politically to reverse the process and re-establish a widely-held ownership structure in the financial sector. This was also pointed out in the following evidence presented by Cadillac Fairview:

> Suppose macro-concentration is allowed to increase and non-financial enterprises are allowed to gain control of very large groups of financial institutions, then in a decade there is sufficient evidence of harm to move Parliament to act. Will Parliament be willing to or be able to force the dismantling of these mega-groups? One can just imagine how much pressure will be brought to bear to leave things pretty much as they are - except perhaps for a symbolic gesture to reassure anxious public opinion. The trouble with "experimenting" with even higher levels of concentration is that it is not a reversible process.

Concern for concentration of economic power, and in particular financial and non-financial linkages, was overwhelming in the evidence presented to the Committee. The Canadian Bankers' Association and consumer groups, such as the Consumers' Association of Canada, the Canadian Federation of Independent Business, and the

Canadian Organization of Small Business, expressed serious reservations in this regard and recommended an imposition of ownership limits on all financial institutions and a roll-back of non-financial ownership of financial institutions. The Cadillac Fairview Corporation expressed concern about retroactive legislation and suggested the grandfathering of existing ownership investment and a prohibition against new or increased non-financial ownership of financial institutions.

The Committee has concluded that closely-held ownership could be beneficial for "de novo" and smaller institutions. The Committee is of the opinion that the retention of closely-held ownership can also be beneficial for growing, medium-size institutions. If closely-held ownership were not permitted, growing institutions would have to divest just when their growth and success dictate a greater need for capital infusion when capital adequacy would be vital for further development. In this context, widely-held ownership rules may not be able to address the capital needs of these institutions. However, the Committee is concerned about the increasing trend towards non-financial ownership of financial institutions and feels that concentrated ownership, particularly that of large financial institutions, should be limited. In order to provide for closely-held ownership while at the same time limiting the degree of non-financial control of financial institutions, the Committee proposes a system of ownership limits based on domestic asset size that would be applied to all Canadian incorporated financial institutions and holding company groups that control affiliated financial institutions.

These limits would allow 100 per cent ownership of a financial institution or holding company with less than $10 billion in domestic assets; 75 per cent ownership if domestic assets are greater than $10 billion but less that $20 billion; 50 per cent ownership if domestic assets are greater than $20 billion but less than $30 billion, 25 per cent ownership if domestic assets are greater than $30 billion but less than $40 billion and 10 per cent ownership when domestic assets exceed $40 billion. In order to avoid any circumstances where attempts are made to circumvent these limits by issuing liabilities domestically and placing these funds offshore, the Committee recommends that Canadian incorporated financial institutions be required to maintain domestic assets greater than or equal to domestic liabilities.

In terms of defining assets to be included in these size limitations, Estate, Trust and Agency assets and the segregated funds assets would be excluded from the assets of trust companies and life insurance companies respectively, as they do not relate to the intermediary activities of those institutions and are not comparable to assets held by other types of financial institutions. For holding companies, total domestic assets of all financial institutions controlled by the holding company would be aggregated to determine their status under these size limitations. Total domestic assets of multiple holding companies and financial institutions controlled by the same ownership interests would also be aggregated. Control of financial institutions would be defined as having a 30 per cent or greater ownership interest by holding companies and related interests on a consolidated basis. For purposes of these limits, the ownership test would be applied at the first ownership level where there is a non-financial ownership interest except for those non-financial activities permitted as ancillary activities.

According to Table 4, this schedule of limits would accommodate existing ownership situations with minimal (if any) immediate broader ownership being required except possibly in the case of Genstar Financial Corporation following their recent takeover of Canada Trust. However, as institutions and holding company groups continue to grow, broader ownership would be triggered by the size limits. A five year period would be provided once an institution or holding company reached a point where

Table 4

ESTIMATED INTERMEDIARY ASSETS OF MAJOR CANADIAN FINANCIAL INSTITUTIONS AS OF DECEMBER 31, 1984

I. *Chartered Banks*

	Domestic Assets	*Worldwide Assets**
	($ billions)	
Canadian-Owned		
Royal Bank of Canada	Not publicly	90.5
Bank of Montreal	available on	76.1
Canadian Imperial Bank of Commerce	individual	71.7
	bank basis.	
Bank of Nova Scotia		58.2
Toronto Dominion Bank	System non-	47.0
National Bank of Canada	resident assets	19.8
Continental Bank of Canada	38 per cent of	6.1
Mercantile Bank of Canada	total world-	4.5
Bank of British Columbia	wide assets.	3.1
Foreign-Owned		
Citibank Canada		3.3
Chemical Bank of Canada		1.5
Barclays Bank of Canada		1.4
Bank of America Canada		1.2
Banque Nationale de Paris Canada		1.1

* Available only on a quarterly basis as of January 31, 1985.

II. *Life Insurance Companies*

	Domestic Assets	*Worldwide Assets**
	($ billions)	
Sun Life Assurance Company	5.7	10.0
London Life Insurance Company	5.5	5.5
Mutual Life Assurance Company	5.1	5.2
Manufacturers Life Insurance Company	3.9	10.8
Great West Life Insurance Company	3.4	7.6
Canada Life Assurance Company	3.2	4.8
Confederation Life Insurance Company	2.7	3.9
Crown Life Insurance Company	1.5	4.3
North American Life Assurance Company	2.0	2.6

* Excluding assets in segregated funds.

III. Trust Companies

	Domestic	Worldwide Assets
		($ billions)
Canada Trust	Equivalent	11.7
Royal Trust	to worldwide	11.2
National Trust	assets since	8.0
Canada Permanent Trust	international	7.6
Guaranty Trust	assets of	3.2
First City Trust	trust companies	3.1
Central Trust	are minimal.	2.6
Montreal Trust		2.5

* Excluding estate, trust and agency assets.

IV. Property & Casualty Insurance Companies

	Domestic Assets ($ millions)
Co-operators General	740
Royal Insurance	717
Allstate	479
Wawanesa Mutual	462
Commercial Union	385
General Accident	377
Economical Mutual	359

V. Holding Companies

	Domestic Assets* ($ billions)
**Genstar Financial Corporation	20
Trilon Financial Corporation	18
Power Financial Corporation	12
E-L Financial Corporation	11
Laurentian Group Corporation	8
Traders Group Limited	4
First City Financial Corporation	3
Crownx Incorporated	2

e Estimates.
* Excluding estate, trust, and agency and segregated fund assets.
** Genstar includes Canada Trust.

Sources: Department of Insurance Office of the Inspector General of Banks.

broader ownership was required. For holding companies, broader ownership would be required at the holding company level. Alternatively, holding companies could reduce their ownership interests in financial subsidiaries below the control level.

The Committee believes such a proposal would affirm and extend the principle of widely-held financial institutions in Canada by providing a practical way by which such an objective could be achieved. The proposal would not disrupt existing operations or ownership patterns of closely-held institutions while at the same time allowing them to broaden ownership as they grow.

In dealing with mergers and acquisitions under this system of ownership limits, consideration should be given to preventing undue concentration of ownership by providing the Minister of Finance with the discretionary power to review and prohibit the merger with or acquisition of an existing institution. The Committee proposes that explicit criteria be developed by NFAA for the application of such a review procedure. The Committee has an immediate concern in this regard and recommends that the Minister of Finance not approve any merger proposal between Canada Trust and Canada Permanent Trust, until an ownership policy for financial institutions has been developed and implemented.

Therefore, the Committee recommends:

50. That domestic ownership limits for all Canadian incorporated financial institutions and holding companies controlling affiliated financial institutions be established on the basis of domestic asset size as follows:

Domestic Asset Size		***Ownership Limits***
under $10 billion	**—**	**100%**
$10-$20 billion	**—**	**75%**
$20-$30 billion	**—**	**50%**
$30-$40 billion	**—**	**25%**
over $40 billion	**—**	**10%**

51. That Canadian incorporated financial institutions be required to maintain domestic assets greater than or equal to domestic liabilities;

52. That the definition of domestic assets for determining these limits exclude the Estate, Trust and Agency assets of trust companies and the segregated funds assets of life insurance companies;

53. That domestic asset size for holding companies and multiple holding companies under the same ownership control be determined by aggregating the total domestic assets of all affiliated financial institutions in which a 30 per cent or greater ownership interest is held by the holding companies and related interests on a consolidated basis;

54. That for purposes of these limits, the ownership test be applied at the first ownership level where there is a non-financial ownership interest except for those non-financial activities permitted as ancillary activities of financial institutions;

55. That a period of 5 years be provided to meet these ownership limits;

56. That for holding companies these limits be met either by broadening ownership at the holding company level or by reducing their ownership interests in financial subsidiaries below the control level;

57. That the Minister of Finance be empowered to review and prohibit the merger with or acquisition of an existing institution and that explicit criteria be developed by NFAA for the application of such review procedure;

58. That the Minister of Finance not approve any merger between Canada Trust and Canada Permanent Trust until an ownership policy for financial institutions has been developed and implemented.

Foreign Ownership

The rapid growth of international trade in the postwar period has been accompanied by a comparable increase in the internationalization of financial services. This trend accelerated sharply in the 1970's following the abandonment of the Bretton Woods fixed exchange rate regime, the first OPEC oil price shock and the subsequent recycling of petrodollars. As a consequence, opportunities for Canadian banks and securities firms expanded dramatically. Canadian banks, in particular, responded aggressively through participation in loan syndications, Euro-currency financing and direct banking operations abroad via subsidiaries and branches. Today, non- resident lending and offshore investments constitute almost 40 per cent of Canadian chartered bank assets. The substantial scale of these operations clearly provides employment, income and tax-revenue benefits to Canada. Although on a smaller scale, Canadian securities dealers also operate a number of branches in international financial centres. Trust companies, too, are becoming more active in international intermediation activities, a trend which is expected to accelerate. Technology has also contributed to this internationalization of financial services, especially with regard to the funding operations of Canadian financial institutions in international money markets.

During the post-war period, demographic trends and the rapid growth of incomes in the western world, particularly in the U.S., have resulted in an ever increasing need for life, health and medical insurance which led to the global expansion of these industries. The size, efficiency and expertise of Canadian life insurance companies have enabled them to compete effectively and gain an important share of world markets for insurance services. In aggregate, it is estimated that the Canadian life insurance industry generates 55 per cent of premium income from outside of Canada. This has given rise to approximately 3000 jobs or 28 per cent of total Canadian employment in that sector.

From an economic perspective, several beneficial effects can be obtained from greater internationalization of financial services. Evidence before the Committee clearly identified such benefits, as illustrated in the following statement by The Manufacturers Life Insurance Company:

> The benefits are felt not only in the financial services sector itself, but across Canada as a whole. These benefits include: i) access to international innovation; ii) Canadian employment; iii) export earnings; and iv) stability of the financial services industry.
>
> Firsthand experience gained in international markets is invaluable in dealing with Canadian problems. Innovative techniques are often developed abroad and subsequently used throughout the Canadian financial sector.

Having conduits for innovative products and practices ensures that the Canadian domestic industry stays competitive with state-of-the-art products and services. Competition from abroad occurs regardless of the degree of concentration in Canadian financial services. A competitive and innovative financial services industry ultimately results in efficient, diverse capital markets that are better able to meet the demands of a growing and changing economy.

As Canadian financial institutions have long benefited from their international operations, there does not seem to be any good reason for them to expect protection from foreign competition in domestic markets. This is not only an issue of reciprocity, but competition in domestic financial markets can also be increased through greater foreign participation. The 1980 *Bank Act* revision, which allowed foreign banks to open subsidiaries here, was a reflection of both reciprocity and the desire to enhance domestic competition. However, their activities were made subject to an aggregate asset ceiling of 8 per cent of total domestic assets. Indeed, this Committee concluded in 1983 that foreign bank subsidiaries had made an important contribution to competition in the medium-sized commercial loan market in Canada and recommended eliminating the aggregate asset ceiling on foreign bank subsidiaries. This recommendation was not acted upon but the limit was subsequently raised to 16 per cent of domestic assets in 1984. In the life insurance industry, foreign ownership limits have been applied to existing institutions but foreign entities have been able to either incorporate new institutions without being subject to ownership limits or to operate directly through branches in Canada.

Increased participation by foreign-owned financial institutions has historically raised concerns about Canadian control of the financial services industry. This has been the rationale for the existing foreign ownership limits at both the federal and provincial level. If Canadian control is deemed to be an overriding objective of public policy, then policymakers must be willing to accept the fact that there may be a greater degree of inefficiency than would be the case if domestic markets were opened to foreign competition. It must also be recognized that financial assets and liabilities are highly liquid and can be traded with comparative ease. Consequently, in the absence of restrictions on capital flows and with continued technological improvements to facilitate such capital flows, the issue of foreign ownership and control of domestic financial institutions will diminish in importance over time.

Control over entry, merger and acquisition by foreign entities is often cited as a requirement in bargaining or negotiating reciprocity for the offshore operations of domestic firms. It is clearly desirable that Canadian financial institutions be allowed into foreign markets to facilitate our export trade and capital flows. This reciprocity principle has been an important consideration historically in drafting foreign ownership provisions covering both the life insurance and banking industries in Canada. Today, most nations do link foreign financial institutions' entry and growth to reciprocal treatment abroad. As pointed out by Metropolitan Life, Prudential Insurance of America and Standard Life in a joint submission to the Committee, the success of Canadian companies abroad has reflected the fact that in foreign jurisdictions they have been allowed equivalent powers to domestic companies. In considering reforms to the Canadian financial system, policymakers ought to be duly aware that restrictions imposed on foreign companies in Canada may result in the imposition of reciprocal restrictions on Canadian institutions abroad.

Furthermore, Canada is considered to possess an advantage in financial services trade, notably in banking, and life and health insurance. Discussions on rules governing international trade in financial services are now at an early stage under the auspices of the General Agreement on Trade and Tariffs (GATT). As these talks progress, the Canadian financial community may wish to be engaged in dialogue about the objectives to be pursued and sensitivities to be borne in mind in these negotiations. As a part of this thrust, Canadian policy should be oriented not only to maintaining current access to foreign markets by Canadian institutions, but also towards increasing such access. In order to accomplish this, restrictions on foreign institutions operating in Canada should be reduced on a reciprocal basis with other countries. An important restrictive element that is of particular concern to foreign jurisdictions is the limitation on foreign ownership in the Canadian financial sector.

The easing of foreign ownership restrictions has already been proposed and implemented within some provincial jurisdictions. The complete elimination of foreign ownership limits on non-bank financial institutions and financial holding companies is the approach that has been taken by Quebec in their life insurance legislation and which will be proposed in their forthcoming trust company legislation. This abandons entirely the concept of Canadian control in the non-bank sector and is in conflict with the continuing foreign ownership limits imposed at the federal level in both the banking and non-banking sectors. Recently, the Ontario Securities Commission also recognized the difficulties of foreign ownership limits and recommended the replacement of the 10-25 rule for investment dealers in Ontario with a 30 per cent limit on foreign ownership providing there was a significant Canadian securities industry investor owning in excess of 50 per cent of the outstanding shares. Since these provincial actions call into question restrictions on the activities of foreign institutions in Canada, the Committee is concerned that the Green Paper did not propose any easing of foreign ownership limits. This is surprising, given the desire to expand Canadian trade in financial services and the need to enhance reciprocity for Canadian institutions operating abroad.

The evidence presented to the Committee also indicated a twofold concern for the Green Paper financial holding company (FHC) and Schedule 'C' bank proposals in the international area. First, existing foreign-owned life insurance companies operating in Canada via branches would be required to incorporate a Canadian subsidiary should they wish to expand and diversify. This is not only costly but could invite reciprocal retaliatory action against Canadian institutions operating through branches abroad. Secondly, a Canadian firm seeking to expand their commercial lending activities would have to form a Schedule 'C' bank. Such action would classify their foreign operations, particularly those in the U.S., as a foreign bank holding company and subject their foreign operations to more restrictive regulations. Since the Committee rejects both the mandatory financial holding company and Schedule 'C' bank proposals, these concerns are negated.

Further, it was brought to the attention of the Committee that provisions of the *Bank Act* may unduly restrict the activities of foreign financial institutions in Canada. The *Bank Act* requires that any foreign financial institution with a bank abroad, irrespective of its size and importance in relation to the parent, be classified as a bank in Canada and such an institution is therefore only allowed to engage in banking in this country. Numerous foreign insurance and finance companies may be affected by this provision. This was seen by some companies as restrictive in terms of their diversification strategies and could well invite retaliatory measures on Canadian operations abroad. The Committee is concerned about this inequity and proposes that Parliament amend the relevant sections of the *Bank Act* to eliminate this effect.

With the objectives of enhanced trade in services, the principle of reciprocity, and increased domestic competition, the Committee believes that foreign-owned financial institutions ought to be afforded similar treatment when operating in Canada as domestic firms. Consistent with the new approach to ownership based upon Canadian domestic asset size, as outlined in the preceding section, the Committee recommends that foreign-owned institutions be subject to similar ownership limits as domestic institutions. This would eliminate all discriminatory restrictions on lending and investing activity by foreign-owned institutions operating in Canada. The concept of the Schedule 'B' bank and the 16 per cent aggregate asset ceiling on them would also be eliminated. There would be only one class of bank whether foreign or domestically owned. The Committee proposes that the chartering, acquisition or merger of a financial institution involving a foreign entity be considered for approval by the Minister of Finance on the principle of reciprocity.

Therefore, the Committee recommends:

59. That foreign-owned Canadian financial institutions be made subject to similar ownership limits based upon Canadian domestic asset size as domestic institutions;

60. That the chartering, acquisition or merger of a financial institution involving a foreign-owned entity be considered for approval by the Minister of Finance on the principle of reciprocity;

61. That consequential amendments to the *Bank Act* be made to eliminate the requirement that a foreign-owned financial institution connected to a banking operation abroad be restricted to establishing a bank in Canada;

62. That the foreign-owned Schedule 'B' bank classification, along with the aggregate asset ceiling of 16 per cent of total domestic assets imposed on these banks, be eliminated;

63. That Canadian investments made on behalf of Canadian depositors or policyholders be deemed to be Canadian-owned assets for purposes of any foreign ownership provisions, including those under the *Investment Canada Act*.

B. Financial Holding Company

The Green Paper permitted cross-ownership of institutions from the various financial pillars, providing it was done so under the umbrella of a federally incorporated, upstream and inactive financial holding company (FHC). Any investor holding directly or indirectly more than 10 percent of two or more financial institutions of which at least one is federally incorporated would be required to establish a financial holding company.

The FHC would be forbidden to engage in direct transactions with the public, to issue debt, and be restricted to only hold equity interest in federally or provincially regulated financial institutions. Affiliated financial institutions would not be allowed to hold equity issued by the financial holding company, or sister affiliates or any company with a significant interest in the FHC. A strict ban on non-arm's-length transactions would apply to all transactions among affiliated institutions within the FHC and between the FHC and affiliated non-financial businesses. Networking or common distribution systems among affiliated institutions would be permitted. Institutions under the holding company umbrella would be separate legal entities, and supervised individually.

The concept of the proposed financial holding company seems intuitively appealing. It would maintain the existing institution-oriented prudential regulatory framework in instances of closely-held, cross-ownership of financial institutions. Consolidated corporate reporting would enable supervisory authorities to trace transactions through the entire chain of companies within the financial holding company framework as circumstances warrant. An additional safeguard against improper transactions could be provided by the restriction on capital transfers within the group. These measures would make transparent any problem associated with inter-corporate transfers, liquidity, and capital adequacy.

The FHC as proposed also seems to facilitate the regulation of existing financial conglomerates, but it also necessarily implies that such a structure would be suitable for all institutions. In addition, it would legitimize financial-industrial ownership linkages. In order to ensure solvency standards and the effectiveness of prudential supervision, different activities would have to be conducted within a compartmentalized structure with a virtual ban on all inter-affiliate transactions. From a solvency perspective, widened business powers, especially into unrelated lines of financial services could involve substantial risk undertakings resulting in potentially larger operating losses. Under the FHC arrangement, each subsidiary would pursue a separate core financial function as a separate legal entity thereby limiting at least in principle the exposure of any one affiliate to its own activities only. Legally, it would also be possible to sever financially troubled subsidiaries from the holding company group without affecting the other affiliates.

The Committee views the financial holding company presented in the Green Paper as an inflexible structure representing a somewhat simplistic picture of a financial conglomerate relationship. Regulatory appeal lies in the ability to identify and isolate the FHC. Separation would clearly be feasible if holding companies did indeed function as mutual funds (ie. passive investors, exercising no management nor operational and financial influence over independently operating firms). In reality, holding companies and their affiliates invariably operate as integrated firms or closed-end funds. The parent often directs key aspects of subsidiary operations such as organizational structure, financial and managerial philosophy, as well as specific functions such as funds management, correspondent relationships, asset and liability management, capitalization and budgets. When activities are either strongly influenced or determined by centralized policies it becomes increasingly difficult, if not impossible, to isolate financial institutions from risk taking in the rest of the conglomerate organization. This tendency is reinforced in the case of closely-held ownership and where the FHC is often dominated by one institution both in resources and management.

Notwithstanding some alleged improved ability to effectively regulate operational subsidiaries (providing the FHC can be isolated), the financial holding company structure may not be able to eliminate all solvency concerns applicable to a parent-subsidiary relationship. Companies in the financial services industry attempt to project images of stability and confidence. The failure of an affiliated company might adversely affect the reputation of the financial holding company and, hence, the business of other affiliates. Experience in the US reveals that holding companies will not "walk away" from troubled subsidiaries and will use innovative means of transferring funds to meet the obligations of troubled affiliates. Trends reveal that despite regulatory powers, the corporate veil can be pierced operationally and when one segment of the holding company experiences difficulties, all segments suffer.

The purpose of the proposed FHC framework is to isolate and protect institutions from excessive risk and abuse. But in reality, the parent is always expected to be a source of financial strength to affiliates and not vice versa. The restrictions on capital transfers coupled with the limited scope to raise new capital could endanger the financial health of the holding company and its subsidiaries, especially in periods of adversity. When a subsidiary is troubled, the financial holding company could find it difficult to raise equity in the marketplace. The public does not separate the risk exposure of any one financial affiliate from the rest of the organization, including the parent. Required injections of new equity capital under these circumstances would likely not be successful.

There is a strong likelihood that in practice, a non-financial holding company may well appear above the FHC within a multi-firm structure as a source of capital by raising debt and downstreaming it as equity to the FHC. The FHC as a focus for consolidation may therefore not be meaningful.

Evidence presented before the Committee was virtually universal that the comprehensive nature and rigidity of the financial holding company model in the very specific form as proposed in the Green Paper was far too global an approach and too standard for meaningful regulatory reform of the financial system in Canada. As such, the structure would be restrictive and inefficient when applied across-the-board to all financial institutions. The overriding concern for self-dealing would eliminate many legitimate transactions which are necessary for appropriate synergy in multi-firm operations, thus sapping internal economies which are often crucial in the early stages of corporate development. Higher standards of conduct imposed on the board, more stringent prudential standards, a ban on abusive self-dealing and greater disclosure obviate the need for a rigid corporate structure. In practice the proposed passive FHC would require the incorporation of a new intermediary holding company for most of the existing financial holding companies and at significant direct costs of compliance. Users of financial services expressed concern that these costs will be passed on to them.

The implementation of the FHC concept will entail new, detailed and complex legislation. A heavier burden would be placed on the supervisors to monitor the movement of funds, control self-dealing and police conflicts of interest. The legalities of the proposed definitions related to this concept such as "affiliation", "relation", "association", "significant business interest", and "substantial shareholder" may well prove unworkable. Additionally, it is impossible to anticipate all the potential abuses of conflicts of interest or self-dealing so as to prohibit them, let alone prevent them. As holding company structures surrounding the proposed FHC form become increasingly complex, supervisory/regulatory costs will rise without necessarily enhancing the quality of regulation. In fact, the FHC framework may well tax the capacity (ability) of our supervisors. As one witness, Excelsior Life, so succinctly put it,

> "(The FHC structure) creates additional regulation and supervision with the potential for overlapping and conflicting federal-provincial authority."

The Green Paper proposal failed to address the implementation mechanism, specifically the inducement to establish a federal FHC. Owners of financial institutions may elect to restructure under provincial legislation if such legislation and regulatory policies proved to be less onerous. The FHC approach may well be construed as a political solution to the establishment of uniform regulation and supervision and this would not generally be desirable. If the imposition of the FHC structure at the federal level became reality, competition in regulatory laxity might develop between governments (federal-provincial, inter-provincial) which could prove destabilizing to the entire financial system. Financial supervision imposes a trade-off between social benefits and profit-making opportunities. This provides incentives to innovate around regulatory guidelines. The FHC structure as proposed with its separate entities subject to differing institutional regulation and political jurisdictions may present opportunities for regulatory "loophole mining" and playing the "cracks" of differing jurisdictional enforcement and compliance. The U.S. experience suggests that the mixing of federal and state chartered or regulated institutions could create significant jurisdictional disputes, a situation that needs to be avoided.

The FHC framework facilitates ownership integration but not functional integration. Service offerings would remain segregated by class of institution. Flexibility to respond to the market would be no greater than exists presently. Only the networking proposal which is not integrally related to the FHC concept provides for cross-selling and flexible service packaging. Competition is not enhanced unless new firms are established. The mandated corporate structure, in its form and restrictions, discriminates against smaller financial institutions. In effect, merger and acquisition of smaller, regional and specialized institutions serving narrower markets may result. Competition policy concerns are heightened by likely amalgamations in the financial sector and the potential for control of financial firms by non-financial interests. No criteria governing competition policy are addressed in the Green Paper. The evidence heard, repeatedly pointed to the dangers from potential concentration of economic power.

The Committee is not convinced that the notion of a one-stop financial supermarket implicitly endorsed in the Green Paper is the wave of the future and believes that public policy should not unduly promote such a trend. This is a function of the marketplace. Subject to safety and soundness considerations, flexibility should be given to companies and their investors to choose the means of diversification appropriate to their needs. The holding company in its active form is an excellent type of structure for diversification but it must be optional. Introducing a single mandatory structure fails to recognize the complexity and variety of institutional approaches to diversification and if imposed could lead to severe tax and financial dislocations.

In summary, the Committee does not endorse the requirement to use a FHC as the only means of diversification for financial institutions. It is also not convinced that this rigid structure would constitute an effective framework for prudential supervision. The potential for federal-provincial discord may be heightened by the compulsory nature of this proposal. Lastly, competition and concentration concerns are not addressed.

The Committee believes that no single corporate structure should be imposed across-the-board. Companies should have the right to choose the diversification route which best suits their needs, subject to safety and soundness requirements. The Committee therefore proposes that diversification be allowed through a choice or combination of upstream or downstream holding companies, direct subsidiaries, in-house expansion of powers and networking. From a prudential perspective, investments in subsidiaries should require strict rules with regard to the double counting of capital. The amount of equity investment in any subsidiary other than a real estate subsidiary should be deducted from the base capital of the investing institution. This is discussed further in a subsequent section on Corporate Powers – Double Leveraging. In-house expansion of business powers should be subject to a limitation on assets for the various types of investments in line with the "prudent portfolio" approach advanced in the *Technical Supplement*.

Therefore, the Committee recommends:

64. That the mandatory form of a financial holding company as proposed in the Green Paper be rejected;

65. That non-bank financial institutions be allowed to diversify flexibly through upstream holding companies and affiliated institutions, downstream holding companies and subsidiaries, together with some limited expansion of in-house powers and networking arrangements;

66. That double counting of capital in respect of investments in downstream holding companies and subsidiaries, except for real estate subsidiaries, not be allowed but that such investments not be limited to a specified percentage of assets or capital of the parent institution.

C. Schedule 'C' Bank

The Green Paper proposed that commercial lending powers of non-bank financial institutions be expanded beyond their limited in-house powers by allowing the creation of Schedule 'C' banks which could be closely-held by financial holding companies and cross-owned with other financial institutions within a financial holding company structure. This proposal reflected the desire to maintain federal jurisdiction over banking and facilitated the imposition of cash reserve requirements on banking activities in order to provide a "level playing field" between the chartered banks and non-bank financial institutions in their commercial lending activities. In addition, the proposal was seen as a means to ensure that the regulation of commercial lending activities of all financial institutions would be undertaken by the banking regulatory agency. The Green Paper also proposed to provide limited commercial lending powers (5 per cent of assets) to non-bank financial institutions without the necessity of creating a financial holding company structure and a Schedule 'C' bank. As a result, only those non-bank institutions that wished to undertake commercial lending beyond this proposed limit would be required to do so through a Schedule 'C' bank.

The restriction of in-house commercial lending powers to 5 per cent of assets could limit the ability of smaller non-bank institutions to expand and diversify into commercial lending activities since they would not be in a position to create a financial holding company structure and form a Schedule 'C' bank. Even for larger institutions, the requirement to form a Schedule 'C' bank does not resolve the problem of finding additional and more diversified outlets for their ongoing inflow of funds which could not be transferred to their Schedule 'C' bank affiliate because of the general ban on self-dealing suggested by the Green Paper. This means that the Schedule 'C' bank concept may not be able to contribute very much to competition in the commercial lending market if non-bank institutions are unable or unwilling to expand their activity in this manner.

An alternative to the Green Paper approach is the expansion of in-house commercial lending power that would allow all non-bank institutions to expand their commercial lending activities directly by allowing a higher percentage of their assets to be invested in commercial loans. This increased power would apply to both small and large institutions equally and would not limit the ability of small institutions to undertake these activities as would be the case under the Schedule 'C' bank proposal. It would also provide greater and more diversified outlets for funds to both small and large institutions to help resolve the problem of investing their inflows of funds in an environment where traditional outlet markets could be contracting and term matching for assets and liabilities has become critical for financial success.

The regulatory problems associated with limited expansion of in-house commercial lending powers would not be substantially different from those associated with the current basket clause provisions or the Green Paper proposal to allow 5 per cent of their assets to be in the form of commercial loans. Federal jurisdiction over these activities would be retained for federally incorporated institutions and, in any case, could only be imposed on provincially incorporated institutions under the Green Paper proposal if those institutions become part of a financial holding company structure. The Committee's views on the imposition of cash reserves on the chartered banks and the inequities this creates among deposit-taking institutions engaged in commercial lending are presented in another section of this Report on commercial lending.

The evidence presented to the Committee strongly rejected the concept of a Schedule 'C' bank and favoured the direct in-house expansion of commercial lending powers for non-bank financial institutions. The reasons for this preference were clearly stated in the submission of the Trust Companies Association of Canada, as follows:

> At the current time, trust companies are able to raise funds in a number of ways and for a variety of terms. Yet lending opportunities are largely restricted to the area of mortgage loans. This is creating diversification and matching problems which are difficult to address within the confines of existing legislation and regulation.
>
> The proposed Schedule 'C' bank structure does not alter this situation for trust companies in any way. Under the federal proposals the trust industry sees two alternatives; either find a way to convert all but the fiduciary business of the trust company to a Schedule 'C' bank in order to obtain the ability to raise funds and diversify assets more efficiently; or remain a trust company with a narrow focus and be subjected to increasing competition with little ability to respond. Neither of these alternatives is attractive to the majority of firms. The latter for obvious reasons, but the former because in many cases it would simply not be feasible to convert to a Schedule 'C' bank. For example such a conversion is not a viable option for smaller trust companies, whether federally or provincially incorporated. Nor is it a viable option for major provincially incorporated trust companies because they would have to convert to a federal company which would be a complex re-organization. Such a re-organization would be very expensive and could take years to accomplish.

In light of these arguments the Committee concluded that a limited expansion of in-house commercial lending powers for non-bank financial institutions is warranted in order to maintain the competitive position of small institutions that could not pursue the Schedule 'C' bank route to expand their commercial lending activities. The details of these expanded powers are presented in the subsequent section on commercial lending. The Committee also agrees that, even for large institutions, the Schedule 'C' bank concept would entail serious problems relating to the necessity of creating a financial holding company structure. Consequently, the Committee rejects the concept of a Schedule 'C' bank. On the other hand, the Committee wants to ensure that all commercial lending, beyond that permitted under basket clause provisions, be undertaken by chartered banks. As a result, the Committee recommends that non-bank institutions expand their commercial lending activities beyond the limited in-house powers through a chartered bank subsidiary or affiliate. Under the domestic ownership limits proposed by the Committee, in a previous section of this Report on ownership, a holding company or a non-bank institution would be permitted to control a chartered bank subsidiary or affiliate on a closely-held basis. Under these circumstances, all chartered banks would have the same powers regardless of their ownership structures.

Therefore, the Committee recommends:

67. That the Schedule 'C' bank concept be rejected;

68. That non-bank financial institutions be permitted a limited in-house expansion of commercial lending powers;

69. That non-bank financial institutions be required to expand their commercial lending activities beyond their limited in-house powers through a chartered bank subsidiary or affiliate;

70. That the Schedule 'A', and Schedule 'B' classifications for chartered banks be eliminated and all banks be allowed to operate under the same rules regardless of their ownership structures.

D. Networking

Networking describes arrangements among financial institutions under which one of the institutions provides the public with access to an investment, contract or service offered by any other institution. The Green Paper proposed removal of restrictions that would inhibit networking among institutions. Specifically, by allowing co-operative credit associations, trust and loan companies, and insurance firms all the powers of a natural person, networking would become permissible unless explicitly prohibited. Tied-selling was to be explicitly prohibited and its proscription reinforced in federal competition policy. Networking would apply to affiliated institutions and independents. Banks were to be excluded with due consideration given their participation at the next scheduled *Bank Act* revision. All arrangements would have to be consistent with provincial government regulations and licensing arrangements. Additionally, rules would have to be clarified regarding the co-mingling of funds of different institutions and identification of the services offered.

The networking provisions received virtually universal support from the public in evidence heard by the Committee. The concept promotes convenience and choice for consumers. It allows financial services to be delivered from remote locations to widely dispersed locations. End-users benefit from the cafeteria-style sale and flexibility of services offered. Both tailored bundles or narrowly targeted services can be sold to meet the variety of financial planning needs. This enables the specialty firm and the large diversified department store of financial services to co-exist and compete directly in any given market. Small independent institutions may take advantage of offering more complete financial packages than they might otherwise be able to do on their own account. In effect, networking extends product market horizons without the heavy fixed costs of branches and labour. Economies of joint marketing and distribution would accrue to firms in the arrangement. This should improve productivity and generally lower the costs of providing financial services to the consumer.

Networking encourages a broadening and deepening of the capital market. Opportunities would emerge for new providers of intermediate and shared-facility services to existing financial service institutions. Additionally, it would enhance greater product differentiation to meet the varying needs of consumers. Technology-based networking would allow transactions to be completed almost instantaneously, thereby increasing the velocity of money in the economy.

Networking is consistent with the policy objective of separation of functions. The regulatory concern for self-dealing would be minimized by the prohibition on tied-selling. Potential conflicts of interest which may be generated would be of an agency nature and as a result somewhat easier to supervise. The benefits of product integration can be gained without enhancing portfolio risk as fees are earned in distribution. As such, regulators would be less concerned for excessive risk-taking. Networking also constitutes an opportunity for harmonizing federal and provincial policies and regulations. Indeed, this harmonization may even be heightened as the provinces have a greater voice and responsibility for the evolution of a new financial system structure. Non-federal financial institutions, notably securities dealers and co-operative credit societies, could be brought into this new system on a more equitable basis. The networking approach to diversification coupled with enhanced federal-provincial co-ordination would reduce the opportunities which firms may perceive to "mine regulatory loopholes". But, of paramount importance, market forces would continue to determine the evolutionary path for the financial services industry. No corporate structure would have to be imposed upon any institution.

The actual form of networking is critical to the regulatory process. Networking could be accomplished by the leasing of physical space from one institution to another, direct cross-selling by marketing representatives of an institution, broking agencies, and shared data processing – information technology systems. In discussing the possible types of networking arrangements that can take place, the Committee wishes to emphasize the need for privacy controls and policies covering trans-border data flows. The Committee is concerned that there is no effective consumer protection which prevents the sharing by financial institutions of a customer's confidential information. Indeed, some data files are readily sold to anyone who cares to pay for the information. Networking, especially of the technology form would only enhance the potential for client data base sharing. Trans-border data flows is a related technology problem where federal policies have yet to be developed. This is a multi-dimensional issue. There are national security concerns, as well as regulatory-supervisory concerns with respect to payments system information. Additionally, with the development of integrated and international networks, financial services firms are vitally dependent upon telecommunication policies in this area. The Committee therefore proposes that policies relating to privacy controls and trans-border data flows appropriate to the confidence, stability and efficient operation of the Canadian financial system be established readily.

The Committee duly notes the problem raised by the independent insurance agents and brokers who fear increased conflicts of interest or tied-selling as a result of networking arrangements where an institution may require insurance coverage from a specified institution as a condition on a loan. An additional underlying issue with the independent agents and brokers would appear to be the fear of undue competitive advantage by the banks with their established widespread distribution system should they enter the broking type of network arrangement. While the Committee views networking as a positive development that should be encouraged, it is also of the view that participation by banks should be studied extensively and a decision rendered at the next scheduled review of the *Bank Act*. It should be noted that evidence before the

Committee, including briefs from the life insurance and trust sectors, supported the principle that networking be extended to all institutions.

The Committee recognizes that the networking proposal would facilitate the present trends in the production and delivery of financial services. One obvious advantage of this trend would be the increased breadth and depth of capital markets. Provinces would have a greater responsibility in the evolution of a new structure. Market forces would continue to determine the evolutionary path for the financial services industry. Networking represents one workable solution to institutions regardless of size or corporate structure and would not entail major changes in the regulatory framework.

Therefore, the Committee endorses the proposals of the Green Paper:

71. That tied-selling be prohibited;

72. That trust and loan companies, insurance companies and co-operative credit associations be allowed to participate in networking arrangements;

73. That due consideration be given to networking participation by the chartered banks in the 1990 *Bank Act* revision;

74. That policies with respect to privacy controls over computer-based information and trans-border data flows appropriate to the confidence, stability and efficient operation of the Canadian financial system be developed not later than December 31st, 1986;

75. That financial institutions not be allowed to share confidential information pertaining to any client without the written consent of the client.

E. Self-Dealing

The Green Paper proposed a ban on all non-arm's-length transactions for financial holding companies and all federal and provincial companies related to them. It would apply to all business services of the institutions including the transfer of assets, and the granting and receiving of credit with a person or group of persons not at arm's-length. A limited number of general exceptions would be permitted as well as exemptions to institutions in special circumstances. There would be a wide ranging, graduated, set of sanctions available to supervisory authorities, professional bodies and eventually the courts for serious breeches of the rules.

The control of self-dealing is one of the seven principles enunciated in the Green Paper and a topic which received a good deal of attention in the Discussion Paper. Four general options were examined: ownership restrictions; institutional regulation; a selective ban; and a general ban.

Ownership restrictions were retained for chartered banks but rejected for non-bank financial institutions on the grounds that a policy aimed at requiring dispersed ownership of trust and insurance companies would be disruptive. With minor exceptions the government was skeptical of the suitability of the institutional approach requiring special board committees to monitor non-arm's-length transactions.

A selective ban was rejected on the grounds it was neither possible to sort out non-arm's-length transactions, which are harmful from those which are not, nor would it be possible to develop an all encompassing definition for regulatory purposes. The preferred option was a general ban on all non-arm's-length transactions.

There are two complex technical issues which made it difficult, for witnesses and the Committee to fully assess the probable impact of a general ban on non-arm's-length transaction. The first relates to what is to be considered a non-arm's-length transaction and what is to be exempted. The second, and even more difficult consideration, particularly within a holding company, relates to who is to be considered a non-arm's-length party. While neither of these two points is made particularly clear in the Green paper, nevertheless witnesses did form views and generally expressed serious doubts about the proposal.

There is increasing evidence that current institutional and regulatory supervision have not been able to prevent self-dealing abuses. A general ban would avoid the difficult task of sorting out harmful transactions and non-arm's-length parties to be included. Also a partial ban would place too much administrative discretion in the hands of regulators, which could cause uncertainty and delays. A general ban would inspire greater public confidence than any other alternative.

While an absolute ban might have some administrative advantages for regulators, it also has several shortcomings. It would fail to recognize that not all self-dealing is harmful to the institution or its customers, nor are all self-dealing transactions of equal concern or severity. Indeed some related party transactions are common in the area of property and casualty insurance and serve legitimate and essential business purposes. A large number of property and casualty insurers for various reasons are members of a group of affiliated insurers. Most of these groups, if not all of them, use inter-company reinsurance to share the insurance risk among their various members. This generally results in an increased protection for the policyholders since a larger capital base is used to support the insurance operations and a better spread of risk is achieved. A ban on internal reinsurance transactions would force many companies to reduce their capacity and would have a significant impact on the availability of insurance in Canada. Harmful non-arm's-length transactions can be identified and prohibited, which is the current practice.

Regulations will not be able to envisage every type of solvency threatening transaction and the parties who might be affected. While conceptually a general ban might be appealing, in practice, it would be subject to so many exceptions that what it would amount to is a policy of selective prohibitions. It would also require a large number of regulatory officials to effectively monitor it.

With a few notable exceptions, most witnesses favoured a partial rather than a general ban.

Investors Syndicate found the proposed ban to be unduly restrictive and pointed out that a request for a completely "insulated operational structure" would reduce significantly the efficacy of an integrated structure. Institutional self-regulation, coupled with supervisory review would avoid an overly rigid structure. The Canadian Bankers' Association commented that the regulatory restrictions proposed to control self-dealing would be extremely costly, cumbersome and ineffective. Instead its preferred alternative was wide ownership. It also pointed out that unscrupulous individuals are unlikely to be dissuaded by a ban on self-dealing; it is not possible to envisage every type of undesirable non-arm's-length transaction; and a ban would require a regulatory army to enforce it. If a ban were introduced, it would be costly and unnecessary to impose such rules on widely-held institutions. The Insurance Bureau of Canada favoured identifying and banning only those non-arm's-length transactions considered especially dangerous and further commented that an outright ban would not leave the flexibility that is wanted in today's environment. To impose an element of control the Board of Directors should appoint a committee comprising outside directors to examine all non-arm's-length transactions, or as an alternative all non-arm's-length transactions over a certain amount would require the approval of a regulator.

Canada Trust commented that the most effective means of combatting self-dealing problems is to impose ownership restrictions. While imposing costs, the imposition of the ban was viewed as the only alternative to the imposition of ownership restrictions. There should however be some mechanism to permit transactions and asset transfers between affiliated, related and associated companies through ministerial or supervisory exemptions. The self-dealing ban should also be relaxed where the discipline of widespread ownership exists. The Quebec Board of Notaries commented that a partial ban would not be effective nor would it protect savers and minor shareholders. A general ban, backed by severe sanctions for infractions would be preferable. The Co-operators Group Limited recommended against a total ban and supported having transactions reviewed by an independent committee of directors. The onus of proof of an unfair transaction should be on the regulatory authority. Sun Life was very concerned that the proposed ban would seriously hinder normal business activities and undermine the goal of efficient delivery of services. Harmless non-arm's-length transactions should be permitted with restrictions in the legislation to apply to specific undesirable activities.

Several factors, including recent financial institution insolvencies, closely-held ownership, the establishment of large financial conglomerates and financial non-financial investment relationships have made self-dealing one of the major public policy issues of the day.

The means chosen to deal with it will have an important impact on the other major public policy objectives of efficiency, stability and consumer protection.

The Committee has given careful consideration to the four options presented in the Green Paper and the arguments of witnesses for and against a particular approach. On balance, it has concluded that the best way of handling self-dealing is to rely on a multi-faceted approach which will lessen the potential for self-dealing abuse and provide redress where it is needed.

The solution would involve a ban on those non-arm's-length transactions which were thought to threaten the ongoing solvency and viability of a financial institution. This would be reflected in new legislation and regulations appropriate to each financial sector. It would be complemented by increased corporate self-regulation and the use of specialized board committees to monitor self-dealing issues.

Additionally, regulatory authorities would be given adequate resources, including staff and enforcement powers with which to be more vigilant and effective. Finally, civil and criminal penalties commensurate with the seriousness of the self-dealing abuses would be introduced.

The Committee believes that an absolute ban would not reflect the fact that not all self-dealing transactions are destructive, indeed the contrary is the case, nor are all of equal weight nor threaten the solvency of the institution. As many witnesses pointed out a ban would significantly impede the achievement of several of the other stated objectives of the Green Paper including increased competition, a broader product mix, and the synergy resulting from financial groupings.

In their appearance before the Committee officials of the Department of Consumer and Corporate Affairs presented a detailed memorandum, prepared by the law firm of Goodman and Carr on the subject of self-dealing. The Committee has examined the proposals contained in it and has incorporated several in the recommendations below.

Therefore, the Committee recommends:

76. That financial institutions be permitted to engage in non-arm's-length transactions except those that are likely to have a significant impact on the institutions' solvency, and requests for exemptions to prohibited transactions be considered by NFAA in special cases;

77. That the prohibited transactions be set forth in regulations governing each of the major sectors of the financial services industry;

78. That professional associations including accountants, lawyers, appraisers, actuaries and representatives from financial institutions and trade organizations be consulted in drawing up a list of prohibited transactions;

79. That NFAA prepare and circulate new guidelines and rules with respect to prohibited transactions and the parties affected by them;

80. That limits on the size of individual transactions and aggregate limits on such transactions be imposed by NFAA where necessary;

81. That NFAA approval be required for all non-arm's-length transactions for a specified period of time after the establishment of a new financial institution or upon a change in the control of the institution;

82. That NFAA be given an overriding discretion to prohibit an institution from engaging in prohibited transactions, if it determines that allowing the institution to engage in such transactions would be contrary to public interest;

83. That NFAA be entitled, in appropriate circumstances, to reverse transactions or to require institutions to dispose of property acquired in a related party transaction;

84. That NFAA be empowered to cause an institution, in the appropriate circumstances, to eliminate the assets so acquired from its borrowing base;

85. That all financial institutions be required to pass a bylaw establishing a committee of the board with responsibility for reviewing and approving all non-arm's-length transactions and that such committees consist of not less than three independent outside members chosen from the Board of Directors of the financial institution;

86. That the responsibilities of the reviewing committee be reinforced by imposing an obligation upon directors, management, auditors, valuation

actuaries, solicitors, and appraisers of financial institutions to report immediately all non-arm's-length transactions of which they become aware.

F. Conflicts of Interest

The Green Paper proposed four new initiatives to increase consumer protection against conflicts of interest.

—the establishment of a Chinese Wall to restrict inside information flows between fiduciary activities and all other operations of a trust company;
—increased institutional disclosure;
—increased access to remedial action largely through the establishment of a Financial Conflicts of Interest Office;
—increased institutional self-regulation.

Conflicts of interest arise in those situations in which a financial institution acts in an intermediary role and has to choose between its own corporate interests and those of a customer or between the interests of one or more customers. While such conflicts can create substantial losses for individual customers they do not generally threaten the solvency of an institution. The existence of real or perceived conflicts can have an important impact on public confidence in an individual institution and the financial system generally.

With few exceptions, there has been little evidence of conflicts of interest abuses involving Canadian financial institutions nor has it in the past been an area of significant consumer or supervisory concern.

The priority given to conflicts of interest abuses in the Green Paper is possibly due to the expansion of powers within financial institutions, increased common ownership links between institutions, and the proposed networking arrangements.

The Green Paper identified three major options for dealing with conflicts of interest situations:
—limit individual or common ownership of financial institutions;
—limit the combination of specific activities within an institution or as part of a corporate group;
—permit a selected combination of activities and ownership links while subjecting them to increased institutional and supervisory regulations.

The third option above would involve changes in three broad areas: the establishment of Chinese Walls, increased institutional disclosure, and the establishment of a Financial Conflicts of Interest Office.

Chinese Wall

A Chinese Wall is the combination of corporate policies, structures and procedures to prevent the flow of information between operating divisions within a company and between affiliated and related companies within corporate groups. In establishing a wall, regulators would have to identify both the type of information to be controlled as well as the persons: among whom the information flow would be controlled.

Supervisory authorities would have to ensure the establishment of the Wall and the directors and management would be responsible for its enforcement.

Chinese Walls are used to prevent deliberate as well as accidental disclosure of certain insider information. While the Wall can be intentionally breached, it is one of several means for lessening conflicts of interest abuses.

The Green Paper suggested that financial institutions be allowed to have the discretion to create Walls where there was a need. Only in the case of fiduciary activities did it recommend that a Wall be established to separate them from all other financial activities.

Based on extensive American experience, the Chinese Wall has been a relatively effective mechanism for restraining the flow of confidential insider information, particularly between commercial lending and trust activities of U.S. banks. There has also been wide acceptance and extensive use of the Wall in the United Kingdom and other countries. A Chinese Wall provides an added safeguard in addition to existing statutes and common law rules designed to protect the public.

While a Chinese Wall could be of some benefit for the protection of the public, it can be easily breached. The Wall would not be effective in situations where individuals wish to ignore it. The chief executive of most institutions sits on the top of the wall and has access to certain information which the Wall by design is established to restrict. Chinese Walls may work well in good economic times, but in the words of one witness they would be more like a "garden fence" in bad times.

The Committee heard mixed testimony on the desirability and effectiveness of the Chinese Wall. Mutual Life, while supporting the Chinese Wall concept also recommended that a code of ethics be adopted by the board to minimize potential problems concerning privacy and conflicts of interest (Appendix E). Canada Trust expressed concern over the provincial implications of a Chinese Wall and suggested that if it were to be workable it would have to be formally included in provincial trust law if it were to deal with matters of trust. The Insurance Bureau of Canada commented that it would be difficult to select activities to be separated and that the process would likely be cumbersome. The Canadian Bankers' Association was of the view that Chinese Walls have more merit in theory than in practice. However, to the extent that this approach is adopted, it may be desirable to extend it to all activities giving rise to conflicts. The Laurentian Group expressed concern over the use of information flows and the development of a common client data base. It recommended the adoption of a code of ethics by each corporation for the use of confidential customer data. If this were not acceptable, then it would favour the adoption of general laws governing data processing.

The Committee has considered the pros and cons of establishing a Chinese Wall and has concluded that the proposal merits adoption. Over time it would play a useful role in preventing conflicts of interest abuses. The Committee recognizes that Chinese Walls have some obvious shortcomings and clearly cannot prevent fraud. They would seem to have much less applicability to small financial institutions in which management plays a number of roles and in which physical separation between departments and personnel would be difficult, if not impossible. While Chinese Walls would be dependent in part on physical separation to restrict the flow of selected internal information, the principal factors determining their success are the business standards and values of the management and the Board of Directors. The Committee is hopeful, that over time, a Chinese Wall, together with the use of business conduct review committees and improved supervision will greatly lessen the potential for conflicts of interest abuses.

In its submission to the Committee, the federal Department of Consumer and Corporate Affairs included a study prepared by the law firm of Goodman and Carr on conflicts of interest. The Committee has examined some of its proposals and has adopted several of them in the recommendations below.

The Committee recommends:

87. That financial institutions be required to create and maintain Chinese Walls to prevent the flow of information between certain departments within an institution or affiliated institutions in situations where the flow of information between them might give rise to a conflict either: (i) between the interests of customers of the institution; or (ii) between the interests of a customer and that of the institution;

88. That specific rules and procedures required for each sector of the financial services industry be left to the discretion of NFAA;

89. That procedures be implemented by institutions and NFAA to ensure effective maintenance and operation of the Chinese Wall on an ongoing basis;

90. That institutions be exempt from liability in certain situations where they would otherwise have been liable, if they can establish that a Chinese Wall prevented the flow of information between two departments.

Increased Institutional Disclosure

The Green Paper has recommended increased disclosure of information to enhance the ability of customers to make informed choices. Such disclosure would include the identification of the "true" supplying company under networking arrangements, disclosure of fees and commissions, and the existence of a Chinese Wall.

The need for increased institutional disclosure is heightened by the general trend towards broader product offerings, and by the proposed new networking relationships between institutions.

Products and services are most often sold as part of a group of items, with advantages to the seller and the consumer alike. The consumer gains through convenience, and often price advantages, and the vendor through lower costs. For these reasons, regulators are seldom willing to impose restrictions on product bundling, preferring instead to let the consumer make the decision based upon the availability of products.

There are however exceptional circumstances in which the grouping of financial services may not be in the interest of the consumer. Problems arise for two reasons, both of which are anti-competitive. The first arises when a financial institution requires a customer, who in purchasing one service, to purchase another or to refrain from dealing with another institution. This practice is referred to as "product tying".

The second problem arises when purchasers of financial services are not fully aware, for whatever reasons, of the conditions of the sale, and thus are not able to make fully informed choices. Ways to address this problem can be broadly described in two categories. The first is to prohibit the combination of certain activities, which has been the traditional approach of federal regulation with respect to certain services where conflicts of interest might arise (i.e. commercial banking and corporate securities underwriting; trust services and commercial lending etc.). The second is to permit the combination or bundling of selected services, while at the same time providing safeguards against conflicts of interest abuses. The principal regulatory tools in use today are the anti-tying provisions of the *Combines Investigation Act*, and federal and provincial consumer protection acts, including consumer disclosure rules.

The Green Paper has recommended increased institutional disclosure as the principal tool for dealing with conflicts abuses which could arise from the broadening of product offerings by institutions either directly, through affiliations or through networking arrangements with other institutions.

Most witnesses were supportive of the proposal for increased disclosure, as well as suggestions for improving it. The British Columbia Branch of the Consumers Association pointed out that the efficiency of the system would depend largely on the type and format of the information required. The Quebec Chamber of Commerce expressed preference for increased self-regulation in dealing with conflicts situations and recommended, among other things, a policy of disclosure of interest in other institutions and a corporate code of ethics. While supporting the proposal the Canadian Bankers' Association suggested that it did not go far enough and recommended a number of additional changes including quarterly reports of balance sheet and income statements along with annual reports. The British Columbia Central Credit Union pointed out that there may be difficulty as a result of statutorily imposed rules requiring confidentiality of client information.

The Committee is in agreement with the Green Paper proposal to increase institutional disclosure of information with respect to the conditions of the financial institutions offer of services; fees and commissions involved and the existence of a Chinese Wall and its implications for the customer.

Therefore, the Committee recommends:

91. That government consult with trade associations, professional groups, financial institutions and consumer groups in developing guidelines for increased institutional disclosure of information to enhance the ability of consumers to make informed choices in view of the increased possibility of conflicts of interest resulting from product bundling, corporate affiliations and networking.

Financial Conflicts of Interest Office

The Green Paper proposed that a government funded office be established to assist aggrieved customers seeking restitution for conflicts of interest abuses. It would be staffed by lawyers and individuals experienced in the area of financial institutions, who would make representations to financial institutions on behalf of the aggrieved party and where necessary launch civil suits to recover losses.

Currently the cost of litigation, the lack of concrete information with respect to the alleged abuse and the burden on the individual to prove wrongdoing on the part of the institution make it very difficult for individuals to commence legal actions against financial institutions, for real or perceived abuses of conflicts of interest. The great number of departments both federal and provincial, having responsibility for consumer protection, making it difficult for consumers to determine their rights and seek timely administrative or legal action. Consequently, the establishment of a Financial Conflicts of Interest Office would facilitate consumer remedial actions.

The Committee received considerable testimony against the creation of a Conflicts of Interest Office. Since there has been very little evidence of conflicts of interest situations arising in the past, scarce supervisory resources should therefore be directed to other areas where they will do the most good. Current civil remedies available to consumers seem adequate. Matters to be dealt with by the proposed Office now fall largely within provincial jurisdiction and the establishment of such an Office could create undesirable conflicts between federal and provincial authorities. Provincial authorities could expand their existing regulatory facilities to deal with the matters to be undertaken by the proposed Federal Office. Lastly the danger that the Conflicts of Interest Office would try conflict abuses in the media before they are adjudicated could produce a negative impact on the reputation of the financial institution involved.

The Insurance Bureau of Canada was adamantly opposed to the establishment of the Office on the basis that it was unnecessary, as there are currently wide protections for consumers under the insurance legislation and the *Unfair Practices Act*. The provincial Superintendents of Insurance have wide powers to deal with specific problems in the insurance industry. The B.C. Central Credit Union recommended, as an alternative to the Conflicts of Interest Office, that all federally incorporated financial institutions comply with provincial consumer protection legislation. The Quebec Board of Notaries recommended that the Financial Conflicts of Interest Office fall under provincial jurisdiction and be attached to the Department of Justice in each province. The B.C. Branch of the Consumers Association of Canada questioned the merits of the Office which it perceived as essentially an after the fact method of handling conflicts of interest problems.

The Committee is of the view that there is no need to establish a federally funded Conflicts of Interest Office. While there is the possibility of conflicts of interest abuses in the future, these are not seen as an area of serious potential trouble requiring the allocation of scarce supervisory resources and additional supervisory structures. Also given provincial jurisdiction for many of the matters which would be dealt with by the proposed Office its creation would lead to increased disharmony between federal and provincial regulatory officials. Finally as noted in other sections of this report, the Committee is of the opinion that future conflicts of interest situations can be better handled through the combination of greater institutional self-regulation, the establishment of Chinese Walls and improved disclosure.

Therefore, the Committee recommends:

92. That the proposed Financial Conflicts of Interest Office not be established.

G. Corporate Governance

The Green Paper proposed increased institutional self-regulation for federally incorporated financial institutions, with the board of directors playing an enhanced role. The changes proposed included updating the corporate governance provisions of non-bank financial institutions; increasing the standard of care of a director and of committees of the board; creating rules relating to changes in board size and composition; and introducing penalties for non-compliance.

The Green Paper has recommended important changes in corporate governance, which together with improved supervision and regulatory updating would be the cornerstones of the proposed regulatory reform. Most of the corporate governance changes will impact on the future role of the board of directors.

One of the basic premises of the Green Paper is that financial institutions have a special role in the financial life of the economy which requires the highest standards of corporate performance to ensure efficiency, and system stability and soundness. It has identified the board of directors of financial institutions as having primary responsibility for corporate performance in the context of public policy objectives and community standards. In putting forward proposals for a new role and standards for board performance, the Green Paper raised some important issues with respect to how corporate performance should be measured and by what standards; to whom do these standards apply and for whose benefit. Similar issues are currently being examined by several other Canadian and foreign jurisdictions.

This section examines the following items with respect to corporate governance generally and the role of the board of directors:

1. Special Act Corporations
2. Standards of Care
3. Registry of Directors
4. Corporate Group Responsibility
5. Standards of Attention and Supervision
6. Limits on Board Size
7. Outside Directors
8. Interlocking Directors

Special Act Corporations

As the Green Paper pointed out one of the most significant changes resulting from the *Canada Business Corporations Act* as a model for loan, trust and insurance companies is that they would acquire the capacity of a natural person and would no longer be deemed "special act companies". The trust and life insurance industries have for several years advocated these changes, which, as in the case of chartered banks and commercial corporations, would give them the right to conduct any business, other than that specifically prohibited by law.

Witnesses representing the trust and insurance industry indicated their strong support for this proposal; nor was there opposition from others.

The Committee concluded that there is no justification for continuing to designate trust, loan and insurance companies as "special act companies", particularly as it puts them at competitive disadvantage in an environment of frequent product change and innovation.

Therefore, the Committee recommends:

93. That amendments be made to the legislation governing trust, loan and insurance companies to give them the capacity of a natural person, and similarly modifications, as appropriate, be made to the legislative powers of financial co-operatives and mutual insurance companies.

Standards of Care

The duties and standards of care of directors have developed in common law and only recently has there been an attempt to upgrade and codify them in statute law in Canada, the U.S.A. and the United Kingdom.

The *Canada Business Corporations Act* provides that in carrying out their duties directors and officers must exercise the care, diligence and skills that a reasonable "prudent person" would exercise in comparable circumstances.

It is interesting to note that when the Business Corporations Act was first introduced in the 1970's the standard was that of a "prudent director". This was subsequently replaced by the "prudent person" standard because of representations from industry that the standards for boards were so high that this would deter non-professional people with wide community representation from serving as directors.

The Green Paper has proposed that the standard of care for directors be increased from that of an ordinary "prudent person" to that of a "prudent and experienced business person".

The Ontario Consultative Draft of June 1985 of the proposed Trust and Loan Corporation Act recommended raising the standard of duty and care for the trust industry to that of a "prudent director". Additionally it also provided that when considering whether a particular transaction or course of action was in the best interest of the corporation that directors would also have to show due regard to depositors as well as to the shareholders of the corporation.

The Committee's overriding concern, and one which was also shared by many witnesses, is to assure that standards of care are developed which reflect the special role and responsibilities of directors of financial institutions but which are not so stringent as to impose unrealistic restraints on board membership. The Committee heard many recommendations which urged a balanced board, to assure a majority of directors with business knowledge while at the same time permitting the election of directors with a wide range of international, regional and non-financial interests or skills. It is also aware of the difficulty in developing a uniform standard of care for all financial institutions ranging from small local entities to multi-billion dollar international banks. The Committee strongly endorses the Green Paper recommendation to increase the standard of care of directors of financial institutions. It would however prefer the standard be that of a "prudent director" in comparable circumstances, rather than the standard of a "prudent and experienced business person". It is concerned that the Green Paper test would not necessarily represent a higher standard than that of a "prudent director" and because of its newness might cause some confusion among financial institutions. The Committee would hope that in dealing with the increased standard that officials of NFAA will make it clear, particularly as it relates to the proposed new registry of directors that the more stringent test would not preclude the appointment of qualified directors with interests or skills other than in business and finance.

Therefore, the Committee recommends:

94. That the standard of care of the board of directors be increased from that of a prudent person to that of a prudent director.

Registry of Directors

In order to assure that only appropriate individuals serve on the board of directors of financial institutions, legislation should be enacted requiring such individuals to be registered with the appropriate regulatory authorities. This requirement will permit regulators to satisfy themselves that directors of financial institutions have the proper skills, experience and character to operate an institution to which the public has entrusted its funds. It will also be a benefit not only at the time individual directors are being considered but also in conjunction with the incorporation process or when licences are being considered for the first time or renewal.

A procedure of this type has been in use in the United Kingdom where extensive background information has for some years been required of all directors, and is also employed in the securities industry in the United States. It is currently in use in Canada in the securities industries. Similar procedures and requirements might be adopted as a guide.

While the Committee recognizes that this procedure would involve an additional regulatory burden on corporations and directors, it considers the requirement justified, particularly given the importance of continuing public confidence in the soundness and efficiency of financial institutions and the increased standards of care and supervision which are to be imposed on the board of directors.

Therefore, the Committee recommends:

95. That no person shall be a director of a financial institution unless the person is registered with NFAA and registration be granted only when the regulators are of the opinion that such person is suitable for registration.

Group Corporate Responsibility

The Committee agrees with the Green Paper proposal that directors of regulated financial holding companies should also be subject to the increased standards of care and supervision proposed for directors of operating financial companies. It does not however agree with the proposal of "corporate group responsibility" under which directors of controlled subsidiaries of a regulated financial corporation would be accountable for the actions of all the companies in the group.

As the Green Paper pointed out the implementation of this concept would require important revisions to the duties of corporate directors and would also not be applicable to corporations which has significant minority shareholders.

Therefore, the Committee recommends:

96. That the legal concept of "corporate group responsibility" not be introduced in the governing legislation of federally incorporated financial institutions.

Standards of Attention and Supervision

The Green Paper recommended higher standards of attention to the affairs of a corporation including being better informed about the company's business affairs through attendance at a minimum of three-quarters of the meetings authorized by the chairman of a board of directors.

While it examined the role and composition of a special board committee to control non-arm's-length transactions, it rejected this option in favour of a general ban on such transactions. Although it foresaw some relatively narrow applications where a board committee might be helpful. Also while it recommended the need to establish a Chinese Wall to control conflicts of interest, it did not recommend any specific oversight role for the board of directors.

Witnesses were supportive of the increased standards of attention but many were critical of the proposed requirement of attendance at board meetings. The Canadian Life Health Insurance Association was of the view that the attendance rule was overly restrictive and should be altered to require institutions to notify shareholders/policyholders of director attendance. The Canadian Bankers' Association wondered why it was necessary to have such a statutory limit and pointed out that under the *Bank Act*, directors' attendance at meetings is published and overseas directors may participate in meetings by telephone. The Trust Companies Association supported the attendance proposal but suggested that exceptions should be made for legitimate absences.

In its brief to the Committee, Royal Trust Limited outlined in detail the role, structure and membership criteria of its recently established Business Conduct Review Committee to deal with business ethics generally and related party transactions applicable to trustee and non-trustee situations (Appendix F). Several other witnesses also indicated that they also have established board committees performing a similar function.

The Committee supports the proposal to increase the standards of attention expected of directors, which is complementary to the increased standard of care. It does not however support the proposal to impose a statutory requirement that directors attend three-quarters of all board meetings. Given the new standards of care and performance expected of board members, the Committee believes that most will fulfill their responsibilities without the need for statutory attendance requirements. Sickness and other factors often make it impossible to attend board meetings at certain times. Also, as representatives from the Canadian Bankers' Association pointed out, the publication of directors' attendance at meetings and its circulation to shareholders is often conducive to a good attendance record.

As indicated in other sections of this report, the Committee strongly endorses the increased institutional supervision in the form of greater vigilance by the board of directors, through the establishment of special committees to deal with conflicts of interest and self-dealing situations.

Therefore, the Committee recommends:

97. That standards of supervision of directors be increased including, as appropriate, more extensive use of specialized oversight board committees aimed at limiting potential abuses arising from conflicts of interest and self-dealing situations and to generally prevent the misuse of corporate powers;

98. That no statutory requirement be introduced for board attendance, although, as in the case of the *Bank Act*, directors' attendance at board meetings be required to be made public.

Limits on Board Size

Considerable discussion took place within the Committee with respect to the maximum limit for the size of the board, including the practice of chartered banks to have boards, in excess of 25 members, including directors from major customer groups. The Green Paper justified the proposed size limitation on the grounds that it would assure the significance of the votes of individual directors.

Several witnesses opposed the upper limit of 25 members on the following grounds:

—While boards might be more effective administratively, they would limit useful regional, international and other representation which has proven to be useful to many financial institutions.

—Given the use of cumulative voting and specialized board committees, individual directors can, notwithstanding a relatively large board, play a active and significant role in board affairs.

—In some financial institutions, such as the credit unions, the board is looked upon as a vehicle for exposing members to the issues and opportunities facing the institution. A decision to impose an upper limit of 25 might in some cases limit this opportunity to become more familiar with and to contribute to the activities of the institution.

The Committee believes that despite the large size of some boards there is no evidence that individual directors are not given an opportunity to play a significant role; particularly in light of the increasing use of cumulative voting provisions and the expanded role being played by specialized board committees.

While the Committee recognizes the potential for self-dealing abuses when loans are made to directors or the companies they are associated with, it also believes that the proposed rules and procedures recommended in this report, together with current legislative provisions are adequate to deal with these situations.

Therefore, the Committee recommends:

99. That the minimum number of directors for financial institutions be determined by present governing legislation and that no upper limits be imposed on the size of the board.

Outside Directors

The recommendation of this report requiring the establishment of a committee of the board of directors to review and approve all permissible non-arm's-length transactions makes it essential that directors on this committee be truly independent from management and the controlling shareholders. As the existing statutory requirements are not sufficiently strict, it is necessary to develop new and higher standards of independence for members serving on a committee with the expressed purpose of reviewing, monitoring and approving all self-dealing and conflicts of interest transactions.

As the Green Paper pointed out independence would be an essential feature of internal control committees which among other things might include directors who:

—are neither officers or employees (or their relatives);

—are not significant borrowers or have significant interests in the institution or its affiliates;

—do not belong to a firm supplying auditing, legal or other professional services.

The Committee has not examined the broad issues of the appropriate portion of the board which should consist of outside directors nor the criteria by which their independence should be determined. It noted however, that the CBCA and the *Bank Act* provide for the independence of directors in the case of the audit committee. The Committee also noted that the consultative draft of the Ontario Loan and Trust Corporations Act provides that one-third of the board was to consist of outside directors who would not be current or past employees or officers during the past two years, did not have a 10 per cent or more share ownership nor were relatives of the individuals in the above two categories.

Few witnesses commented on the issue of outside directors. Several commented on it indirectly by cautioning regulators not to put board qualifications so high that directors cannot be recruited without business experience. The Insurance Bureau of Canada commented that "outside" directors were quite common in the property and casualty insurance industry and served a very useful purpose. London Life pointed out that it was currently subject to the requirement that at least one third of its directors represent the interests of policy holders and be elected by them. It was also supportive of the requirement that at least one third of the board be outside directors.

The Committee is of the opinion that there is an increasing need for financial institutions to create a board of directors which is independent from management and controlling shareholders. One which is able to deal with the basic goal of corporate efficiency and profitability while at the same time being aware and responsive to the needs and standards of the public and communities in which it operates. The trend towards the appointment of outside directors should increase both the appearance of independence and the capacity to properly staff board oversight committees to monitor and approve all permissible non-arm's-length transactions. The Committee does not believe it is necessary to introduce a statutory minimum on the proportion of outside director appropriate for financial institutions.

Therefore, the Committee recommends:

100. That all members of board committees established to monitor, review and approve non-arm's-length transactions be independent members of the board with the criteria for independence to be established along the lines provided for the appointment of auditors in the *Canada Business Corporations Act* and the *Bank Act*.

Interlocking directors

Several features of the Green paper proposal, including closely-held ownership, financial and non-financial linkages, the financial holding company structure, and networking have led to the proposal to impose limits on interlocking directorships. The *Bank Act* revision of 1967 imposed restrictions on cross-directorships between banks and trust companies. Presently there are no limits on interlocking directorships among: trust, life, property and casualty and securities firms.

Some witnesses argued against the prohibitions to restrict interlocking directorships while most did not comment. Sun Life pointed out that 10 of its 17 directors serve as directors of banks and 2 on the boards of trust companies. It viewed the proposed ban on interlocking directors as both unnecessary and disruptive. The Insurance Bureau of Canada recommended against the ban on interlocking directors and pointed out that while such a prohibition might be appropriate for deposit taking institutions it was not appropriate for property and casualty companies where there is no conflict of interest involved. The Laurentian Group recommended that any restrictions in the *Bank Act* or any other future legislation preventing individuals from sitting on the boards of affiliated companies should be abolished.

Given the Committee's recommendations with respect to ownership and the financial holding company structure there seems to be little necessity to impose limits either on interlocking directorships, within holding company groups, nor with other financial institutions.

Therefore, the Committee recommends:

101. That no restrictions be imposed on financial directorships with other non-bank financial institutions nor on the percentage of directors serving on one or more boards within a holding company group.

VII. Prudential Standards and Corporate Powers

A. Diversification of Powers

The Green Paper proposed that all financial institutions retain their exclusive core functions (commercial lending for chartered banks, fiduciary activities for trust companies, insurance underwriting for insurance companies, and corporate securities underwriting for investment dealers) and that expansion into other core functions be undertaken only through the creation of affiliated financial institutions under a financial holding company structure. This proposal was based on an implicit acceptance of closely-held cross-ownership by the Green Paper. If cross-ownership of institutions were to be permitted through a financial holding company structure, the retention of core functions for each type of institution within this structure followed the logic of such a structure. This institutional structure also appealed from a regulatory perspective since each institution within the cross-ownership structure would be regulated in accordance with its own legislation and supervisory system. As a result of this proposal, individual financial institutions could not directly expand their powers, but an ownership group could achieve broader powers through the establishment of a financial holding company which could own different types of financial institutions with different core functions.

A major problem with this proposal is the restriction it places on individual financial institutions that need to expand their powers for competitive reasons but which cannot, or do not wish to, establish a financial holding company structure. This proposal would reduce the flexibility with which financial institutions can organize and expand their financial activities and would also force all institutions into the same organizational structure if they wished to expand their powers. This limitation is particularly severe for smaller regional financial institutions which would be permanently locked into their existing core function with very little scope to expand into other "core" functions. In effect, institutions that do not become part of a holding company structure would be limited in the expansion of powers to those provided in their governing legislations only. This could place smaller institutions in an uncompetitive position compared to the larger financial holding company groups that could achieve diversification of powers through the establishment of affiliated institutions in other core activities.

A number of constraints in the Green Paper also created concerns about this approach to the question of diversification of powers. The proposals relating to the expansion of powers in the Green Paper were limited to non-bank financial institutions only. The expansion of powers for chartered banks is not being contemplated until the next scheduled revision of the *Bank Act* in 1990. This may shift the competitive balance between banks and non-bank institutions during the intervening period and could affect the relative growth potentials of the various institutions and ownership groups involved. Another inconsistency under the Green Paper proposals was the proposed treatment of mutual life insurance companies and financial co-operatives. These institutions, owing to their unique ownership characteristics, cannot establish "upstream" financial holding companies through which they could expand into other core activities. Instead, it was suggested that they be allowed to form downstream financial holding companies or subsidiary financial institutions as their major means of diversification. This proposal would thus place these institutions in a unique position and result in different treatment of similar institutions simply on account of the corporate structure, such as the case between stock and mutual life insurance companies.

One alternative to the Green Paper proposal would be to allow the diversification of powers by granting additional in-house powers within their current institutional structures. For example, the commercial and consumer lending power for trust and insurance companies could be expanded by allowing these companies to invest a greater percentage of their assets in this type of lending under specified limits or through an expansion of their current basket clause provision. The extent of this power expansion would be limited to a specified percentage of assets.

Another alternative to the Green Paper proposals on the expansion of powers would be to allow diversification through the formation of downstream subsidiary financial institutions, either directly or through a downstream holding company. For example, a life insurance company that wished to expand into trust activities could form a subsidiary trust company to undertake these activities. Investments in subsidiaries, except for real estate subsidiaries, would be deducted from the capital of the parent company to prevent the double counting of capital. This approach would maintain the separation of "core" powers as in the Green Paper but would not require the use of upstream financial holding companies since cross-ownership would not necessarily be involved. Each type of institution could also be regulated in accordance with its own legislation and supervisory system but reporting on a consolidated basis would also be required. The one area of expansion that is difficult under this approach would be commercial lending powers through a bank subsidiary unless closely-held ownership of banks is permitted. The views of the Committee on this matter are discussed under the section on Schedule 'C' bank and ownership.

The Committee heard considerable evidence regarding the powers expansion proposal of the Green Paper and alternatives to that proposal. The evidence pointed out that a flexible approach to diversification is both necessary and desirable because of the varying circumstances facing non-bank institutions of different types and sizes. It was indicated by many witnesses that any attempt to force all institutions into an upstream financial holding company structure in order to obtain diversification powers would seriously discriminate between large and small institutions and would entail unnecessary and costly re-structuring even for large institutions and ownership groups. The preference among a majority of witnesses was for a combination of greater in-house powers, particularly in the commercial lending area, and the ability to form direct subsidiaries to undertake fiduciary and insurance activities with the precise choice of structure being left to individual institutions.

The Committee accepts this evidence and concludes that a flexible approach to the expansion of powers is required if all non-bank institutions are to have equitable opportunities to expand their activities. This, the Committee concludes, could involve the expansion of powers through an upstream holding company with affiliated institutions, through downstream holding companies with subsidiaries, through direct subsidiaries and through limited expansion of in-house powers within existing institutions. In the case of downstream holding companies and subsidiaries, except real estate subsidiaries, the Committee feels that if strict rules regarding the double counting of capital are applied, these investments should not be limited to specified percentages of assets or capital of the parent institution. The Committee also concludes that this expansion of powers should be limited to the non-bank financial institutions and that the evidence does not warrant the extension of additional powers to the chartered banks until the next scheduled revision of the *Bank Act* in 1990.

To ensure that future expansion of financial institutions would not occur at the expense of the stability or solvency of the system, the investment powers outlined below for each type of institution has been reviewed and revised within an overall framework of prudential regulation. Of particular concern to the Committee are questions relating to capital adequacy and leverage. Specifically, they pertain to the types of instruments that ought to be allowed in a uniform definition of capital for all federally regulated financial institutions, the treatment of different classes of capital for purposes of leveraging, and the treatment of equity investment in a subsidiary by a parent in terms of leverage.

B. Initial Capitalization

The minimum initial capital required for the establishment of trust, loan and insurance companies has been in effect for several decades and has never been revised. The Committee therefore concurs with the proposal contained in the *Technical Supplement* to increase the minimum initial capitalization requirements substantially as set out below.

Proposed Minimum Levels of Start-Up Capital

	Current Statutory Levels	Proposed Statutory Levels
Trust Companies	\$1 million	\$5 million
Loan Companies	\$0.5 million	\$5 million
Life Insurance Companies	\$2 million	\$6 million
Property and Casualty Insurance Companies	\$1.5 million	\$5 million

While the new initial capitalization requirement would not affect most federally incorporated property and casualty insurance companies it has been brought to the attention of the Committee that many provincially chartered companies may have serious difficulty in complying with this requirement if they wished to participate in the insurance policyholder compensation plan proposed to be administered by the NFAA. Hence, it is the Committee's view that it would not be unreasonable to "grandfather" existing property and casualty insurance companies that do not meet the requirement.

Furthermore, the Committee recommends:

102. That the Minister of Finance or the Minister of State (Finance) have the discretionary power to review and revise the minimum initial capitalization requirement, as deemed appropriate;

103. That life and trust companies be allowed a 5-year transition period to comply with the new initial capitalization requirements, and that existing property and casualty insurance companies, which do not meet such requirements be "grandfathered".

C. Capital

The *Technical Supplement* proposed that the definition of capital for regulated financial institutions be reviewed and that permissible instruments to be included in the definition of capital meet the following criteria:

—those which have no date of maturity or not redeemable and are subordinated to the claims of depositors and policyholders;

—those on which payment of income can be suspended in accordance with the earnings of the institution;

—those which do not contain restrictive covenants regarding future issues of equity.

It is generally recognized that the guidelines issues by the Inspector General of Banks in March 1983 on the definition of capital for purposes of measuring the capital adequacy of Canadian chartered banks constitutes a comprehensive discussion of the subject. Indeed, the properties of permanence, freedom from mandatory fixed charges against earnings, and subordination to the rights of depositors and other creditors are the critical criteria for determining the admissibility of capital instruments in the capital base of chartered banks.

While common shares, contributed surplus, retained earnings and accumulated appropriations for contingencies readily qualify as base capital by virtue of possessing the three above-mentioned properties, how preferred shares and subordinated debentures ought to be treated is less straightforward. Any institution wishing to raise capital must strike a balance between the need for funds to ensure an acceptable risk profile in the market and the need to provide a sufficient return on equity to ensure a new issue to be attractive to prospective investors. This trade-off between the need for funds and the need for profitability is further complicated by the tax treatment of the various capital instruments and hence their receptivity by investors. For these considerations, preferred shares and subordinated debentures have been accepted by bank regulatory authorities in both the United States and the United Kingdom for inclusion in the capital base of a bank to a limited degree and subject to specified constraints. In recognition of the competitive significance such a rule may have on Canadian banks, the Inspector General of Banks has also adopted this distinction between common equity (often also referred to as primary capital or base capital) composed of common shares, contributed surplus, retained earnings and accumulated appropriations for contingencies, and uncommon equity (often also referred to as secondary capital or supplementary capital) composed of preferred shares and subordinated debentures.

While preferred shares and subordinated debentures are generally considered to be secondary capital, under the current guidelines of the Inspector General of Banks, certain preferred shares could qualify as primary capital. These would include:

—perpetual preferreds where the aggregate redemption obligation of the issuing institution represents 15 per cent or less of the issue amount;

—long-term convertible preferreds subject to the three following conditions:

- where the term to maturity is 20 years or more,
- where no redemption occurs in the first 10 years, and
- where the maximum redemption obligation in any single year is restricted to 5 per cent of the original issue amount.

For subordinated debentures to be included in secondary capital, the Inspector General imposes the following standards to be observed:

—subordination to deposit obligations,

—minimum term to maturity of 5 years with no redemption or retraction privilege in the first five years, and

—no performance covenants that could potentially interfere with a bank's ability to conduct normal banking operations, such as accelerated redemption in the event of failure to meet particular earnings coverage test.

It has been brought to the attention of the Committee that the Inspector General of Banks has recently accepted an issue of subordinated debentures by a chartered bank as primary capital. The decision was based upon the following considerations:

—term to maturity of 99 years,

—no redemption or retraction privileges by holders of the instrument,

—redemption and retraction by the institution subject to prior supervisory approval, and

—yield on the debentures would decline pro rata in the event that the dividends payable on common equity declined.

Lastly, the Inspector General of Banks stipulates two general limits with respect to the use of secondary capital:

—secondary capital cannot exceed primary capital;

—preferreds and subordinated debentures considered to be primary capital cannot exceed 20 per cent of common equity.

The Committee endorses the approach used by the Inspector General of Banks to differentiate primary and secondary capital as a flexible and practical approach to addressing the need for prudential standards by regulators as well as the need for capital by institutions. The Committee believes that there is some merit in establishing a uniform standard definition of capital for competitive equity reasons. Trust companies up to now have not utilized subordinated debentures to any extent as a source of capital. Insurance companies are not permitted to issuing debentures for capital, and have only begun using preferred stock as a form of capital over the past year or so. Mutual insurance companies face a particular challenge in the new environment under the proposed diversification of powers. Presently, their only external source of capital is from the sale of participating policies. The ability to raise capital from outside sources through the issuance of preferred stock and subordinated debentures will make the diversification of power proposals of this report more meaningful to these companies.

The Committee therefore recommends:

104. That NFAA be encouraged to adopt a two-tier structure for the definition of capital in respect of trust and insurance companies similar to that for the chartered banks;

105. That both stock and mutual insurance companies as well as their subsidiaries be allowed to issue preferred stock and subordinated debentures.

D. Leverage

While infusion of capital is foremost for solvency considerations, the profitability derived from the capital investment (i.e. return on equity) is dependent on leverage (i.e.

debt to equity ratio) and asset quality. All factors being equal, a more highly leveraged operation would yield a higher return on equity than a less highly leveraged operation. While this incentive towards profitability tends to induce institutions to operate at as high a leverage as permitted by regulation, supervisors must ensure that the permissible leverage would be sufficient for the shareholders to earn an acceptable level of return to maintain investment in the institution and yet not so high as to jeopardize the fundamental solvency of the institution.

The formulation of a uniform standard of capital for banks, trust and insurance companies would not be meaningful unless the allowable leverage for the various types of institutions are also determined on a comparable basis.

Under current legislation and regulations, the largest and well diversified Canadian banks may operate with a leverage ratio (i.e. ratio of assets to capital) not exceeding 30 times. Small and less established banks including foreign bank subsidiaries are limited to a leverage of 20 times. Large foreign bank subsidiaries with capital exceeding $15 million and total assets exceeding $500 million may operate with a leverage of up to 25 times. The current statutory borrowing multiple for trust companies ranges from 12½ times to 25 times. In the interest of strengthening prudential standards and providing a comparable guideline on leverage for all deposit-taking institutions, the Committee recommends:

106. That the range of permissible leverage for all deposit-taking institutions be reduced over some period to between 10 and 20 times and that NFAA be encouraged to establish comparable standards and criteria for granting any increase in leverage to all such institutions;

107. That institutions be allowed to operate with a leverage above the permissible limit only when solvency and market conditions are deemed to be appropriate by NFAA.

Having determined the desirable range of leverage ratios, it is imperative to ensure that the various components of capital, particularly of secondary capital, of both types of institutions be treated in a similar manner for leveraging purposes. Preferred shares and subordinated debentures of chartered banks are subject to a straight-line amortization in the final five years prior to maturity. Furthermore, for purposes of leveraging, these instruments of secondary capital are only counted as having one third the weight of primary capital. In contrast, preferred shares by trust companies are not subject to amortization and are counted as having the full weight of common equity for the calculation of the borrowing base. Subordinated debentures are not included as capital for the purposes of borrowing limits. In addition, the Superintendent of Insurance has the discretionary power to authorize subordinated shareholder loans (i.e. loans by a shareholder to the trust company for a fixed term where the legal rights of the shareholder are subordinated to those of depositors and other creditors) as part of a trust company's borrowing base on a temporary basis when it might be difficult for the company to secure permanent capital. In order to provide a consistent framework in determining leverage for both trust companies and chartered banks, the Committee recommends:

108. That all preferred shares and subordinated debentures having an outstanding maturity or retraction right exceeding 5 years and forming part of secondary capital of an institution be allowed to have the weight equalling one third of common equity in determining leverage, and that such instruments with a maturity or retraction right of less

than 5 years be subject to a straight-line amortization for leverage purposes.

E. Double Leverage

When a financial institution creates downstream subsidiaries as envisaged by the diversification of powers proposed in this report, prudential safeguards must be established to ensure that the equity investment made by the parent in a subsidiary is not counted as equity in the parent company as well as in the subsidiary. The prudential implications of this type of double counting of capital is especially serious when the subsidiary itself is also a financial institution leveraging its operations with funds entrusted to it by the public at large. The net effect of the double counting of capital is leveraging a given amount of equity capital twice – double leveraging. This would negate the attempt to define leverage for chartered banks and trust companies on the basis of a comparable definition of capital. It would also thwart the intent to strengthen prudential standards by reducing the statutory range of allowable leverage.

Under the current regulatory regime, life insurance companies are permitted to double count capital in respect of their equity investments in a foreign life insurance subsidiary or a domestic property and casualty insurance subsidiary. Similarly, chartered banks are allowed double leveraging when share investments in an associated corporation does not exceed 20 per cent of that corporation's equity capital. However, when such investments exceeds 20 per cent, the amount of the equity investment would be deducted from the bank's base capital. Although double leveraging has not been identified by supervisory authorities as a major prudential concern because of the limited powers trust and insurance companies now have under their respective legislation to create financial subsidiaries. It would become a significant supervisory matter if the diversification of powers to create downstream financial subsidiaries by trust and insurance companies proposed in this report were to be adopted.

Under the Green Paper proposal, diversification of powers by trust and insurance companies into other areas of financial services would have to be accomplished through the structure of an upstream or downstream financial holding company. The proposed restrictions pertaining to inter-affiliate transactions as well as the inherent corporate inability for mutual insurance companies and financial co-operatives to raise outside capital prompted the government to consider allowing double counting of capital by these institutions in respect of their investments in a downstream financial holding company and subsidiaries, albeit limited to an aggregate limit of 5 per cent of assets of the investing company. It is the Committee's view that without the requirement to establish a financial holding company in order to create subsidiaries in other areas of financial services coupled with the power to issue preferred stock and subordinated debentures would obviate the need for mutual insurance companies and financial co-operatives to be accorded special treatment insofar as double leveraging is concerned. It would also seem more equitable to have a single rule for all financial institutions.

Therefore, the Committee recommends:

109. That the amount of equity investment in subsidiaries except real estate subsidiaries created by all federally regulated financial institutions be deducted from the base capital of the investing institution.

In order to ensure double leveraging would not be achieved through the acquisition of an existing financial institution under the guise of portfolio investments, the Committee further recommends:

110. That when share investments in any existing financial institution exceed 20 per cent of the voting stock of that institution, the entire amount of investment be deducted from the base capital of the investing institution.

F. Commercial Lending

One of the reasons for the trust and insurance industries to seek a comprehensive revision of their governing legislations is among others to obtain greater scope of operation in some of their non-traditional activities, such as consumer and commercial lending. Insofar as commercial lending is concerned, the Green Paper and the *Technical Supplement* proposed a combination of in-house commercial lending power up to 5 per cent of assets and the possibility for trust and insurance companies to conduct unlimited commercial lending through the establishment of a Schedule 'C' bank within the structure of a financial holding company. The rationale for the proposal as enunciated by both the Minister of State (Finance) and the Governor of the Bank of Canada is based on several considerations. Foremost is the notion that commercial lending is the core function of chartered banks. Moreover, it is an activity historically regulated under the *Bank Act* whereby the major suppliers of commercial credit in the country, namely chartered banks, are subject to reserve requirements prescribed by the Bank of Canada. The proposal recognizes the need to provide some flexibility for existing non-bank financial institutions to conduct commercial lending within their respective institutional structure. However, beyond the limit of 5 per cent of assets, it is the view of the Green Paper that the non-bank institutions would be engaging in commercial lending in a major way. It would therefore be desirable for these institutions to establish separate entities known as Schedule 'C' banks in order to participate fully in the commercial lending market. The requirement for the Schedule 'C' bank to maintain non-interest bearing cash reserves with the Bank of Canada would thus preserve the competitive equity among all suppliers of commercial credit.

Of the one hundred thirty seven submissions received by the Committee, only four groups endorsed the concept of a Schedule 'C' bank. Furthermore, only one of the four groups was a non-bank institution. The most important reason for the non-acceptance of the Schedule 'C' proposal lies in its impracticality. In addition to the high cost of establishing a bank, one of the intended beneficiaries of this proposal, namely trust companies, would have to duplicate their existing deposit-taking function. The combination of these two factors would effectively eliminate small trust companies from competing in the commercial lending market. Moreover, most non-bank institutions submitted to the Committee that they did not wish to enter into banking, but simply needed greater commercial lending power.

The rationale provided by the trust industry and the life insurance industry for greater commercial lending power under their respective governing legislations were different. For the trust industry, it argued that their traditional residential mortgage market has been subjected to intense competition from the chartered banks since the 1967 revision of the *Bank Act* when chartered banks were permitted to provide residential mortgages. Over the years, as trust companies became relatively more successful in their deposit gathering activity, the scope of their traditional lending activity has proved to be limited. Greater commercial lending power would widen the scope of their asset use in response to a changing competitive environment in the market place. Moreover, since interest rates have become more volatile, an increase in floating rate assets would be desirable for matching purposes. In presenting the case to the Committee, one trust company official stated that most trust companies would not be involved in commercial lending if chartered banks were to be disallowed in residential mortgage lending.

The life insurance industry contended that commercial lending in the form of private placements is an appropriate activity for them. Due to the relative long-term and fixed rate nature of the industry's liabilities, most private placements done by life insurance companies are with a fixed rate and with a term to maturity beyond five years. Not only would this seem prudent in terms of matching the terms and rates of assets with those of liabilities, it is also generally recognized as a segment of the lending market where there is not an excessive supply of such credit.

Under the investment rules of the existing federal insurance and trust legislations, eligible investments are determined according to a number of quality of asset tests such as earnings and dividends record or loan to value ratio. All other ineligible investments including commercial loans would fall under the category of basket clause investments which is subject to an aggregate limit of 7 per cent of assets of a trust or insurance company. An additional difficulty created by the *Technical Supplement* was its proposed definition of a commercial loan. This was defined to include all means of advancing funds, credit, or guarantee of funds to businesses except securities issued under prospectus, securities issued in private placements with a sufficiently large and varied subscribing clientele as to be virtually the equivalent of a market offering, commercial paper issued under prospectus or the equivalent of a market offering, and corporate mortgage loans that meet the 75 per cent loan to value ratio or insured corporate mortgage loans. This proposed definition of commercial loan would render many eligible investments under the existing quality of asset investment test to be basket clause investments, one notable example being the private placements of life insurance companies. Furthermore, numerous companies' current level of private placements already exceed the proposed allowable limit of 5 per cent of assets. While the life insurance industry did not propose a definition of commercial lending, it did submit to the Committee that private placements should be excluded from the definition, however defined. In addition, it suggested that a limit of 20 per cent of assets as being appropriate if such activities were to be confined within a percentage of total assets. The trust industry recommended a limit of between 20 and 25 per cent of assets and also argued for a definition by exclusion through the continued application of the quality of asset tests for determining eligible investments. As a result, term loans over one year and private placements would be excluded provided the client company's earnings record met the requirements of the quality of asset test. Similarly, commercial mortgages would be excluded provided the 75 per cent loan to value ratio has been observed. Whereas representatives from the trust industry referred to commercial lending as unsecured lending, lending against current assets such as receivables, working capital lending and factoring, the chartered banks seemed to view commercial lending as any lending to a commercial enterprise. It is worthy to note that the *Bank Act* also uses the exclusion approach for determining what banks are allowed to do.

While the Committee was unsuccessful in developing a definition of commercial lending, it questions the feasibility and practicality of doing so in view of innovations in financing techniques. It also seems obvious that if commercial lending were the core function of banking, defining it would amount to defining banking. Therefore, defining commercial lending would seem to be more appropriate as an object of the decennial review of the *Bank Act*.

For reasons of practicality, flexibility and competitive equity, the Committee recommends:

111. That all investments for which no specific aggregate limits are imposed be considered as basket clause investments for non-bank financial institutions;

112. That the aggregate limit on basket clause investments for all non-bank financial institutions be established at 15 per cent of assets.

The Committee shares the concerns of chartered banks that the granting of greater commercial lending power to non-bank financial institutions may result in competitive inequity. It is the view of the Committee that the requirement for chartered banks to maintain non-interest bearing cash reserves with the Bank of Canada constitutes a form of hidden taxation. As at the end of August this year, this amounted to almost $2.5 billion. Based on an interest rate assumption of 10 per cent, the effective cost to the Canadian banking system for maintaining these reserves would be approximately $250 million. Notwithstanding that the Green Paper has proposed to eliminate such requirements with respect to term deposits exceeding one year in maturity, and given the fact that there seems to be some divergence of opinion among experts about the necessity of reserves for the conduct of monetary policy, the Committee therefore recommends:

113. That the requirement for chartered banks to maintain non-interest bearing cash reserves with the Bank of Canada be eliminated;

114. That the Minister of Finance, if necessary, to make up this loss of revenue, consider the advisability of imposing a tax on the total deposits of all deposit-taking institutions.

G. Quality Mortgage

In so far as owner-occupied residential property is concerned, the *Technical Supplement* defined the concept of a quality mortgage to be any first mortgage that does not exceed the 75 per cent loan to value ratio or any such excess which is either insured or guaranteed by a government agency, and junior mortgages which are similarly insured or guaranteed. There is some concern expressed by industry that the definition may be unnecessarily restrictive in instances where there was no third party claim on the property and a single financial institution has provided both first and junior mortgages to a borrower the sum total of which did not exceed the 75 per cent loan to value ratio. In such situations, it can be argued that the institution has not extended credit beyond any prudential limit provided the general limitation on a single mortgage loan not exceeding 15 per cent of shareholders' equity has been observed. The extension of this reasoning is that junior mortgages in such cases may well merit to be considered as quality mortgages.

Therefore, the Committee recommends:

115. That the definition of a quality mortgage with respect to owner-occupied residential property include first and junior mortgages provided the following conditions are met:
—a single financial institution provided both the first and the junior mortgage loans;
—no third party claim on the property in question;
—the total value of the first and junior mortgage not exceed the 75 per cent loan to value ratio;

—no single mortgage loan exceeding 15 per cent of shareholders' equity of the lending institution.

With respect to other properties, the *Technical Supplement* proposed to substitute the current 75 per cent loan to value test by a number of rules in order to strengthen the control of risk exposure to real estate lending. These proposed rules relate to the adequacy of cashflow from the mortgage, third party encumbrance on the property, and whether mortgages are insured. The Committee received some evidence from industry groups that the proposed definition of a quality mortgage with respect to property other than owner-occupied residential property would adversely impact upon their ability to provide construction financing because of inherent difficulties in applying the cashflow test to construction financing. Such financing would thus be considered as non-quality mortgages subject to an aggregate limit of 5 per cent of assets. This would be equivalent to 100 per cent of equity for a company leveraged at 20 times. Given the Committee's recommendation to increase the basket clause from 7 to 15 per cent of assets, the proposed rules would not seem as constraining and onerous as they seem. Since the Committee does not believe that lending institutions should be exposed to the same degree of risk as real estate developers, it has concluded that the rules proposed by the *Technical Supplement* are reasonable and serve a useful purpose in controlling the risk exposure of lending institutions in real estate development ventures.

H. Trust Companies

The Committee recommends the following investment rules for trust and loan companies:

116.

A. MINIMUM INITIAL CAPITALIZATION	**$5 million**
B. BORROWING MULTIPLE (trust companies only)	**10x – 20x on a consolidated basis**
C. ASSET MIX	**PER CENT OF ASSETS**
Debt securities and quality mortgages	**Minimum 60%**
Preferred shares	**Maximum 10%**
Non-quality mortgages	**Maximum 5%**
Real estate and real estate subsidiaries	**Maximum 5%**
Subsidiaries:	
Financial	**No statutory limit**
Non-financial	**Aggregate Maximum 5% Each individual subsidiary, Maximum 2%**
Basket clause(except real estate)	**Maximum 15%**
D. MAXIMUM EXPOSURE TO 1 INDIVIDUAL OR GROUP OF RELATED ENTITIES	**20% of shareholders' equity**
E. PORTFOLIO INVESTMENT	**Maximum 20% of voting stock**

Where the above proposed limits differ from those contained in the *Technical Supplement*, clarifications are elaborated in the sections below.

Real Estate

Whereas the *Technical Supplement* contained a variety of rules regarding real estate holdings depending on whether it was for investment or for own use, and whether it was income-producing or non-income producing, it is the Committee's view that the limit of 5 per cent of assets on all real estate holding including those for own use would suffice for prudential regulation. For a trust company with a maximum statutory leverage of 20 times, 5 per cent of assets is equal to 100 per cent of shareholders' equity. The maximum exposure to real estate by a fully leveraged trust company is therefore the total shareholders' own funds. No depositors' funds would be exposed to such risks. Moreover, it would seem impractical to enforce any sub-limit on real estate investments because there will always be extenuating circumstance where companies would be able to plead for an exemption from the supervisory body. Since all financial institutions are to adopt a "prudent man's rule" for their investments coupled with higher standards of care for the board of directors, the sub-limits on real estate investments would not seem necessary. However, any real estate in excess of 5 per cent of assets would not be permitted as basket clause investments.

Subsidiaries

The Committee distinguishes investments in subsidiaries established by a financial institution depending on whether the subsidiary in question is a financial or non-financial corporation. In the case of a financial subsidiary, no statutory limit on investment is required because double leveraging will not be permitted. Consequently risk exposure through investments in downstream financial subsidiaries would not increase disproportionately. The limit proposed for investments in non-financial subsidiaries reflects the Committee's views on the co-mingling of financial and non-financial activities as expressed elsewhere in this report. It is believed that public funds entrusted with financial institutions are primarily for financial intermediation and should therefore not be subject to risks associated with non-financial activities undertaken by these institutions. The Committee concurs with the proposal contained in the *Technical Supplement* to treat real estate held through a real estate subsidiary in the same manner as if it were a direct real estate investment. The Committee also wishes to emphasize that real estate subsidiaries will be restricted to activities pertaining to real estate and not be given the powers of a natural person to engage in other businesses.

Basket Clause

The *Technical Supplement* proposed to eliminate the provision of a basket clause for unspecified investments. Instead, it proposed to allow trust companies to invest up to 5 per cent of assets in commercial lending, and up to 10 per cent of assets in consumer lending. For reasons outlined in an earlier section under commercial lending, the Committee concluded that there is merit in retaining a basket clause for investments to which no specified aggregate limits apply such as common stocks, leasing, factoring, consumer and commercial lending. Moreover, the basket may apply to all specified investments that have exceeded the imposed aggregate limit except real estate.

Portfolio Investments

Whereas the investment limits under the category of subsidiaries relate to de novo subsidiary corporations created by the parent company, the limit on portfolio investments relates to share investments in an existing corporation. The Committee believes it is important to distinguish passive investments from active investments. The *Technical Supplement* proposed the test for determining corporate control or active participation in a business as 10 per cent of voting stock. This will be a significant tightening from the current rule of 30 per cent. The Committee believes that 20 per cent would be more constraining than the present rule to reflect the intricacies of techniques by which effective control of a corporation can be exercised. At the same time, it would not be as onerous as the proposed 10 per cent limit for divesting. If, for example, a financial institution wished to invest in more than 20 per cent of the voting stock of an existing corporation, the investment rules for subsidiaries would apply because participation beyond 20 per cent would be considered being actively engaged in the business of the corporation. In accordance with the Committee's proposal on double leveraging, the full amount of the investment would be deducted from the base capital of the investing corporation. This is to ensure that the double counting rule with respect to investments in subsidiaries remains neutral whether the subsidiary in question is newly established or acquired through share ownership.

I. Life Insurance Companies

The Committee recommends the following investment rules for stock and mutual life insurance companies:

117.

A. MINIMUM INITIAL CAPITALIZATION	**$6 million**
B. LEVERAGE	**To be determined pending introduction of a minimum continuing capital and surplus requirement which varies by the nature of liabilities**
C. ASSET MIX	**LIMITS**
Debt securities and quality mortgages	**No statutory limit**
Preferred shares	**Maximum of 10% of assets**
Non-quality mortgages	**Maximum of 5% of assets**
Real estate for investment, including real estate subsidiaries	**35% of equity & 25% of par liabilities & 15% of non-par liabilities**
Real estate for own use, including real estate subsidiaries	**35% of equity**
Common stocks	**35% of equity & 25% of par liabilities & 15% of non-par liabilities**
Common stocks of venture capital corporations	**10% of equity**

Total common shares and real estate combined	**100% of equity & 40% of par liabilities & 20% of non-par liabilities**
Subsidiaries:	
Financial	**No statutory limit aggregate**
Non-financial	**maximum 5% of assets and 2% of assets on each individual subsidiary**
Basket clause (except real estate)	**Maximum 15% of assets**
D. PORTFOLIO INVESTMENT	**Maximum 20% of voting stock**

As acknowledged by the *Technical Supplement*, the reason for permitting life insurance companies greater flexibility than trust companies to invest in common stocks and real estate is because a significant portion of the liabilities of life insurance companies is much longer term in maturity than those of deposit institutions. For prudential reasons, the Committee also concurs with the *Technical Supplement* to relate such investment limits to shareholders' equity (for stock companies), unappropriated surplus (for mutual companies), participating life insurance policy liabilities, and non-participating life insurance policy liabilities.

Rationale for the limits on portfolio investments and investment in subsidiaries and real estate developed in respect of trust companies would apply equally to the life insurance companies.

The Committee received considerable representation from the life insurance industry to have trustee powers to administer funds payable on insurance contracts, registered pension plans and registered retirement savings plans. Considering the scope of diversification powers being recommended for this industry, it seems that the above-mentioned trustee powers would be logical extensions of the life insurance business.

Therefore, the Committee recommends:

118. That life insurance companies be allowed to act as trustees of funds payable on insurance contracts, registered pension plans and registered retirement savings plans.

Valuation Actuary

Under current legislation each life insurance company is required to appoint a valuation actuary whose main responsibility is to certify that the actuarial reserves shown in the financial statements are sufficient to cover the expected liabilities of the company under policies that are in force as of the statement date. The certification is therefore restricted to the question of whether the company would have sufficient reserves if it stopped writing new business on the statement date.

The scope of this certification appears too limited to provide a sufficient guarantee that the company would be able to meet its financial obligations to its policyholders. Policyholders must be assured that the company will have sufficient liquidity when insurance protection or the savings entrusted to it are needed.

This first requires that the investment policy of the insurer be appropriate in relation to the types of contracts that it sells. The investments must be reasonably well matched to the nature of the liabilities to ensure that sufficient liquidity will be available at the time the liabilities must be discharged.

A second aspect of the question relates to the current and future investment and pricing practices of the company. While a company could have sufficient reserves to cover policies sold in the past, improper pricing for new business if pursued over time could lead to a gradual deterioration of its financial condition and potentially impair its ability to meet its obligations.

To address these specific concerns, the Committee believes that the role of the valuation actuary should be broadened. The Committee has reviewed the role of the Appointed Actuary in the United Kingdom and finds that it includes important responsibilities that are worthy of consideration in Canada.

In the United Kingdom, the Appointed Actuary is appointed by the Board of Directors. This person informs the Board of any situation or practice that in his opinion could have a significant impact on the financial condition of the company. His statutory responsibility is to carry out, from time to time, and to report on an investigation into the financial condition of the company, including a valuation of its liabilities. This includes:

a) the premium rates on which existing business has been, and current new business is being, written,

b) the nature of the contracts in force and currently being sold, with particular reference to all guarantees,

c) the existing investments and the continuing investment policy,

d) the marketing plans, in particular the expected volumes and costs of sales,

e) the current and likely future level of expenses,

f) the extent of the company's free capital and surplus,

g) the reinsurance arrangements,

h) an assessment of the company's current and continuing solvency.

The Appointed Actuary also has responsibilities and obligations to the Department of Trade and Industry by reason of his statutory duties and must inform the regulator of any situation which in his judgement could affect the protection of policyholders.

The Committee believes that the role of the valuation actuary should be expanded and therefore recommends:

119. That NFAA review the present role of the valuation actuary in consultation with the Canadian Institute of Actuaries and broaden this role to include an appropriate responsibility for the continuing financial condition of the company along the lines of the Appointed Actuary in the United Kingdom.

J. Property and Casualty Insurance Companies

Prudential regulations for property and casualty insurance companies need to be strengthened in light of the financial difficulties experienced in recent years by some of the members of the industry. A few factors have played a major contribution in the insolvencies that have occurred: inadequate capitalization, failure to maintain sufficient premiums, understatement of liabilities and inadequate reinsurance protection. It is therefore imperative that the revisions to prudential regulations address these specific areas of concern.

Initial Capitalization

The Committee supports the Green Paper proposal to increase the minimum capitalization required for new companies from $1.5 million to $5 million. Existing companies should not however be made subject to this new requirement as outlined in a recommendation in the section on initial capitalization.

On-Going Capital Requirements

Each insurer should be required to maintain at all times sufficient capital to support its on-going operations.

The current provisions require that a company's "adjusted" capital and surplus represent at least the sum of (1) 15 per cent of the liability for unpaid claims and (2) up to 15 per cent of the liability for unearned premiums, depending on the company's past and anticipated claims experience. The capital and surplus is adjusted to exclude certain assets which are not eligible for the test such as deferred acquisition expenses.

It appears that the existing requirements in some cases have not been sufficient to bring to attention at an early stage certain problem situations. The Superintendent of Insurance has proposed that an additional test be included in the legislation to supplement the present minimum capital requirement. This test would provide that capital and surplus is sufficient to cover the larger of:

a) 15 per cent of the gross premium income of the company during the immediately preceding financial year plus the smaller of $500,000 or 5 per cent of the premiums; and

b) 22 per cent of the average annual amount of claims incurred by the company during the immediately preceding three financial years plus the smaller of $490,000 or 7 per cent of the said average amount.

Credit would be given for reinsurance but, for other than reinsurance companies, not such as to reduce the capital and surplus required to less than 50 per cent of the figures calculated without regard to reinsurance.

On an overall basis, the inclusion of this test would not have a major impact on the current solvency margin of the property and casualty insurance industry. It would help to correct certain technical flaws of the current minimum capital requirement calculation and would affect a few companies which today are able to operate with a very small capital base in relation to their operations and still pass the present tests. This would give the supervisor greater flexibility in using discretionary power to deal with these specific situations. In this context, the Committee concurs with the inclusion of this supplementary test in the minimum capital requirement calculation.

Investments

The property and casualty insurance industry has generally followed conservative investment practices. In fact, current regulation allows greater flexibility than is being used by most companies. Quality of investment portfolio does not seem to have been a factor in the recent failures of property and casualty insurers. Revision of this area of regulation would not therefore appear as imperative as for the other types of prudential regulations.

The Committee has heard evidence from the Insurance Bureau of Canada that the current investment rules are satisfactory and that they should be maintained. The Bureau expressed its preference for the present qualitative tests to the quantitative restrictions that have been proposed in the *Technical Supplement*.

An argument can be made on the other hand that the qualitative approach is cumbersome from an administrative standpoint and does not in itself significantly contribute to the overall quality of the investment portfolios of property and casualty insurers.

The Green Paper proposals on investment rules would not in general have a restrictive impact on the current practices followed by the industry. There would however, be two main exceptions.

The first exception is the proposed limitation of 10 per cent of assets for investments in preferred shares, which are not today subject to any specific restriction. Since property and casualty insurers are not highly leveraged when compared to trust and loan companies, the proposed limitation would in effect result in a more stringent restriction for preferred shares than for common shares, which would be limited to 100 per cent of shareholders' equity. A preferable approach would be not to restrict preferred shares as such, but to impose a combined limitation on investments in preferred shares, common shares and real estate equalling 150 per cent of shareholders' equity, while maintaining the proposed sub-limits on common shares and real estate.

Investments in subsidiaries is a second area where the Green Paper proposals would be more restrictive than what is allowed under the present legislation. This subject has been discussed at length previously in this report. Investments in subsidiaries should be subject to similar considerations and limitations for property and casualty insurers as for trust and loan companies and life insurance companies.

In conclusion, the Committee has not perceived any significant pressure to modify the rules governing the investments of property and casualty insurers. However, if the legislation were to be reviewed and the investment rules of life insurers were to be modified from the current qualitative tests to a quantitative approach, then it would appear appropriate to review the property and casualty insurance investment rules at the same time. The approach of the Green Paper in general seems acceptable with the two modifications that are recommended above for investments in preferred shares and in subsidiaries, and the addition of a basket clause of 15 per cent of assets, as discussed in the section on Commercial Lending.

In order that investments that were previously legal do not become illegal when the legislation changes, a transition period should be allowed for companies to comply with the new requirements.

The Committee recommends the following rules for property and casualty insurance companies:

120.

A. MINIMUM INITIAL CAPITALIZATION	**$5 million**
B. MINIMUM ON-GOING CAPITALIZATION	**Maintain Test 103 of current insurance legislation. Introduce new test proposed by Superintendent of Insurance based on 15% of premiums and 22% of claims.**
C. ASSET MIX	
Debt securities and quality mortgages	**no statutory limit**
Real estate for investment, including real estate subsidiaries	**35% of equity**
Real estate for own use, including real estate subsidiaries	**35% of equity**
Common stocks	**100% of equity**
Common stocks of venture capital corporations	**10% of equity**
Total common stocks, preferred shares and real estate combined	**150% of equity**
Subsidiaries	
Financial	**No statutory limit**
Non-financial	**5% of assets aggregate maximum** **2% of assets on each individual subsidiary**
Basket clause (except real estate)	**Maximum 15% of assets**
D. PORTFOLIO INVESTMENT	**Maximum 20% of voting stock**

Reinsurance

The Superintendent of Insurance has proposed a number of measures that would place restrictions on the use of reinsurance. The principal recommendations are:

—to prohibit new companies and other companies with less than $25 million in assets from ceding reinsurance to reinsurers who are not registered in Canada;

—to impose a requirement on all companies other than reinsurance companies that a minimum of 50 per cent of the reinsurance ceded be placed with registered reinsurers; and

—to require all companies to retain for their own account a minimum of 50 per cent of their business. An exception would be made for new companies in their first five years of operations which would be allowed to cede up to 75 per cent of their business.

The Committee recognizes that a few companies have been placed in financial difficulty as a result of excessive reliance on reinsurance or in some cases because of reinsurance with non-registered markets which turned out to be uncollectible when needed.

Reinsurance is an essential need of property and casualty insurance companies. Catastrophe risks need to be spread around the world among a large number of companies. The registered reinsurance market in Canada represents only a portion of the world reinsurance capacity. Certain forms or levels of catastrophe reinsurance might not be fully available to Canadian insurers if access to non-registered reinsurance were prohibited. Canadian-owned insurers would be particularly at a disadvantage, since many foreign-owned Canadian insurers would keep access to non-registered reinsurance indirectly through their parent insurance companies.

The Committee does not believe that it would be practical or desirable to completely prohibit access to non-registered reinsurance to any insurer. However, it supports the second recommendation of the Superintendent which would place some control on the use of non-registered reinsurance.

Requiring companies to retain at least 50 per cent of their business and after only five years of existence appears stringent and could have in some cases an effect opposite to what is intended. With the addition of the supplementary test for minimum capital which allows no more than 50 per cent credit for reinsurance, and the proposed limitation on the use of non-registered reinsurance, the Committee feels that the need for a minimum retention would not seem essential.

The Committee therefore recommends:

121. That the amount of premiums that a company, other than a reinsurance company, can cede to a non-registered reinsurer be limited to the amount of premiums ceded to a registered company.

Valuation Actuary

Life insurance companies have been required for many years to have their actuarial reserves certified by a fully-qualified actuary who is a member of the Canadian Institute of Actuaries.

The Superintendent of Insurance has proposed that such a requirement be extended to property and casualty insurance companies, and this has received the support of the Insurance Bureau of Canada.

The necessity to introduce the concept of the valuation actuary to property and casualty insurers has been discussed at various times. Probably the main reason why it is still not part of the federal legislation is due to the current shortage of qualified actuaries in the property and casualty insurance field. However, although it is still insufficient, the number of property and casualty actuaries is now growing at a rapid pace. The Committee believes that the time is now appropriate to amend the insurance legislation to include the actuarial certification requirement for property and casualty insurers.

Under the proposal of the Superintendent of Insurance the main objective of the actuarial certification would be to cover the adequacy of the provisions for unearned premiums and unpaid claims. In principle, the role and responsibilities of the valuation actuary would be similar for life insurance and for property and casualty insurance. The Committee has recommended that the role of the valuation actuary for life insurers be broadened to include the main responsibilities of the Appointed Actuary in the United Kingdom. It would be appropriate that similar responsibilities be also conferred upon the valuation actuary of a property and casualty insurer to the extent that they are relevant to the property and casualty insurance context.

A transition period of five years should be allowed during which the supervisor could accept a certification by a person other than a fully qualified actuary if a company could demonstrate that it was unable to secure the services of an actuary under normal terms and conditions. The supervisor, in granting such permission, could give due consideration to the size and financial condition of the company involved.

The Committee therefore recommends:

122. That property and casualty insurance companies be required as soon as possible to appoint a valuation actuary and include with their financial statements a report by the actuary certifying that the provisions for unearned premiums and unpaid claims are adequate;

123. That a transition period of five years be allowed during which a company could appoint a person other than a fully-qualified actuary if it could demonstrate to NFAA that it was not reasonably able to secure the services of a fully-qualified actuary;

124. That the review of the role of the valuation actuary recommended by the Committee for life insurance companies also be applicable to property and casualty insurance companies.

K. Pension Funds

The Committee received only one submission regarding the proposed changes to the investment rules of pension funds. The Committee's views and deliberations are as a result based upon the joint submission from the Association of Canadian Pension Management and the Investment Counsel Association of Ontario. Since the submission was based on the consensus of 50 pension fund managers administering almost 90 per cent, or $89 billion, of all trusted pension assets in Canada, there is no reason for the Committee not to accept the views expressed in the submission as being representative of those of the entire industry.

The Committee endorses the following proposals contained in the *Technical Supplement*:

—that the investment rules and objectives be clearly outlined in the pension fund contract between the sponsor and members;

—that pension funds establish specific investment criteria to meet the objectives and rules of the contract and the duty of prudence, and that such duty would extend to pension fund managers;

—that trustees of pension plans be required to establish a management committee composed of representatives of the plan sponsor and of plan members to oversee compliance with the rules and objectives of the plan.

While the "prudent portfolio" approach to investment was contemplated by the *Technical Supplement*, it also proposed numerous rules regarding diversification, corporate control and small business and foreign investment.

Diversification

The *Technical Supplement* proposed that the limit on investments in any one single corporation or group of related corporations be reduced from the current level of 10 per cent of assets to 5 per cent of assets. It was brought to the attention of the Committee that the 5 per cent limit on a group of related corporations would restrict the ability of pension funds to invest in major blue-chip Canadian stocks such as Bell because the number of corporations related to these major corporations represent considerably more than 5 per cent of corporate bonds and stock outstanding in Canada. To disallow holdings of such securities commensurate with their market weighting seems arbitrary and inappropriate. Moreover, it would force investment funds away from stable corporations to less stable ones. As a result, the diversification proposal may well be counterproductive to the underlying principle of diversification and prudence.

Therefore, the Committee recommends:

125. That the existing limit of 10 per cent of assets on the investment in a single corporation or group of related corporations be retained.

Portfolio Investment Limit

The *Technical Supplement* proposed that the limit on investments in the voting stock of a corporation by pension funds be reduced from 30 per cent to 10 per cent. While most pension funds holding would not exceed the new limit by virtue of their diversification, few major pension funds do currently own up to 30 per cent of the voting stock of a corporation. While the proposed limit may appear to be justifiable as a means to ensure pension investments remain "passive" in nature, it seems to run counter to the objective of promoting investments in small and medium-sized businesses. For example, 1 per cent of a $1 billion pension fund could represent substantially more than 10 per cent of voting stock of a small private corporation. In line with the Committee's decision on this subject with respect to other non-bank financial institutions, the Committee therefore recommends:

126. That investments in a single corporation be limited to 20 per cent of voting stock.

Securities in Default

The *Technical Supplement* proposed that investment in securities "in default" be prohibited. The merit of such prohibition is obvious. But such investment may not necessarily be inconsistent with "a prudent portfolio" approach. It may sometimes be necessary for an investor to make additional investments in a small business which is viable but experiencing temporary cashflow problems. Allowing such investments under a basket clause would not jeopardize the solvency of a pension fund and could promote investment in small business. Outright prohibition would not seem necessary in view that pension funds will be required to specify its investment rules and objectives and to establish a management committee for compliance purposes.

The Committee therefore recommends:

127. That a basket clause of 15 per cent of assets for investment in ineligible assets be established;

128. That the proposed prohibition of investment in securities "in default" be rescinded and that such prohibition be determined within the investment rules and objectives of individual pension funds.

L. Chartered Banks

Proposals in the Green Paper do not pertain to chartered banks. The revisions contemplated immediately focussed on non-bank financial legislation for which the review process is not mandated by statute and is in much need of adaptation to present market realities. Extensive alterations were made to the *Bank Act* in 1980 and no major revisions are planned until the next decennial review. The government indicated it was prepared to begin consultation on the 1990 revision of the *Bank Act*. The government also proposed that chartered banks will hence not be required to hold primary reserves on term deposits with a maturity of over one year.

In the hearings before the Committee, the Canadian Bankers' Association maintained that the exclusion of chartered banks from planned reform would deny many Canadians access to an expanded range of financial services – a view also expressed by some consumer groups. The concept of networking was universally supported by the banks with a recommendation that they be included in shared or common distribution systems. Additionally, some banks expressed a desire for domestic provision of investment banking services similar to those which they presently offer offshore. It was argued that this would reduce costs to their domestic customers. Generally, they were in agreement that the expansion of product mix be undertaken through the formation of subsidiaries. Collectively, they advised that corporate powers for all financial institutions be reviewed synchronously. This would not only preserve competitive equity, but lessen the planning uncertainties which would otherwise be faced by all institutions.

From a financial service user perspective, the Canadian Organization of Small Business also acknowledged the pro-competitive thrust and spirit of fair play by advocating opportunities for chartered banks to enter fields now served by other non-bank institutions should these expand their personal and commercial lending activity. The Economic Council which has since 1976 promoted regulation by activity – functional regulation – also supported widening the scope of service offerings to all financial institutions. The co-operative movement in Canada was of a similar view.

The Committee recognizes that the Green Paper is unclear as to the role chartered banks would play in a framework of widened financial service offerings. This could indeed present planning uncertainties not just for the banks but other financial institutions and their customers. The Committee advocates that the chartered banks be considered in the future for the same opportunities as other financial institutions, providing reasonable safeguards of safety and soundness can be maintained. A logical extension of the Committee's approach suggests that the banks be permitted networking, and other diversification of powers being recommended in this report for non-bank institutions.

However, given this Committee's recommendation regarding ownership for all financial institutions except mutual insurance companies and credit unions, the issue of broadened chartered bank business powers should be fully explored in the context of altered ownership considerations. Moreover, no evidence was presented before the Committee focussing on the issues surrounding expanded bank service offerings. Therefore, the Committee would prefer that this matter be considered at the next scheduled review of the *Bank Act*. It finds no reason why consultation could not commence immediately and in fact, urges that the government proceed readily with the 1990 planned revision. Failure to do so would only perpetuate uncertainties in the marketplace and could deter implementation of effective corporate strategies.

The Committee has made known its views on the subject of non-interest bearing cash reserves in a previous section on commercial lending and wishes to reiterate its recommendation:

129. That the requirement for chartered banks to maintain non-interest bearing cash reserves with the Bank of Canada be eliminated.

M. Co-operative Credit Institutions

The Green Paper proposed that co-operative credit associations registered under the federal *Co-operative Credit Association Act* (CCCA) be permitted to expand business opportunities through the creation of downstream financial groups, either individually or jointly. Investments in financial holding companies would be made subject to the proposed investment rules and existing provincial restrictions. It was left to future discussion with the industry as to how the general ban on non-arm's-length transactions would apply. This is so because the co-operative movement by its very nature involves self-dealing activities. It was proposed in principle that the definition of capital would be broadened to place co-operatives on an equal footing with other financial institutions. The Government is also prepared to revise statutory liquidity requirements which would be based on the concept of pooling liquidity within the entire financial co-operative system.

The Committee is mindful of the difficulties that may be engendered by a compulsory financial holding company structure. It advocates that the route of diversification be the choice of management subject to adequate safety and soundness considerations. Based upon evidence before the Committee, financial co-operatives would prefer diversification through in-house power expansion. The Committee duly notes that much financial innovation in Canada has stemmed from the co-operative movement and hence, encourages a study of an expansion of business powers along the lines they suggest. However, this is primarily a matter of provincial governance which is beyond the Committee's consideration.

Within federal jurisdiction, the Committee does not see why the Canadian Co-operative Credit Society (CCCS) could not be granted the same powers permitted other financial institutions. Specifically, consumer and commercial lending may be undertaken in-house up to 15 per cent of CCCS' assets, and/or subsidiaries may be established to enter other fields of financial sector activity subject to the rules on double counting of capital. The definition of capital (primary and secondary) would be similarly applied as to other financial institutions. Refinements would have to be made to the definition of primary capital to reflect the nature of equity capital within a co-operative framework. Additionally, maximum permitted secondary capital would likely be defined as a percentage of pooled equity. These matters could be left to the appropriate authorities for discussion with the industry. CCCS may also engage in networking arrangements with other financial institutions.

The Committee believes that such a package of proposals would meet the Green Paper's objective to provide co-operatives at the consolidated level with a regular means of raising external funds, and to allow them to place surplus system funds, investments and loans outside the co-operative movement if they so desire. Under the proposed ownership rules, the Committee sees no reason why provincial centrals could not transform CCCS into a bank if even broader lending and investment powers are contemplated. Given such consideration, only the CCCS and its subsidiary bank would be subject to federal regulation, not the centrals or the locals. The Committee is of the opinion that this approach provides flexibility while recognizing the unique ownership characteristics of the co-operative movement and the special place of provinces in sharing jurisdiction over the financial system in Canada.

Therefore, the Committee recommends:

130. That the Canadian Co-operative Credit Society be given the same powers of diversification as those contemplated for non-bank financial institutions;

131. That NFAA be encouraged to develop ways and means to enable CCCS to establish a bank should the provincial centrals so desire.

N. Securities Dealers

The Green Paper pointed out that investment dealers have traditionally been regulated by the provinces. With a number of provincial governments already reviewing their policies in this sector and considering the possibility of altering domestic and foreign ownership limitations for securities dealers, the Green Paper proposed that the federal government not interfere with provincial policies in respect of the ownership issue. However, it was also proposed that investment in securities dealers by financial holding companies be permitted to the extent eventually permitted in the various provincial jurisdictions after their review processes have been completed.

The Committee acknowledges that the securities industry is under exclusive provincial jurisdiction and that it should remain so. As a result, the securities industry would not be involved in the powers expansion or NFAA supervisory framework proposed by the Committee. However, the Committee proposes that a position on the Board of NFAA be reserved for the securities industry in the event that provincial ownership rules allowed other financial institutions to have ownership interest in securities firms. The Committee does not see any reason why in principle, this type of ownership could not be permitted.

Therefore, the Committee recommends:

132. That a position on the Board of NFAA be reserved for the securities industry if and when provincial governments permit ownership rules allowed other financial institutions to have ownership interest in securities firms.

VIII. Federal-Provincial Relations

Money knows no boundary. It is fungible and mobile. Technology only accentuates these qualities of financial assets. Today, financial services can be delivered instantaneously within and across national boundaries. This is of vital importance to a country like Canada which possesses geographic and economic diversity and is heavily involved in international trade and capital flows. A genuine national financial market free of obstacles and barriers is therefore imperative for the flow of goods and services in the Canadian economy. Financial intermediation allows for surplus funds raised in some regions and economic sectors to be used in other locations and industries, thus contributing to an efficient allocation of financial resources for productive economic use. This means a greater pool of capital, lower interest rates and a wider variety of financial services are available to all Canadians. The real benefits of this intermediation process are ultimately reflected in the growth of employment and production in the non-financial sector of the economy. However, this efficient functioning of a national financial market requires a degree of uniformity in the regulation and supervision of financial institutions across the country. Equally important is the enforcement of and compliance with such regulations. Without these prerequisites, the cost of providing financial services would escalate and confidence in the financial system would be weakened, eventually impacting adversely upon the allocation of financial resources.

The allocation of responsibilities between federal and provincial jurisdictions for the regulation and supervision of financial institutions in Canada has given rise to a dual regulatory structure which makes the harmonization of regulations and supervisory systems more complex and politically sensitive. Competitive forces have resulted in a blurring of distinctions with respect to the boundaries of markets served by various types of financial institutions. Hence, the jurisdictional boundaries pertaining to the responsibilities for the regulation and supervision of these financial institutions have also blurred, resulting in a need to clarify the rules and regulations under which institutions must operate. All parties affected, including financial institutions, federal and provincial governments, have voiced their concern with the possible trend towards the "balkanization" of Canada's financial regulatory system.

One concern regarding this is the potential duplication of regulation and supervision which could result in increased compliance costs to firms. Another issue is the 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 system. A third concern is the potential for competitive deregulation which could distort the free flow of capital in the national context. Against the backdrop of increased internationalization of financial markets, Canada can ill afford a breakdown in this traditional jurisdictional harmonization. The consequences for the growth and international competitive ability of our financial institutions would be serious. In addition, any discord will retard the process of regulatory reform which is necessary to ensure that the Canadian financial system remains stable, competitive and efficient within the context of a global capital market.

The division of legislative and regulatory responsibility between the federal government and the provinces has until recently, changed very little since it was put into place over a century ago. Federally incorporated financial institutions, trust, life and property and casualty companies are subject both to the laws of their jurisdiction of incorporation, as well as the laws of the provinces in which they operate. Provincially incorporated financial companies wishing to operate in other provinces must obtain the permission from the latter to do so and must also comply with the laws pertaining to contracts and other matters of the jurisdictions in which they operate.

This division of legislative and regulatory responsibilities has not traditionally created problems for financial institutions wishing to operate regionally or nationally. Most financial institutions are federally incorporated, including the chartered banks and life insurance, property and casualty insurance and trust companies. Of the last three categories of companies, 91 per cent, 71 per cent, and 66 per cent of industry assets are respectively held by federally regulated companies. Securities firms, credit unions and pension funds are largely regulated by the provinces. There has been a relatively high degree of uniformity among different jurisdictions with respect to the prudential supervision of financial institutions. As a consequence, there has been little "regulatory competition" aimed at attracting financial institutions to operate under any particular jurisdiction. This harmony can be further characterized by a high degree of federal-provincial co-operation at the supervisory level, which has, by agreement, entailed federal supervision of provincially incorporated trust and insurance companies in a number of provinces. The creation of CDIC in 1967 has also increased the level of supervisory co-ordination and uniformity of regulations with respect to capital adequacy and acceptable business practices. Despite these co-operative and co-ordinating efforts however, there are still concerns about the consistent application and enforcement of these standards.

The in-depth studies and changes taking place, notably in the regulatory regimes of Ontario and Quebec, are evidence of the breakdown of the traditional approach to regulatory co-ordination and could result in important differences between the eleven political jurisdictions with respect to powers, corporate structures, corporate governance and ownership. The changes which have already taken place in Quebec under its recent insurance legislation, Bill 75, have affected the structure, powers, and the corporate governance of financial institutions in that province. Similar deregulation-oriented changes are likely to be introduced to provincial legislations and regulations governing trust companies and caisse populaires. These changes are aimed at updating the provincial regulatory structure to bring it in line with rapidly changing market conditions and thereby to attracting financial institutions to a deregulated environment in which they can compete more effectively.

In June 1984, the Ontario Government appointed a Task Force to undertake an extensive review of the organization and operation of financial institutions in Ontario. An interim report was issued in December 1984 and a final report is expected by year end 1985. Other industry specific reviews have also been undertaken over the past few years, notably with respect to the securities industry, the trust industry and credit unions. The regulatory changes recommended in these reviews could result in an Ontario regulatory "model" which would differ in important respects from those at the Quebec and federal levels in so far as ownership, powers and corporate structure are concerned.

These changes at the provincial level underline the need for increased efforts to bring about greater national regulatory harmony as there are significant and potentially troublesome differences developing in a number of important areas including: investment and lending powers; capital and leverage provisions; corporate structures – up and downstream holding companies and subsidiaries; ownership; and financial – non-financial relationships. The increased possibility of any provincially incorporated company being granted significantly broader powers by its home jurisdiction than companies incorporated in another province could give rise to important inter-provincial and federal-provincial regulatory conflicts when it seeks to operate outside of the home jurisdiction.

The Committee is of the view that a number of the Green Paper proposals, particularly those with respect to the mandatory financial holding company structure, Schedule 'C' bank, the Conflicts of Interest Office and ownership would lead to less rather than more regulatory harmony between the federal government and the provinces. As evidenced by its foregoing recommendations, the Committee has steered away from what could be perceived as confrontation with the provinces. For example, the Committee has rejected the financial holding company and Schedule 'C' Bank concepts as being too intrusive into provincial jurisdiction. The Committee recommends a flexible approach to diversification through either, or a combination of, in-house powers expansion, affiliates and subsidiaries. This approach is much more in line with both the Quebec and Ontario positions on reform. The Committee's approval of networking as a means of diversification recognizes and invites provincial involvement in this important new initiative in the financial system. The approach to ownership proposed by the Committee attempts to strike a balance between the Quebec and Ontario views on this highly controversial matter. By rejecting the Conflicts of Interest Office, the Committee has eliminated any potential for disputes arising from this proposal.

The Committee firmly believes that governments at both levels have a common interest in the promotion of stability, competition and efficiency in the Canadian financial system. Major elements common to all in the achievement of these objectives is regulation, supervision and consumer protection. The Committee considers that harmonization of these efforts is the best means of maximizing benefits to all Canadians. The proposed National Financial Administration Agency (NFAA) constitutes an ideal vehicle for accomplishing this necessary degree of harmonization. The Committee emphasizes that this new regulatory authority is a national agency, not federally controlled but a fully autonomous body involving federal, provincial and industry input into policy formation and management.

The NFAA as proposed is explicitly structured with provincial participation to facilitate discussion and implementation of financial system reform on a continuing basis. First, provincial and regional input into standards setting, supervision and enforcement within the financial system would be greatly assisted by this mechanism. Secondly, for financial industries which clearly fall under provincial jurisdiction, namely securities firms and financial co-operatives equitable provisions could be made for their participation in the reform process. Thirdly, under NFAA, more co-ordinated flows of information between jurisdictions could be achieved with consequent benefits to both national and provincial regulatory authorities. Finally, NFAA also provides for joint accountability of existing deposit insurance plans in areas of overlapping jurisdiction and the development of programs in consideration of new or additional protection systems for the insurance sector and financial co-operatives. Above all, NFAA is a focus for federal-provincial-industry consultation in the formulation of regulatory policies and the management of the supervisory and enforcement system for financial institutions. This process would not be restricted to the immediate reforms proposed by the Committee but serve as a forum for continuous dialogue on issues that affect the financial system.

The Committee also recognizes that apart from the proposed NFAA regulatory framework there are specific federal-provincial interfaces that will have to be dealt with on a consultative basis, perhaps using NFAA as the forum for such discussion.

A. Networking

While provisions can be made in federal legislation that would permit networking arrangements and ban tied-selling, provincial licensing and contract policy will play a determining role as to the extent to which national common shared distribution systems become a reality. In addition, the securities industry and financial co-operatives which are under the exclusive jurisdiction of the provinces will only be able to participate in networking to the degree allowed by provincial authorities. The Committee supports in principle that networking be allowed to all institutions, and therefore, urges the federal and provincial governments to co-ordinate and harmonize policies in this regard. As pointed out in the section of this report on networking, the Committee is concerned about the protection of clients' confidential financial information in any system of networking.

B. Securities Dealers

The Committee acknowledges that the securities industry is under exclusive provincial jurisdiction and that it should remain so. As a result, the securities industry would not be involved either under the supervisory framework or through representation on the Board of NFAA. However, the Committee proposes that a position on the Board of NFAA be reserved for the securities industry if and when provincial governments permit ownership structures for securities firms that would allow them to be cross-owned with, or controlled by other financial institutions. The Committee does not see any reason why in principle this type of ownership could not be permitted.

C. Financial Co-operatives

The Committee appreciates the concerns of the financial co-operatives regarding the relationship between their provincial stabilization funds and the deposit insurance system. The Committee agrees that the stabilization funds have functioned effectively in the past but that in the consumer's mind there is a perception problem which leads to competitive inequities between credit unions at the local level and other financial institutions that have deposit insurance coverage. Consequently, the Committee proposes that a separate fund financed by financial co-operatives be established under NFAA which would also provide supplementary coverage in addition to that provided by provincial stabilization funds. This would qualify credit union locals for certification under the national consumer protection system. The Committee suggests that consultation regarding the development and implementation of such a plan take place under the auspices of NFAA.

D. Insurance Policyholder Compensation Plans

The establishment and administration of insurance policyholders compensation plans is another area requiring consultation between the federal and provincial governments. Likewise, the Committee views NFAA as the appropriate forum under which these discussions could take place. Since provincial companies would be invited to join the plans, the determination and application of prudential regulation needs to be harmonized. Provinces could also choose to require all the insurance companies under their jurisdiction to be covered under the plans. In the same way, the determination of appropriate coverage levels would also require input from the provinces.

In conclusion, evidence presented before the Committee clearly presented a case for the jurisdictional harmonization of regulation, supervision and enforcement in the Canadian financial system to ensure stability, competition and efficiency. This would benefit all Canadians and permit Canadian financial institutions to participate actively and effectively in world financial markets. The Committee believes that it is not necessary to alter the current constitutional framework for the financial sector but that in the spirit of federal-provincial co-operation, the National Financial Administration Agency (NFAA) would be the effective vehicle for achieving these harmonized objectives. The Committee firmly urges that consultation pertaining to the development and implementation of the recommendations contained in this report be carried out under the auspices of NFAA.

Therefore, the Committee recommends:

133. That federal and provincial governments pursue discussions to harmonize legislation, regulation, supervision and enforcement of the Canadian financial system within the framework of NFAA.

governments. Consistent with the Committee's view of NFAA as the appropriate forum under which these discussions could take place. Since provincial companies would be asked to join the plans, the determination and application of prudential regulation needs to be harmonized. Provinces might also choose to require all incorporated companies under their jurisdiction to be covered under the plans. In this way the determination of appropriate coverage levels would receive input from the provinces.

In conclusion, evidence presented before the Committee clearly presented a case for the introduction of harmonization of regulation, supervision and enforcement in the Canadian financial system to ensure stability, competition and efficiency. This would benefit all Canadians and enable Canadian financial institutions to participate actively and effectively in the global marketplace. The Committee believes that it is not necessary to create a new, centralized framework for the financial sector but that, in the spirit of federal-provincial co-operation, the National Financial Administration Agency (NFAA) would be the effective vehicle for achieving these harmonized objectives. The Committee firmly urges a co-operative approach to the development and implementation of the recommendations contained in this report be carried out under the auspices of NFAA.

Therefore, the Committee recommends:

> 13. That federal and provincial governments pursue discussions to harmonize legislation, regulation, supervision and enforcement in the Canadian financial system within the framework of NFAA.

IX. Conclusion

In conclusion, the Committee hopes the results of its deliberations on the Green Paper, the *Technical Supplement* and the Wyman Report would assist and expedite the government's legislative revisions regarding deposit insurance and the trust and insurance industries. To ensure that legislations governing all sectors of the financial services industry will in the future be equitable and will reflect modern day commerce and finance, the Committee concurs with the Green Paper and recommends:

134. That all federal legislation governing financial institutions be reviewed and revised on a decennial basis.

It is also hoped that the Committee's proposal for the establishment of a National Financial Administration Agency would facilitate federal-provincial harmonization, improve the existing system of regulation and supervision and strengthen prudential standards. This package of recommendations, in the view of the Committee, would restore stability and confidence in Canada's financial system, enhance the international competitive capability of Canadian financial institutions, and improve consumer protection for all Canadians.

Therefore, the Committee implores the government to proceed rapidly with the implementation of the recommendations in this report. Failure to do so during this period of rapid evolution and instability would only add uncertainty to the financial services industry and consumers alike. The need for a comprehensive review and revision of trust and insurance legislation cannot be postponed on account of the recent failures. As it has already been expressed in the introduction to this report, the goals of deregulation and re-regulation are not mutually exclusive. The decisive moment to act is now, not to do so would be to admit irresponsibility.

X. Conclusion

In conclusion, the Committee hopes the results of its deliberations on the Green Paper, the *Technical Supplement* and the Wyman Report would assist and expedite the government's legislative revisions regarding deposit insurance and the trust and insurance industries. To ensure that legislation governing all sectors of the financial services industry will in the future be equitable and will reflect modern day commerce and finance, the Committee concurs with the Green Paper and recommends:

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Therefore, the Committee implores the government to proceed rapidly with the implementation of the recommendations in this report. Failure to do so during this period of rapid evolution and instability would only add uncertainty to the financial services industry and consumers alike. The need for a comprehensive review and revision of trust and insurance legislation cannot be overstated on account of the recent failures. As it has already been expressed in the introduction to this report, the goals of deregulation and re-regulation are not mutually exclusive. The decisive moment to act is now; not to do so would be to admit irresponsibility.

X. Appendices

APPENDIX A

List of Witnesses

The Committee wishes to express its thanks to the Honourable Barbara McDougall, Minister of State (Finance) for meeting with its Members to discuss issues relating to the Canadian financial institutions.

List of Witnesses who appeared before the Committee during its consideration issues relating to the Canadian financial institutions, showing the Issue in which their Evidence appears.

	Issue No.
APPRAISAL INSTITUTE OF CANADA	57
ASSOCIATION OF CANADIAN PENSION MANAGEMENT (ACPM)	67
ASSUMPTION MUTUAL LIFE INSURANCE COMPANY	73
ATLANTIC ALLIANCE OF INSURANCE AGENTS AND BROKERS ASSOCIATIONS	73
ATLANTIC TRUST COMPANY OF CANADA	73
BANK OF BRITISH COLUMBIA	72
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BINHAMMER, H.H.	49
BOREHAM, GORDON	48

APPENDIX B

List of Submissioners who were not Witnesses

List of Individuals and Organizations who submitted Briefs and Letters to the Committee.

ASSOCIATION OF CANADIAN FINANCIAL CORPORATIONS
BELL CANADA ENTERPRISES INCORPORATED
BERMAN, JOSEPH
CANADA TRUST COMPANY
CANADA TRUSTCO MORTGAGE COMPANY
CANADIAN JOURNAL OF LIFE INSURANCE
CANADIAN ORGANIZATION OF SMALL BUSINESS
COLHOUN, J.L.A.
COMMONWEALTH INSURANCE COMPANY
CONFEDERATION OF REGIONS PARTY OF ALBERTA
CO-OPERATIVE TRUST COMPANY OF CANADA
CREDIT UNION MEMBERS' INSURANCE SOCIETIES
FINSETH, WILLIAM D.
FRIEDLAND, SEYMOUR
FULCHER, E.E.
GENERAL TRUST OF CANADA
GIBSON, J. DOUGLAS
LE GROUPE COMMERCE COMPAGNIE D'ASSURANCE
INSTITUTE OF OBJECTIVE ECONOMICS
JARISLOWSKY, FRASER & COMPANY LIMITED
JOINT SECURITIES INDUSTRY COMMITTEE ON PENSION REFORM
LIFE INSURANCE MANAGERS ASSOCIATION OF CANADA
LIFE UNDERWRITERS ASSOCIATION OF CANADA

LINCLUDEN MANAGEMENT LIMITED
MACGREGOR, K.R.
MCLEAN, BUDDEN LIMITED
THE MERCANTILE BANK OF CANADA
METALEX INVESTMENTS LTD.
MIDLAND DOHERTY LIMITED
OPSTAD, ALBERT
POOLE, JOHN E.
PRAIRIE POOLS INCORPORATED
QUITTNER, J.
REED, D.A.
UNITED BOND & SHARE LIMITED
WAITZER, EDWARD

APPENDIX C

Federal Laws Affected by Proposed Changes

BANK ACT
CANADA BUSINESS CORPORATIONS ACT
CANADA DEPOSIT INSURANCE CORPORATION ACT
CANADIAN AND BRITISH INSURANCE COMPANIES ACT
COMBINES INVESTIGATIONS ACT
CO-OPERATIVE CREDIT ASSOCIATIONS ACT
FOREIGN INSURANCE COMPANIES ACT
LOAN COMPANIES ACT
PENSION BENEFITS STANDARDS ACT
QUEBEC SAVINGS BANKS ACT
TRUST COMPANIES ACT

APPENDIX D

Glossary

AFFILIATE COMPANY	An operating corporation owned by a parent holding company related to other operating companies through common ownership by a parent corporation but does not necessarily undertake specific activities related to the parent or other corporations in the group.
BASKET CLAUSE	A legal provision which allows non-bank financial institutions to undertake any investment or lending activity not explicitly defined up to a given percentage of total assets.
CAPITAL	The sum of shareholders' funds invested in a company that represents their proprietary interest in that company.
CEASE AND DESIST ORDER	A legal remedy used by American banking supervisors, directed at persons or institutions requiring that they cease and desist from a practice or violation or take affirmative action to correct a situation. The order ban is removed when the problem has been resolved and the institution returns to good condition. Non-compliance could result in the supervisory authority taking possession of the bank, shutting it down, selling or merging it.
CHINESE WALL	The combination of corporate policies, structures and procedures designed to prevent conflicts of interest arising from the flow of selected inside information between the operating divisions of a corporation and between affiliated and related companies.
CLOSELY-HELD OWNERSHIP	Ownership of a company by a single shareholder or limited number of shareholders who can exert control over its activities.

CONFLICTS OF INTEREST	Situations which arise in a financial institution in the performance of its intermediary role, in which it must choose between its own interests and those of clients, or between the interests of client's. Conflicts of interest do not generally threaten the solvency of a financial institution.
CROSS-OWNERSHIP	The ownership of two or more types of financial institutions by the same ownership interests, often through a holding company structure.
CURATOR	A person appointed by the Minister of Finance, under the provisions of the *Bank Act* to supervise the business and affairs of a bank in those situations where the bank suspends payments of its liabilities or the Inspector General is of the opinion that the bank will not be able to pay its liabilities as they accrue.
DEPOSIT INSURANCE	A federally operated system which provides coverage for deposits of up to $60,000 per person per institution.
DIRECTOR'S STANDARD OF CARE	The duty of care for directors to act honestly and in good faith and in the best interest of the corporation; and to exercise the care, diligence and skill that a reasonable "prudent director" would exercise in comparable circumstances. The setting of a statutory duty of care is relatively new to federal company law.
DOUBLE LEVERAGE	Investment of funds by a parent financial institution in a subsidiary financial institution which are then used as the capital base upon which a multiple expansion of assets occurs without first being deducted from the capital base of the parent institution.
DOWNSTREAM HOLDING COMPANY	A unitary corporate structure in which an operating corporation acts also as a parent corporation to one or more operating subsidiaries, including chains of operating subsidiaries.
ESTATE, TRUST AND AGENCY FUNDS	Assets of trust companies over which the institution does not have ownership. The trust deed defines the powers that the trust manager has in administering his client's assets and the client's rights to the income generated by the assets being so administered. Similarly, the institution, subject to specific agreements, may act as agent or registrar for various types of assets.
"GRANDFATHER"	To exempt an entity from compliance with a law or regulation following a change in the law or regulation.

IN-HOUSE POWERS — Lending and investment business activities which may be undertaken within the corporate structure of a single financial institution.

LEVERAGE — Broadly defined as the debt to equity ratio. For chartered banks, it is measured as the ratio of assets to equity. For trust companies, it is measured as the ratio of deposits to equity. For insurance companies, it is measured as the ratio of liabilities to equity. It is an indicator of safety and stability of an institution.

LIQUIDATION VALUE — The net value of all assets upon liquidation.

NETWORKING — Common or share distribution arrangements between affiliated and/or non-affiliated institutions.

PREFERRED STOCK — A class of share capital which entitles the shareholder to certain preferences over common shareholders, such as dividends and return of the stock's par value in a liquidation. Preferred stock does not normally have any voting rights attached to it.

PRIMARY CAPITAL — That portion of capital which is permanent and represents the shareholders' own funds. It comprises primarily of common shares, contributed surplus, retained earnings, and accumulated appropriation for contingencies.

PRUDENTIAL STANDARDS — Standards of corporate behaviour imposed by regulators to assure the stability and soundness of financial institutions and to protect the consumer of financial services against loss through fraud or mismanagement.

RECIPROCITY — The granting of equal treatment to foreign institutions as those received by domestic institutions abroad.

REGULATION — The imposition of rules, backed by sanctions for non-compliance, to change the behaviour of individuals or corporations. Re-regulation refers to changes in rules and de-regulation to the elimination or lessening of rules.

REGULATORY SUPERVISION — The process of implementation of legislation and regulations.

SECONDARY CAPITAL — That portion of capital composed of preferred shares and subordinated debentures that meet certain redemption, retraction, and term to maturity restrictions.

SEGREGATED FUNDS	Assets of life insurance companies and fraternal benefit societies which are recorded and maintained separately from other asset accounts to operate as investment funds subject to investment restrictions imposed under various insurance acts. While the assets are owned by the institutions, investors are able to participate by purchasing units at the net asset value of the fund at time of purchase and redeem them at the fund's net asset value at time of sale.
SELF-DEALING	A non-arm's-length transaction between a financial institution and its major shareholders, directors or senior officers or with other companies in which they are otherwise affiliated and between a financial institution and its subsidiaries and affiliates. Self-dealing abuses are serious and could threaten the solvency of a financial institution.
SELF-REGULATION	The responsibility for and monitoring of the conduct of companies and their compliance with laws and regulations by an industry association or by the Board of Directors and senior management of an individual company.
SOLVENCY	The financial status of a company characterized either by its ability to meet its obligation as they become due or the fact that its assets exceed its liabilities.
SUBORDINATED DEBENTURE	An unsecured bond representing a direct obligation of the issuing corporation and ranking behind all current liabilities in the case of liquidation, including deposits of a deposit-taking institution.
SUBSIDIARY COMPANY	An operating corporation owned by another operating company or a holding company often undertaking specific activities related to its parent organization.
TIED-SELLING	The practice in which an institution requires a customer, who is purchasing one financial service to purchase another or to refrain from dealing with another financial institution. Tied-selling is prohibited by federal laws.
UPSTREAM HOLDING COMPANY	A multiple entity corporate group structure in which the operating corporations are typically not subsidiaries of other operating corporations, but are related to them by affiliation through a common parent which is a passive owner of many companies.

WIDELY-HELD OWNERSHIP	Ownership characterized by a large number of shareholders where no one shareholder can exert control over the activities of the company. Traditionally, for Canadian financial institutions, widely-held ownership is synonymous with a shareholding not exceeding 10 per cent of common equity.

APPENDIX E

Mutual Life – Code of Business Conduct

This booklet brings together for the first time the general principles which govern our way of doing business and the standards of behaviour expected from all Mutual Life of Canada people.

The functions of certain departments may require the establishment of more detailed sub-codes with respect to their personnel and activities.

This Code was adopted by the Board of Directors on November 12, 1981.

Purpose

The Mutual Life Assurance Company of Canada is committed to the highest level of legal and ethical standards in the conduct of its business. In all its activities, it is essential that the Company be known as a good corporate citizen and as a company of integrity which deals fairly and equitably with its clients, employees and agents.

This Code of Business Conduct sets out the minimum standards of behaviour so that the Company may continue to earn the trust and confidence of its clients and the public at large.

Scope

This Code applies to the members of the Board of Directors and to all employees of the Company and its subsidiaries.

It is anticipated that commissioned agents will adopt the standards of this Code in their activities related to the business of the Company.

This Code does not cover all activities but it is indicative of the Company's commitment to high ethical standards and the behaviour expected in all circumstances. The Company places heavy reliance on the good judgement of its people to maintain these standards. Anyone in doubt about the relevance of this Code in a specific situation should consult with his or her superiors or the Secretary of the Company.

The provisions of this Code are mandatory and full compliance is expected under all circumstances. The Company will undertake appropriate procedures to monitor such compliance. Anyone who is aware of a contravention of this Code shall report the matter promptly to the proper authority. Violation of this Code will be cause for remedial actions which could include termination of employment.

Compliance with Laws and Regulations

The Company and all persons acting on its behalf shall comply with the laws and regulations governing its business in the jurisdictions in which it operates.

The Company's operations are subject to complex and changing laws and regulations which may result in possible inadvertent infringements. Whenever an employee is in doubt about the application or interpretation of any legal requirement, referral shall be made to his or her superior who, if necessary, shall seek the advice of the Law Department.

Privacy

In its business as an insurer, financial intermediary, investor and employer, the Company must obtain and use certain personal information.

To ensure the privacy of its clients, employees and agents, the Company will conduct its business in accordance with the following principles:

(a) The Company will collect only that personal information which is relevant to the conduct of its business, and will retain such information only as long as it remains relevant or is required by law.

(b) The main source of information about an individual will be that person. The collection of information from other sources will be subject to the consent of the person concerned or as permitted by law. On request, the Company will advise the person and these other sources of the relevance and intended use of information being collected.

(c) The Company will maintain, utilize and dispose of all personal information to protect its confidentiality in a manner commensurate with the sensitivity of the information. It will appropriately control access by its employees and agents to such information, granting access only to those with legitimate business needs.

(d) The Company will not disclose personal information to others outside the Company without the consent of the person concerned, except as permitted under statutory authority, legal process, contractual obligation, or widely accepted and ethical business practice.

(e) The Company will make available to a person on request, the information maintained in the files on that person, with due concern for the protection of the privacy of its source, and subject to any applicable legal or ethical prohibition or privilege. Personal health information will only be made available through an appropriate health professional. In the case of employees and agents, personal access to business planning information is not available.

(f) The person concerned will have the opportunity to request the Company to correct or clarify personal information. The Company will amend the person's file to the extent it agrees that the original information was incorrect, biased or irrelevant. In the case of disagreement, the person will be allowed to file his or her opinion. The Company will undertake to inform other organizations which have been provided with such information of any amendments which are made.

Conflicts of Interest

Directors and employees shall avoid all situations in which their personal interests conflict or might conflict with their duties to the Company. They shall avoid acquiring any business or financial interests or participating in any commercial activities that would tend:

(a) to deprive the Company of the time or attention required to perform their duties properly, or

(b) to create an obligation or distraction which could affect their judgement or ability to act in the Company's best interests.

In certain instances, ownership, participation or investment in a business enterprise could create conflict, or a situation where conflict could arise, between a person's own interests and his or her duty to promote the best interests of the Company.

Directors and employees are required to make timely disclosure, in writing or as may be otherwise authorized, of all business, commercial or financial interests or activities where such interests or activities might reasonably be regarded as creating an actual or potential conflict with their duties toward the Company. A director or an employee who has a conflicting or possible conflicting interest with respect to any transaction which he or she knows in under consideration by a body or committee of which he or she is a member shall make timely disclosure of such interest so that it may be taken into account in the consideration of the transaction.

Directors and employees shall not use their position in the Company or confidential information acquired in connection with the business of the Company to gain either directly or indirectly a personal benefit for themselves or others.

Those whose positions involve the authorization of expenditures, the handling of the Company's assets or access to confidential information are expected to maintain the high standards required of those in a position of trust. The law provides that if a personal benefit is gained in breach of those standards, the person must account to the Company for any such benefit.

One must do more than merely act within the law. A person must act in such a manner that his or her conduct will bear the closest scrutiny should circumstances demand that it be so examined.

Every employee of the Company who is charged with executive, managerial or supervisory responsibility is required to see that actions taken and decisions made within his or her jurisdiction are free from the influence of any interest which might reasonably be regarded as conflicting with that of the Company.

Gifts and Favours

A person or a member of his or her immediate family shall not accept gifts, valuable services or opportunities and privileges for personal gain or pleasure from anyone with whom the Company is doing or negotiating business.

Conversely, a person shall not be a party to giving gifts, valuable services or opportunities and privileges to persons with whom the Company is doing or negotiating business, or to the families of such persons.

This is not intended to prohibit normal and widely accepted business practices, such as business meals and receptions, including mementos or gifts of nominal value. However, anything which could be construed as an inducement, sensitive payment, pay-off or secret compensation is prohibited. If there is any doubt about the propriety of a particular situation, it should be avoided.

Public Affairs

The Company encourages the active involvement of its people in the political life of their community, province and nation, acting on their own behalf and not as representatives of the Company.

The Company does not participate in partisan politics and its present policy is not to make political contributions of any kind. Changes in this policy, where allowed under the laws of the relevant jurisdiction, may be made only by the Board of Directors. No person may make a political contribution purporting in any way to be a contribution by the Company, nor will the Company reimburse any person for any political contribution which he or she might make. However, senior management may utilize appropriate means to express its views, or support the views of others, on public and other issues which may affect the social, economic or regulatory environment in which the Company operates.

All dealings with public officials are to be conducted in a manner which will not compromise the integrity or impugn the reputation of any public official or the Company. As even inexpensive gifts or modest entertainment may be construed as being provided to gain influence, they may not be provided to public officials by other than a Corporate Officer or by an officer of the Company who is authorized by a Corporate Officer to do so.

Confidential Information

In today's business environment of rapid change and intense competition, the plans of the Company for new products, systems and investments, together with documents supporting them, are considered secret. Included in this category are systems, programs and processes developed internally and any other project or accomplishment which may provide a competitive advantage. This confidential information shall not be communicated to **anyone** outside the Company without authorization from the person's immediate superior.

Information gained on a confidential basis and patented or copyrighted material of others must not be used for the Company's advantage nor disclosed to third parties without permission.

Records and Reporting

All assets, liabilities and transactions of the Company are to be recorded in an accurate and timely manner. No unrecorded funds are to be maintained, and all expenses must be properly reported.

Complete, accurate and timely communications with the Board of Directors, Corporate Officers and internal and external auditors on all matters relevant to them is essential.

It is the position of the Company that full and complete reporting to regulatory bodies and the provision of information to the public, as required by law, constitute a responsible approach to the matter of public disclosure.

APPENDIX F

Royal Trust Business Conduct Review Committee

BUSINESS CONDUCT REVIEW COMMITTEE GUIDELINES FOR IDENTIFICATION OF SIGNIFICANT BUSINESS ACTIVITIES INVOLVING MATERIAL CONFLICTS OF INTEREST AND THE FUNCTIONING OF THE BUSINESS CONDUCT REVIEW COMMITTEE IN RELATION THERETO

I. Introduction

By-Law No. 2 of the Corporation provides for the establishment of a Committee of the Board of Directors to be known as the Business Conduct Review Committee (the "Committee") and charges the Committee with a number of matters relating generally to business ethics and conflicts of interest applicable to employees, directors and shareholders of the Corporation. Specifically, By-law No. 2 of the Corporation authorizes and requires the Committee to review and approve all proposed significant investments or loans or other significant business activities of the Corporation or any of its subsidiaries which do not have substantial minority interests which may involve a material conflict of interest.

Pursuant to its mandate, the Committee has prepared and approved a Code of Business Conduct, which was approved by the Board of Directors on January 31, 1985. In addition, management of the Corporation has prepared an Employee Code of Conduct and Ethics embodying the principles enunciated in the Code of Business Conduct.

The Committee hereby establishes these guidelines (the "Guidelines") to assist the management of the Corporation and of any subsidiary of the Corporation to which these Guidelines are made applicable by action of its own Board of Directors, in determining when a proposed loan, investment or business activity should be referred to the Committee as part of the corporate approval process. As contemplated by By-law No. 2 of the Corporation, once a matter has been referred to the Committee, the

Committee will make a determination as to whether or not the matter should be approved.

The Guidelines are based upon conflict of interest rules applicable to trust companies performing trustee functions, under the relevant statutory provisions of the common law. Such substantive provisions are applicable to The Royal Trust Company (which is subject to the Trust Companies Act of Quebec) and Royal Trust Corporation of Canada (which is subject to the Trust Companies Act of Canada). The Guidelines must not be interpreted as suggesting any departure by such companies from the legal requirements applicable to their trust operation. At the same time the Guidelines must not be interpreted as imposing the legal duties of a trustee upon the Corporation in relation to non-trust business activities. Non-trust matters referred to the Committee will be dealt with on the basis of the corporate and commercial legal principles applicable to the Corporation and its non-trust business activities.

The Committee intends to review the Guidelines periodically in light of experience gained in administering them and in light of developments in applicable law and practice.

The Guidelines are applicable to the operations of the Corporation and will be made applicable to the operations of the principal subsidiaries of the Corporation and their subsidiaries which do not have substantial minority interests.

II. Administration of Guidelines

The Secretary of the Corporation will develop appropriate administrative procedures to enable functional heads to assume responsibility for compliance by their units with the Guidelines. In addition, the following reporting requirements have been established.

1. *Investment Committee*

The Investment Committee of the Board of Directors is, by its terms, required to refer certain types of transactions to the Committee. Since the Investment Committee reviews major investment decisions and investment policies in relation to Own, Guaranteed and Clients Funds, the Investment Committee is expected to be an important source of referrals to that Committee.

2. *Director Disclosure*

Any disclosure of conflict of interest made by a director or officer to the Corporation (whether pursuant to applicable law or otherwise) involving matters dealt with by the Board will be reported to the Committee. In this regard it shall be the responsibility of the director or officer to ensure that any such report is made or copied to the Secretary of the Corporation who, in turn, shall be responsible for noting and forwarding any such reports to the Committee.

3. *Related Parties*

To assist management and the Committee in implementing the Guidelines a list of persons, firms and corporations having a significant relationship with the Corporation or any of its directors will be established and updated continuously, with the approval of the Committee. This list (the "Related Party List") will be established on the basis that a transaction involving the Corporation and any person, firm or corporation whose name is listed merits special attention by management to determine whether or not such transaction is required to be referred to the Committee.

4. *Auditors*

The auditors of the Corporation (internal and external) will be instructed to identify and report to the Committee on related party transactions identified in accordance with generally accepted accounting principles and auditing standards. In this respect, the auditors will be advised of the existence of the Guidelines and the Related Party List.

5. *The General Counsel*

The General Counsel will be the Secretary of the Committee and will be responsible for advising and assisting the Committee generally. In particular, the General Counsel will assist the Committee and the Secretary of the Corporation in developing appropriate reporting procedures and the Related Party List. The Committee may, at any time, engage independent outside legal counsel.

6. *Code of Business Conduct* and
Code of Conduct and Ethics

Policy matters raised by the Code of Business Conduct or the Code of Conduct and Ethics shall be reported to the Committee by the Senior Vice-President of the Corporation responsible for Human Resources. Also, the Committee may enquire of the Corporate Ombudsman with respect to policy matters dealt with by the Ombudsman and affecting matters described in the Code of Business Conduct and Code of Conduct and Ethics.

7. *Trilon Activities*

The Guidelines apply not only to proposed loans and investments, but also to business activities. The business activities which the Committee presently anticipates as most likely to require consideration from a conflict of interest point of view are those in which the Corporation and one or more other members of the Trilon Group jointly engage in a business activity. Examples would be:

1. Interchange of goods and services, including management services such as computer sharing and data processing.
2. Cross-selling or joint selling of products.
3. Fee sharing arrangements.
4. Joint marketing or other activities.
5. Transactions where no fee or charge is involved.

Although such joint business activities are expected to be to the advantage of the Corporation, if significant they should be carried on only under policy statements or other umbrella plans approved by the Committee.

III. Conflicts of Interest

Conflicts of interest may arise in connection with proposed loans or investments or in connection with proposed significant business activities. Set forth below are principles which are embodied in the statutory conflict of interest rules applicable to trust companies and which may be derived from the common law applicable to trustees. A transaction exhibiting any element of conflict of interest identified by such principles should be referred to the Committee as part of the corporate approval process where the conflict of interest is material and the transaction is significant. However, a decision to exclude a matter from review by the Committee on the grounds of materiality or significance should be taken only by senior management with the advice of the General Counsel.

1. *Statutory Conflict of Interest Rules*

The *Trust Companies Act* (Canada) prohibits a trust company subject thereto from:

(a) investing its own funds or guaranteed trust money by way of loan to

   (i) a director or officer of the trust company or a spouse or child of such director or officer, or

   (ii) an individual, his spouse or his children under the age of 21 if any of them, or all of them as a group, is a substantial shareholder of the trust company; or

(b) lending trust funds to a director or officer of the trust company or a spouse or child of such a director or officer or to a corporation more than one-half of the capital stock of which is owned by a director or officer of the trust company or a spouse or child of such director or officer; or

(c) investing (by way of loan or the purchase of equity or debt) its own or guaranteed funds in any corporation that is a substantial shareholder of the trust company or in a corporation in which;

   (i) a director or officer of the trust company or a spouse or child of such director or officer has a significant interest;

   (ii) an individual who is a substantial shareholder of the trust company has a significant interest;

   (iii) any corporation that is a substantial shareholder of the trust company has a significant interest, or

   (iv) a group consisting exclusively of a director or officer of the trust company or a spouse or child of such director or officer, has a significant interest.

A significant interest in a corporation, generally speaking, means, in the case of a person, more than 10 per cent of the outstanding shares of the corporation being owned by the person or, in the case of a group, more than fifty per cent of the outstanding shares of the corporation being owned by the group. A person or group is a substantial shareholder of a corporation if the person or group owns, directly or indirectly, equity shares of the corporation carrying more than ten per cent of the voting rights attached to all outstanding shares of the corporation.

2. *Common Law Conflicts of Interest Principles*

There is also a body of common law which enunciates principles dealing with conflicts of interest and trustees.

These principles may be generally summarized as follows:

(i) A conflict of interest exists where a trustee's own interest conflicts, or may potentially conflict, with its duty to others. For a conflict of interest to exist, it is not necessary for the trustee to have actually made a choice which favoured its own interest over its duty to others. Rather, the fact that it has placed itself in a position where it might have to make a choice between its own interest and the interests of others to whom it owes a duty is itself a conflict of interest. Where a conflict of interest exists, the transaction giving rise to the conflict is voidable even if no loss has occurred and no damages have been suffered. If, in fact, a loss has occurred or damages have been suffered, a trustee would be accountable for the loss or damages. Furthermore, if the trustee places itself in a position where its interest could conflict with its duty and earns a profit or gain for itself arising out of such position, then the trustee will have to account for the profit or gain to those to whom it owed the duty.

(ii) If a trustee engages in a transaction which may be in its own interest and which may be contrary to the interest of its clients, the beneficiaries of the trust, it does not matter that the trustee is acting in the utmost good faith. Good faith will not justify a trustee's breach of its duty.

(iii) It does not matter that the profit which accrues to a trustee in a conflict of interest situation could not have been received directly by the client. The trustee is nevertheless accountable.

(iv) A conflict of interest will arise where a trustee has dealings with a corporation in which the trustee has a "substantial interest". In determining what is a "substantial interest" regard must be had both to financial and non-financial interests of the trustee in the investee corporation.

IV. Materiality

By-law No. 2 of the Corporation requires that the Committee review only significant transactions which may involve a material conflict of interest. The qualification that a conflict of interest be material before it is required to be reviewed by the Committee has been inserted in By-law No. 2 on the basis that business efficacy may be achieved in appropriate cases, as a practical matter, without compromising ethical standards. Indeed, even in relation to trustees the courts have recognized that in appropriate cases, a conflict of interest may be so immaterial (that is to say the "interest" in conflict may be so unsubstantial) as to permit the conflict to be disregarded as a practical matter on the basis that it could not reasonably be regarded as having had any effect on the judgement of a trustee. However, this is a largely subjective judgment. Accordingly, a transaction would not be excluded from review by the Committee solely on the grounds of materiality of a conflict of interest except by a decision of senior management taken with the advice of the General Counsel.

V. Significant Transactions

By-law No. 2 requires that, in order for a transaction to be reviewed by the Committee, it must involve a material conflict of interest and must also be significant. The "significance" of a transaction must be assessed both from the point of view of the Corporation and from the point of view of the other party to the transaction. This is because, given the size of the Corporation, a transaction which may appear to be relatively insignificant from the Corporations's point of view, may take on a different appearance when viewed by reference to its importance or significance to the other parties. As well, in determining the significance of a given transaction, the Committee should examine transactions to determine that there is no segmenting or splitting of transactions which would cause them to become not "significant". For this purpose, the thresholds referred to hereafter are described as aggregate amounts.

In assessing the significance of a transaction from the Corporation's point of view, the Committee has determined that loans or investments which aggregate more than 2 per cent of the net assets of the Corporation should be considered significant. Such investments or loans would be in respect of the following functions:

Personal Financial Services/Mortgages
Corporate Services/Mortgages
Corporate and Government Loans
Guaranteed Funds/Lease Investments
Guaranteed Funds/Equity Investments
Energy Investments
Own Funds Equity Investments
Client Funds
Property Investments/Builders' Capital

In considering "significance" from the point of view of other parties to a transaction, it is recommended that secured personal loans aggregating $1 million or more, unsecured personal loans aggregating $150,000 or more and collateral mortgage loans aggregating $500,000 or more, be viewed as significant. Such loan amounts are equivalent to the signing authority of the Executive Vice-President, Personal Financial Services. With regard to corporate loans or investments, any investment which would result in the Corporation having an equity investment in excess of 10 per cent of the equity of a corporation or firm or which would see the Corporation holding in excess of 10 per cent of the debt of the corporation or firm, or which in either case does not meet the "legal for life" criteria applicable to trust companies under the *Trust Companies Act* (Canada), should be regarded as significant.

Established by the
Business Conduct Review Committee
on February 14, 1985.

APPENDIX G

Dissenting Opinion

STANDING COMMITTEE ON FINANCE, TRADE &
ECONOMIC AFFAIRS

REPORT ON

THE REGULATION OF CANADIAN FINANCIAL INSTITUTIONS:
PROPOSALS FOR DISCUSSION

DISSENTING OPINION

by

Nelson A. Riis M.P.
(Kamloops-Shuswap)

&

Simon de Jong M.P.
(Regina East)

In our opinion, the major factor creating pressures to change from segregated services to integrated services do not come as a result of demand from consumers. Rather the blurring of the roles of the 'four pillars' is increasingly being engineered by the desire of certain corporations to gain larger shares of the existing market in order to increase profits.

Consumers' Association of Canada (Ontario)
Submission to the Dupré Commission

Introduction

At no time in recent memory has the Canadian financial system come under such intense scrutiny as in the last several months. The collapse of the Canadian Commercial Bank, the Northland Bank, and several regional trust and loan companies have together shaken the confidence that Canadians have traditionally placed in the stability of their financial system.

It is against this backdrop that the Standing Committee on Finance, Trade and Economic Affairs has considered the proposals contained in the Government's Green Paper on the regulation of financial institutions. In preparing its report, the Committee consulted with a wide range of individuals and groups from both within and outside the financial community and Canadian society at large. Almost from the very outset of these hearings regarding the Green Paper proposals, serious reservations were expressed by many of these important groups. In the end, the Committee was unable to identify a consensus regarding many of the Green Paper proposals.

In its place, the Committee has developed a package comprising over 100 recommendations that imply sweeping and fundamental changes for our financial institutions and the regulatory environment in which they operate. Many of these recommendations we support. The changes that the Committee has proposed in the regulation and supervision of our financial institutions are long overdue. However, taken together, we believe that these recommendations fail to address a number of crucial areas of public concern posed by financial de-regulation. We have elaborated on these concerns in the following sections.

Ownership Proposals

Domestic

The Committee report proposes a sliding scale of domestic ownership limits for all Canadian incorporated financial institutions. We feel that this would likely bring about an even greater level of ownership concentration in the financial sector than we have at present.

We are strongly opposed to this proposal on the grounds that it would create new and uncontrollable opportunities for selfdealing and conflicts of interest. Recent experience indicates that a wide distribution of ownership is indeed required in the banking industry as an important safeguard against these abuses. As the Consumers' Association of Canada pointed out in its brief to the Committee, "the 10 per cent rule in the banking sector has protected the consumers from the consequences of some of the worst kinds of abuse." (Finance Committee Minutes, Thursday, September 19, 1985; 67A:31)

We also noted that in addition to the Consumers' Association of Canada, other notable witnesses who opposed the concept of greater scope for closely-held financial institutions include the Economic Council of Canada, the Canadian Federation of Independent Business and the Canadian Organization of Small Business.

We believe that serious consideration should be given to extending the 10 per cent ownership limit to all financial institutions.

Foreign

In conjunction with the changes to domestic ownership limits, the Committee recommends that all restrictions on foreign banking activity in Canada be removed. This would mean the elimination of the current asset ceiling of 16 per cent of total domestic assets presently imposed on the foreign owned Schedule 'B' banks.

We are strongly opposed to this recommendation for two reasons. First, experience with the Schedule 'B' banks has shown that for the most part their lending tends to be skewed towards the upper end of the commercial market with relatively little activity in the small to medium sized business sectors. This demonstrates an unwillingness on the part of the Schedule B banks to seek out business in the small business sector – a sector that is a primary source of jobs, yet is chronically undercapitalized.

Second, Canada already has the highest level of per capita foreign ownership of any industrialized country. The problems that result from that foreign control are well documented. To allow unrestricted access by "suit-case" banks to the Canadian domestic market would, in our view, exacerbate these problems and would create added problems of supervision. Indeed, we wonder whether the other Committee members opted for this proposal on its own merits or rather in order to demonstrate Canada's good faith in free trade talks with the United States.

For our part, we have found no convincing evidence that the Canadian interest would be well served by allowing foreign banks unrestricted access to our domestic market. Accordingly, we are opposed to the removal of the existing restrictions on foreign banks.

Financial Holding Company: The Threat of Concentration

The Committee's report proposes to sanction the growth of complex corporate conglomerates that would bring together both financial and non-financial elements under one potentially closely-held corporate umbrella. This is not a new phenomenon. Names such as Genstar, Trilon and Power Corporation are already well known corporate Goliaths. Between these three companies alone are assets estimated at nearly $50 billion. Indeed, it seems that not a week goes by without another report that one of these large holding companies has acquired yet another company to add to their already lengthy list of corporate holdings.

The response of the Committee to this increasing concentration of economic power has been to recommend that financial holding companies be required to conform to the domestic ownership limits set for all financial institutions. We believe that this is a totally inadequate provision with which to meet the threat that increasing corporate concentration poses to the Canadian consumer and the efficient operation of the Canadian economy.

Undue market powers, waste, inefficiency, an increased potential and an increased ability to influence public policy are but a few of the many abuses that arise out of increased concentration of economic power. It is of note that many of the witnesses who appeared before the Committee chose to single-out the potential for significant concentration of power as an issue of the utmost concern. It is imperative that any discussion of regulatory reform for the financial industry, make corporate concentration a paramount concern.

In our opinion, the Committee has not given this subject the consideration that it deserves. This was a very serious omission. We believe that economic power in Canada is already wielded by too few individuals and corporations and that the Canadian consumer pays the price in higher cost and lower quality for goods and services.

Therefore, we strongly reject this section of the report and, instead repeat our call for an extension of the 10 per cent ownership limit to all financial institutions.

Furthermore, we fully support the recommendation of the Consumers' Association of Canada that the federal government give the highest possible priority to strengthening the Combines Investigation Act before undertaking any further restructuring of the financial industry.

Networking

Networking refers to the practice of two of more financial institutions sharing a common distribution network in the provision of their respective services. The Committee proposes to allow a wide scope for such networking arrangements, confident that a regulatory prohibition against tied-selling will adequately control abuse of the professional-client and producer-purchaser relationship, with a consequent diminution of the level of competition in the financial services marketplace.

We feel that the confidence the Committee places in the ability to control tied-selling is overstated if networking is permitted. For example, is it not reasonable to argue that in times of economic recession, when business is slow, competition is such that the pressures to engage in this sort of abuse would increase? How would the subtle, yet highly effective techniques of tied-selling be detected, and how would consumers be protected from this threat to their economic freedom?

It is our opinion that this issue needs further study. It is reasonable to argue that networking creates the potential for increased efficiencies and consumer convenience. But the potential for abuse is great as was pointed out by the Canadian Federation of Independent Business in their testimony before the Committee. Examining this issue further would be a prudent decision.

Self-Dealing

The Committee report deals with the problem of self-dealing as essentially one of regulation. Financial institutions should be permitted to engage in non-arm's-length transactions, "except those that are likely to have a significant impact on the institution's solvency..." (page 73).

The Green Paper, on the other hand, proposed a ban on all such transactions for financial holding companies and companies related to them.

As did many of the witnesses that appeared before the Committee, we believe that the best protection against self-dealing is strict ownership limits for all financial institutions, no matter what their asset size.

However, ownership restrictions are not enough. There must be strict regulatory mechanisms to prohibit self-dealing and severe penalties imposed on those found guilty of such abuses.

We hesitate to advocate a comprehensive ban on all non-arm's-length transactions as we recognize that this could hinder normal operating efficiencies. Accordingly, it might be appropriate to consider a regulatory framework within which a financial holding company would require prior approval from the regulatory body before engaging in a non-arm's-length transaction.

Conflicts of Interest

The Chinese Wall

The Committee proposes that financial institutions be required to create and maintain a 'Chinese Wall' between various departments within an institution or affiliated institutions to prevent the flow of insider information between them, which might give rise to conflicts of interest.

Unfortunately, we feel that the 'Chinese Wall' has the very real potential to become a flimsy 'Bamboo Curtain' especially in an increasingly competitive market. Consequently, we believe that severe penalties must be imposed on those found guilty of conflicts of interest abuses.

Conflicts of Interest Office

The Green Paper called for the establishment of a Financial Conflicts of Interest Office to investigate consumer complaints arising out of alleged conflicts of interest.

The Committee proposes that such a Conflicts of Interest Office not be established.

We hold that an 'Ombudsman's Office' should be established as a part of the regulatory authority to deal specifically with consumer complaints about unfair treatment by financial institutions. This recognizes that consumers who are mistreated by insensitive financial institutions have, at present, no recourse to any accessible authority charged specifically with investigating consumer complaints.

Corporate Governance

Boards of Directors

As part of the changes to our financial institutions we believe that there must be important reforms to the rules governing boards of directors. Given the critical role that financial institutions play in our economy we believe that their boards of directors must more accurately reflect the community at large. Accordingly we believe that it should be made mandatory that consumer, farmer, and small business groups be represented in some minimum percentage on the boards of directors of financial institutions.

Furthermore, whereas the Committee recommends that no restrictions be imposed on the inter-locking nature of financial/non-financial directorships, we strongly believe that this is an area requiring immediate reform. Inter-locking directorships reflect the concentration of economic power in Canada and the perpetuation of an economic elite.

Therefore, we recommend that tight restrictions be imposed that would see an end to the overlapping of directorships on the boards of directors of financial institutions.

Commercial Lending

In the area of commercial lending the Committee recommends that the current 7 per cent limit on commercial lending for non-bank financial institutions be raised to 15 per cent. Should these institutions wish to go beyond this 15 per cent limit they would be required to establish a chartered bank.

Permitting non-bank financial institutions expanded commercial lending power will undoubtedly provide for an increase in the competitiveness of the commercial lending market. However, within the framework of strict ownership limits discussed earlier we see no reason why this 15 per cent limit could not be increased.

We suggest that a more appropriate limit might be 25 or 30 percent. However, an existing non-bank financial institution would be permitted to take advantage of this 10 to 15 percent increase in the commercial lending limit only if this additional lending was directed towards the small and medium-sized business sector. This would be an incentive for smaller, regionally based non-bank financial institutions to direct capital into locally-based, employment-generating small and medium sized business ventures.

We believe that this would be an important element in an overall strategy to direct capital into those regions of the country and sectors of the economy that are currently undercapitalized and as a result underdeveloped.

The Committee also recommends the elimination of the requirement for chartered banks to maintain cash reserves with the Bank of Canada. This, it is argued is necessary in order to address the concern of the chartered banks that the granting of greater commercial lending power to non-bank financial institutions, "may result in competitive inequity". (p. 96)

We believe that the requirement that cash reserves be held by the chartered banks at the Bank of Canada should be maintained. These reserves can be used in the conduct of monetary policy and they serve as an important source of liquidity should the Bank of Canada be required to support a solvent but temporarily weakened financial institution.

In order to address the issue of competitive inequity we suggest that all non-bank financial institutions be required to maintain cash reserves with the Bank of Canada in quantities proportional to their commercial lending. We see this as a more appropriate proposal to deal with this legitimate competitive concern.

Chartered Banks

The Committee proposes that the chartered banks be given the same powers of diversification as those contemplated for non-bank institutions at the next decennial review of the *Bank Act* in 1990.

We recognize that there is a legitimate argument to be made on behalf of regulatory uniformity. On the other hand, we also recognize that in comparison to the non-bank financial institutions the chartered banks are very large and very powerful. In our view there is a very real possibility that if given similar powers of diversification at such an early date the banks current market penetration could afford them significant short-run competitive advantages over non-bank financial institutions.

We believe, therefore, that a 'level playing field' should be a long term objective of regulatory reform but that a move towards such a regulatory framework now would not be advisable.

Conclusion

There is no question that the Canadian financial industry is undergoing change. The traditional separation between the four pillars is being eroded as financial institutions find new and imaginative ways in which to encroach upon heretofore forbidden territory. Our goal in presenting this dissenting opinion has not been to stand in the way of change. In a vibrant and dynamic economy change is not only inevitable but is indeed welcome. The question therefore becomes not whether change should occur but rather what changes and for whose benefit.

We believe that the Report of the Committee fails to address some of the major concerns expressed by many of the groups that appeared before us. We hope that our observations and criticisms will serve to broaden the scope of the discussion regarding the regulation of financial institutions in Canada.

> We cannot realistically discuss economic issues outside the context of how the real world operates. The reality of the business world, as with politics, is that once power is attained, the temptation to exercise that power to the full is almost irresistible. Those who possess it often are prepared to go to great lengths not to give it up.
>
> Bernard I. Ghert
> President & CEO,
> Cadillac-Fairview Corp. Ltd.

A copy of the relevant Minutes of Proceedings and Evidence of the Standing Committee on Finance, Trade and Economic Affairs (*Issues 40, 42 to 73 inclusive, and 74 which includes this report*) are tabled.

Respectfully submitted,

Don Blenkarn, M.P.
Chairman

MINUTES OF PROCEEDINGS

THURSDAY, JULY 11, 1985
(72)

The Standing Committee on Finance, Trade and Economic Affairs met *in camera* at 12:33 o'clock a.m. this day, the Chairman, Don Blenkarn, presiding.

Members of the Committee present: Bill Attewell, Don Blenkarn, Claude Lanthier, George Minaker, Nelson Riis, Norm Warner, Geof Wilson.

Alternates present: Simon de Jong, Paul McCrossan.

In attendance: From the Library of Parliament: Randall Chan, Research Officer. *From E. Wayne Clendenning Consulting 1983 Ltd.:* E. Wayne Clendenning. *From Dennis Madden & Associates:* Dennis Madden.

The Committee resumed consideration of its Order of Reference dated Thursday, April 18, 1985 in relation to the document entitled "The Regulation of Canadian Financial Institutions: Proposals for Discussion". (*See Minutes of Proceedings and Evidence, Wednesday, June 12, 1985, Issue No. 40*); its Order of Reference dated Monday, June 17, 1985, relating to the document entitled: "Final Report of the Working Committee on the Canada Deposit Insurance Corporation". (*See Minutes of Proceedings and Evidence, Thursday, June 27, 1985, Issue No. 46*); its Order of Reference dated Wednesday, June 26, 1985, relating to the document entitled "The Regulation of Financial Institutions: Proposals for Discussion", dated June 1985 (Technical Supplement) (*See Minutes of Proceedings and Evidence, Thursday, June 27, 1985, Issue No. 46*).

On motion of Geof Wilson, it was agreed,—That the Committee commend the work of the Clerks of the Committee and of the Research Staff for the organization of the Committee meetings of July 9, 10 and 11, 1985.

At 2:01 o'clock p.m., the Committee adjourned to the call of the Chair.

MONDAY, SEPTEMBER 30, 1985
(103)

The Standing Committee on Finance, Trade and Economic Affairs met *in camera* in Halifax, at 2:25 o'clock p.m., this day, the Chairman, Don Blenkarn, presiding.

Members of the Committee present: Bill Attewell, Don Blenkarn, Claude Lanthier, George Minaker, Aideen Nicholson and Geoff Wilson.

Alternates present: Simon de Jong and Nic Leblanc.

In attendance: From the Library of Parliament: Randall Chan, Research Officer. *From Dennis Madden & Associates:* Dennis Madden. *Consultant:* Brian Carter.

The Committee resumed consideration of its Order of Reference dated Thursday, April 18, 1985 in relation to the document entitled "The Regulation of Canadian Financial Institutions: Proposals for Discussion". (*See Minutes of Proceedings and Evidence, Wednesday, June 12, 1985, Issue No. 40*); its Order of Reference dated Monday, June 17, 1985, relating to the document entitled "Final Report of the Working Committee on the Canada Deposit Insurance Corporation". (*See Minutes of Proceedings and Evidence, Thursday, June 27, 1985, Issue No. 46*); its Order of Reference dated Wednesday, June 26, 1985, relating to the document entitled "The Regulation of Canadian Financial Institutions: Proposals for Discussion", dated June 1985 (Technical Supplement) (*See Minutes of Proceedings and Evidence, Thursday, June 27, 1985, Issue No. 46*).

The Committee proceeded to consider certain guidelines relating to its Draft Report to the House.

At 4:30 o'clock p.m., the Committee adjourned to the call of the Chair.

WEDNESDAY, OCTOBER 2, 1985
(104)

The Standing Committee on Finance, Trade and Economic Affairs met *in camera* in Mont-Gabriel, Québec, at 4:05 o'clock p.m. this day, the Chairman, Don Blenkarn, presiding.

Members of the Committee present: Bill Attewell, Don Blenkarn, Murray Dorin, Claude Lanthier, Paul McCrossan, George Minaker, Louis Plamondon, Nelson Riis, Norm Warner and Geoff Wilson.

Alternates present: Simon de Jong, Jim Jepson and Nic Leblanc.

In attendance: From the Library of Parliament: Randall Chan, Research Officer. *From E. Wayne Clendenning Consulting 1983 Ltd.*: E. Wayne Clendenning. *From Dennis Madden & Associates:* Dennis Madden. *Consultants:* Brian Carter; Alain Thibault, Actuary.

The Committee resumed consideration of its Order of Reference dated Thursday, April 18, 1985 in relation to the document entitled "The Regulation of Canadian Financial Institutions: Proposals for Discussion". (*See Minutes of Proceedings and Evidence, Wednesday, June 12, 1985, Issue No. 40*); its Order of Reference dated Monday, June 17, 1985, relating to the document entitled "Final Report of the Working Committee on the Canada Deposit Insurance Corporation." (*See Minutes of Proceedings and Evidence, Thursday, June 27, 1985, Issue No. 46*); its Order of Reference dated Wednesday, June 26, 1985, relating to the document entitled "The Regulation of Canadian Financial Institutions: Proposals for Discussion", dated June 1985 (Technical Supplement) (*See Minutes of Proceedings and Evidence, Thursday, June 27, 1985, Issue No. 46*).

The Committee resumed consideration of guidelines relating to the Draft Report to the House.

At 6:25 o'clock p.m., the Committee adjourned to the call of the Chair.

EVENING SESSION
(105)

The Standing Committee on Finance, Trade and Economic Affairs met *in camera* in Mont-Gabriel, Québec, at 8:25 o'clock p.m., this day, the Chairman, Don Blenkarn, presiding.

Members of the Committee present: Bill Attewell, Don Blenkarn, Murray Dorin, Claude Lanthier, Paul McCrossan, George Minaker, Louis Plamondon, Nelson Riis, Norm Warner and Geoff Wilson.

Alternates present: Simon de Jong and Nic Leblanc.

In attendance: From the Library of Parliament: Randall Chan, Research Officer. *From E. Wayne Clendenning Consulting 1983 Ltd.:* E. Wayne Clendenning. *From Dennis Madden & Associates:* Dennis Madden. *Consultants:* Brian Carter; Alain Thibault, Actuary.

The Committee resumed consideration of its Order of Reference dated Thursday, April 18, 1985 in relation to the document entitled "The Regulation of Canadian Financial Institutions: Proposals for Discussion". (*See Minutes of Proceedings and Evidence, Wednesday, June 12, 1985, Issue No. 40*); its Order of Reference dated Monday, June 17, 1985, relating to the document entitled "Final Report of the Working Committee on the Canada Deposit Insurance Corporation". (*See Minutes of Proceedings and Evidence, Thursday, June 27, 1985, Issue No. 46*); its Order of Reference dated Wednesday, June 26, 1985, relating to the document entitled "The Regulation of Canadian Financial Institutions: Proposals for Discussion", dated June 1985 (Technical Supplement) (*See Minutes of Proceedings and Evidence, Thursday, June 27, 1985, Issue No. 46*).

The Committee resumed consideration of guidelines relating to the Draft Report to the House.

At 10:20 o'clock p.m., the Committee adjourned to the call of the Chair.

THURSDAY, OCTOBER 3, 1985
(106)

The Standing Committee on Finance, Trade and Economic Affairs met *in camera* in Mont-Gabriel, Québec, at 9:07 o'clock a.m. this day, the Chairman, Don Blenkarn, presiding.

Members of the Committee present: Bill Attewell, Don Blenkarn, Murray Dorin, Claude Lanthier, Paul McCrossan, George Minaker, Louis Plamondon, Nelson Riis, Norm Warner and Geoff Wilson.

Alternates present: Simon de Jong, Jim Jepson and Nic Leblanc.

In attendance: From the Library of Parliament: Randall Chan, Research Officer. *From E. Wayne Clendenning Consulting 1983 Ltd.:* E. Wayne Clendenning. *From Dennis Madden & Associates:* Dennis Madden. *Consultants:* Brian Carter; Alain Thibault, Actuary.

The Committee resumed consideration of its Order of Reference dated Thursday, April 18, 1985 in relation to the document entitled "The Regulation of Canadian Financial Institutions: Proposals for Discussion". (*See Minutes of Proceedings and Evidence, Wednesday, June 12, 1985, Issue No. 40*); its Order of Reference dated Monday, June 17, 1985, relating to the document entitled "Final Report of the Working Committee on the Canada Deposit Insurance Corporation". (*See Minutes of Proceedings and Evidence, Thursday, June 27, 1985, Issue No. 46*); its Order of Reference dated Wednesday, June 26, 1985, relating to the document entitled "The Regulation of Canadian Financial Institutions: Proposals for Discussion", dated June 1985 (Technical Supplement) (*See Minutes of Proceedings and Evidence, Thursday, June 27, 1985, Issue No. 46*).

The Committee resumed consideration of guidelines relating to the Draft Report to the House.

At 10:58 o'clock a.m., the sitting was suspended.

At 11:05 o'clock a.m., the sitting was resumed.

The Committee resumed consideration of guidelines relating to the Draft Report to the House.

At 12:20 o'clock p.m., the Committee adjourned to the call of the Chair.

AFTERNOON SESSION
(107)

The Standing Committee on Finance, Trade and Economic Affairs met *in camera* in Mont-Gabriel, Québec, at 2:05 o'clock p.m., this day, the Chairman, Don Blenkarn, presiding.

Members of the Committee present: Don Blenkarn, Murray Dorin, Claude Lanthier, Paul McCrossan, George Minaker, Louis Plamondon, Nelson Riis, Norm Warner and Geoff Wilson.

Alternates present: Simon de Jong, Jim Jepson and Nic Leblanc.

In attendance: From the Library of Parliament: Randall Chan, Research Officer. *From E. Wayne Clendenning Consulting 1983 Ltd.:* E. Wayne Clendenning. *From Dennis Madden & Associates:* Dennis Madden. *Consultants:* Brian Carter; Alain Thibault, Actuary.

The Committee resumed consideration of its Order of Reference dated Thursday, April 18, 1985 in relation to the document entitled "The Regulation of Canadian Financial Institutions: Proposals for Discussion". (*See Minutes of Proceedings and Evidence, Wednesday, June 12, 1985, Issue No. 40*); its Order of Reference dated

Monday, June 17, 1985, relating to the document entitled "Final Report of the Working Committee on the Canada Deposit Insurance Corporation". (*See Minutes of Proceedings and Evidence, Thursday, June 27, 1985, Issue No. 46*); its Order of Reference dated Wednesday, June 26, 1985, relating to the document entitled "The Regulation of Canadian Financial Institutions: Proposals for Discussion", dated June 1985 (Technical Supplement) (*See Minutes of Proceedings and Evidence, Thursday, June 27, 1985, Issue No. 46*).

The Committee resumed consideration of guidelines relating to the Draft Report to the House.

At 3:33 o'clock p.m., the sitting was suspended.

At 3:40 o'clock p.m., the sitting was resumed.

The Committee resumed consideration of guidelines relating to the Draft Report to the House.

At 5:55 o'clock p.m., the Committee adjourned to the call of the Chair.

EVENING SITTING
(108)

The Standing Committee on Finance, Trade and Economic Affairs met *in camera* in Mont-Gabriel, Québec, at 7:40 o'clock p.m., this day, the Chairman, Don Blenkarn, presiding.

Members of the Committee present: Don Blenkarn, Murray Dorin, Claude Lanthier, Paul McCrossan, George Minaker, Louis Plamondon, Nelson Riis and Geoff Wilson.

Alternates present: Simon de Jong, Jim Jepson and Nic Leblanc.

In attendance: From the Library of Parliament: Randall Chan, Research Officer. *From E. Wayne Clendenning Consulting 1983 Ltd.:* E. Wayne Clendenning. *From Dennis Madden & Associates:* Dennis Madden. *Consultants:* Brian Carter; Alain Thibault, Actuary.

The Committee resumed consideration of its Order of Reference dated Thursday, April 18, 1985 in relation to the document entitled "The Regulation of Canadian Financial Institutions: Proposals for Discussion". (*See Minutes of Proceedings and Evidence, Wednesday, June 12, 1985, Issue No. 40*); its Order of Reference dated Monday, June 17, 1985, relating to the document entitled "Final Report of the Working Committee on the Canada Deposit Insurance Corporation". (*See Minutes of Proceedings and Evidence, Thursday, June 27, 1985, Issue No. 46*); its Order of Reference dated Wednesday, June 26, 1985, relating to the document entitled "The Regulation of Canadian Financial Institutions: Proposals for Discussion", dated June 1985 (Technical Supplement) (*See Minutes of Proceedings and Evidence, Thursday, June 27, 1985, Issue No. 46*).

The Committee resumed consideration of guidelines relating to the Draft Report to the House.

At 10:03 o'clock p.m., the Committee adjourned to the call of the Chair.

FRIDAY, OCTOBER 4, 1985
(109)

The Standing Committee on Finance, Trade and Economic Affairs met *in camera* in Mont-Gabriel, Québec, at 8:47 o'clock a.m. this day, the Chairman, Don Blenkarn, presiding.

Members of the Committee present: Don Blenkarn, Claude Lanthier, Paul McCrossan, George Minaker, Nelson Riis and Geoff Wilson.

Alternates present: Simon de Jong, Jim Jepson and Nic Leblanc.

In attendance: From the Library of Parliament: Randall Chan, Research Officer. *From E. Wayne Clendenning Consulting 1983 Ltd.:* E. Wayne Clendenning. *From Dennis Madden & Associates:* Dennis Madden. *Consultant:* Brian Carter.

The Committee resumed consideration of its Order of Reference dated Thursday, April 18, 1985 in relation to the document entitled "The Regulation of Canadian Financial Institutions: Proposals for Discussion". (*See Minutes of Proceedings and Evidence, Wednesday, June 12, 1985, Issue No. 40*); its Order of Reference dated Monday, June 17, 1985, relating to the document entitled "Final Report of the Working Committee on the Canada Deposit Insurance Corporation". (*See Minutes of Proceedings and Evidence, Thursday, June 27, 1985, Issue No. 46*); its Order of Reference dated Wednesday, June 26, 1985, relating to the document entitled "The Regulation of Canadian Financial Institutions: Proposals for Discussion", dated June 1985 (Technical Supplement) (*See Minutes of Proceedings and Evidence, Thursday, June 27, 1985, Issue No. 46*).

The Committee resumed consideration of guidelines relating to the Draft Report to the House.

At 11:08 o'clock a.m., the sitting was suspended.

At 11:20 o'clock a.m., the sitting was resumed.

The Committee resumed consideration of guidelines relating to the Draft Report to the House.

At 12:15 o'clock p.m., the Committee adjourned to the call of the Chair.

WEDNESDAY, OCTOBER 16, 1985
(110)

The Standing Committee on Finance, Trade and Economic Affairs met *in camera*, at 3:35 o'clock p.m. this day, the Chairman, Don Blenkarn, presiding.

Members of the Committee present: Don Blenkarn, Murray Dorin, Donald Johnston, Sherley Martin, Paul McCrossan, George Minaker, Aideen Nicholson, Nelson Riis, Norm Warner and Geof Wilson.

Alternates present: Raymond Garneau and Jim Jepson.

In attendance: From the Library of Parliament: Randall Chan, Research Officer. *From E. Wayne Clendenning Consulting 1983 Ltd.:* E. Wayne Clendenning. *From Dennis Madden & Associates:* Dennis Madden. *Consultants:* Brian Carter; Alain Thibault, Actuary.

The Committee resumed consideration of its Order of Reference dated Thursday, April 18, 1985 in relation to the document entitled "The Regulation of Canadian Financial Institutions: Proposals for Discussion". (*See Minutes of Proceedings and Evidence, Wednesday, June 12, 1985, Issue No. 40*); its Order of Reference dated Monday, June 17, 1985, relating to the document entitled "Final Report of the Working Committee on the Canada Deposit Insurance Corporation". (See Minutes of Proceedings and Evidence, Thursday, June 27, 1985, Issue No. 46); its Order of Reference dated Wednesday, June 26, 1985, relating to the document entitled "The Regulation of Canadian Financial Institutions: Proposals for Discussion", dated June 1985 (Technical Supplement) (*See Minutes of Proceedings and Evidence, Thursday, June 27, 1985, Issue No. 46*).

The Committee proceeded to the consideration of the Draft Report to the House.

At 6:10 o'clock p.m., the Committee adjourned to the call of the Chair.

THURSDAY, OCTOBER 17, 1985
(111)

The Standing Committee on Finance, Trade and Economic Affairs met *in camera*, at 9:35 o'clock a.m. this day, the Chairman, Don Blenkarn, presiding.

Members of the Committee present: Don Blenkarn, Murray Dorin, Donald Johnston, George Minaker, Aideen Nicholson, Norm Warner and Geoff Wilson.

In attendance: From the Library of Parliament: Randall Chan, Research Officer. *From E. Wayne Clendenning Consulting 1983 Ltd.:* E. Wayne Clendenning. *From Dennis Madden & Associates:* Dennis Madden. *Consultants:* Brian Carter; Alain Thibault, Actuary.

The Committee resumed consideration of its Order of Reference dated Thursday, April 18, 1985 in relation to the document entitled "The Regulation of Canadian Financial Institutions: Proposals for Discussion". (*See Minutes of Proceedings and Evidence, Wednesday, June 12, 1985, Issue No. 40*); its Order of Reference dated Monday, June 17, 1985, relating to the document entitled "Final Report of the Working Committee on the Canada Deposit Insurance Corporation". (*See Minutes of Proceedings and Evidence, Thursday, June 27, 1985, Issue No. 46*); its Order of Reference dated Wednesday, June 26, 1985, relating to the document entitled "The Regulation of Canadian Financial Institutions: Proposals for Discussion", dated June 1985 (Technical Supplement) (*See Minutes of Proceedings and Evidence, Thursday, June 27, 1985, Issue No. 46*).

The Committee resumed consideration of the Draft Report to the House.

At 12:35 o'clock p.m., the Committee adjourned to the call of the Chair.

AFTERNOON SESSION
(112)

The Standing Committee on Finance, Trade and Economic Affairs met *in camera* at 4:00 o'clock p.m. this day, the Chairman, Don Blenkarn, presiding.

Members of the Committee present: Don Blenkarn, Murray Dorin, Donald Johnston, George Minaker, Aideen Nicholson, Norm Warner and Geoff Wilson.

In attendance: From the Library of Parliament: Randall Chan, Research Officer. *From E. Wayne Clendenning Consulting 1983 Ltd.:* E. Wayne Clendenning. *From Dennis Madden & Associates:* Dennis Madden. *Consultants:* Brian Carter; Alain Thibault, Actuary.

The Committee resumed consideration of its Order of Reference dated Thursday, April 18, 1985 in relation to the document entitled "The Regulation of Canadian Financial Institutions: Proposals for Discussion". (*See Minutes of Proceedings and Evidence, Wednesday, June 12, 1985, Issue No. 40*); its Order of Reference dated Monday, June 17, 1985, relating to the document entitled "Final Report of the Working Committee on the Canada Deposit Insurance Corporation". (*See Minutes of Proceedings and Evidence, Thursday, June 27, 1985, Issue No. 46*); its Order of Reference dated Wednesday, June 26, 1985, relating to the document entitled "The Regulation of Canadian Financial Institutions: Proposals for Discussion", dated June 1985 (Technical Supplement) (*See Minutes of Proceedings and Evidence, Thursday, June 27, 1985, Issue No. 46*).

The Committee resumed consideration of the Draft Report to the House.

At 6:40 o'clock p.m., the Committee adjourned to the call of the Chair.

TUESDAY, OCTOBER 22, 1985
(113)

The Standing Committee on Finance, Trade and Economic Affairs met *in camera*, at 10:08 o'clock a.m. this day, the Chairman, Don Blenkarn, presiding.

Members of the Committee present: Bill Attewell, Don Blenkarn, Murray Dorin, Donald Johnston, Paul McCrossan, George Minaker, Norm Warner and Geoff Wilson.

Alternates present: Paul Gagnon and Nic Leblanc.

In attendance: From the Library of Parliament: Randall Chan, Research Officer. *From E. Wayne Clendenning Consulting 1983 Ltd.:* E. Wayne Clendenning. *From Dennis Madden & Associates:* Dennis Madden. *Consultants:* Brian Carter; Alain Thibault, Actuary.

The Committee resumed consideration of its Order of Reference dated Thursday, April 18, 1985 in relation to the document entitled "The Regulation of Canadian Financial Institutions: Proposals for Discussion". (*See Minutes of Proceedings and Evidence, Wednesday, June 12, 1985, Issue No. 40*); its Order of Reference dated Monday, June 17, 1985, relating to the document entitled "Final Report of the

Working Committee on the Canada Deposit Insurance Corporation". (*See Minutes of Proceedings and Evidence, Thursday, June 27, 1985, Issue No. 46*); its Order of Reference dated Wednesday, June 26, 1985, relating to the document entitled "The Regulation of Canadian Financial Institutions: Proposals for Discussion", dated June 1985 (Technical Supplement) (*See Minutes of Proceedings and Evidence, Thursday, June 27, 1985, Issue No. 46*).

The Committee resumed consideration of the Draft Report to the House.

At 11:58 o'clock a.m., the Committee adjourned to the call of the Chair.

EVENING SITTING
(114)

The Standing Committee on Finance, Trade and Economic Affairs met at 8:10 o'clock p.m., this day, the Chairman, Don Blenkarn, presiding.

Members of the Committee present: Bill Attewell, Don Blenkarn, Murray Dorin, Paul McCrossan, Aideen Nicholson, Nelson Riis, Norm Warner and Geoff Wilson.

Alternate present: Paul Gagnon.

In attendance: From the Library of Parliament: Randall Chan, Research Officer. *From E. Wayne Clendenning Consulting 1983 Ltd.:* E. Wayne Clendenning. *From Dennis Madden & Associates:* Dennis Madden. *Consultants:* Brian Carter; Alain Thibault, Actuary.

The Committee resumed consideration of its Order of Reference dated Thursday, April 18, 1985 in relation to the document entitled "The Regulation of Canadian Financial Institutions: Proposals for Discussion". (*See Minutes of Proceedings and Evidence, Wednesday, June 12, 1985, Issue No. 40*); its Order of Reference dated Monday, June 17, 1985, relating to the document entitled "Final Report of the Working Committee on the Canada Deposit Insurance Corporation". (*See Minutes of Proceedings and Evidence, Thursday, June 27, 1985, Issue No. 46*); its Order of Reference dated Wednesday, June 26, 1985, relating to the document entitled "The Regulation of Canadian Financial Institutions: Proposals for Discussion", dated June 1985 (Technical Supplement) (*See Minutes of Proceedings and Evidence, Thursday, June 27, 1985, Issue No. 46*).

The Committee resumed consideration of the Draft Report to the House.

At 10:10 o'clock p.m., the Committee adjourned to the call of the Chair.

WEDNESDAY, OCTOBER 23, 1985
(115)

The Standing Committee on Finance, Trade and Economic Affairs met *in camera*, at 3:42 o'clock p.m. this day, the Chairman, Don Blenkarn, presiding.

Member of the Committee present: Bill Attewell, Don Blenkarn, Murray Dorin, Donald Johnston, Paul McCrossan, George Minaker, Aideen Nicholson and Nelson Riis.

Alternate present: Raymond Garneau.

In attendance: *From the Library of Parliament:* Randall Chan, Research Officer. *From E. Wayne Clendenning Consulting 1983 Ltd.:* E. Wayne Clendenning. *From Dennis Madden & Associates:* Dennis Madden. *Consultants:* Brian Carter; Alain Thibault, Actuary.

The Committee resumed consideration of its Order of Reference dated Thursday, April 18, 1985 in relation to the document entitled "The Regulation of Canadian Financial Insitutions: Proposals for Discussion". (*See Minutes of Proceedings and Evidence, Wednesday, June 12, 1985, Issue No. 40*); its Order of Reference dated Monday, June 17, 1985, relating to the document entitled "Final Report of the Working Committee on the Canada Deposit Insurance Corporation". (*See Minutes of Proceedings and Evidence, Thursday, June 27, 1985, Issue No. 46*); its Order of Reference dated Wednesday, June 26, 1985, relating to the document entitled "The Regulation of Canadian Financial Institutions: Proposals for Discussion", dated June 1985 (Technical Supplement) (*See Minutes of Proceedings and Evidence, Thursday, June 27, 1985, Issue No. 46*).

The Committee resumed consideration of the Draft Report to the House.

At 5:50 o'clock p.m., the Committee adjourned to the call of the Chair.

EVENING SITTING
(116)

The Standing Committee on Finance, Trade and Economic Affairs met *in camera,* at 8:05 p.m. o'clock p.m., this day, the Chairman, Don Blenkarn, presiding.

Members of the Committee present: Bill Attewell, Don Blenkarn, Paul McCrossan, George Minaker, Aideen Nicholson and Nelson Riis.

Alternate present: Raymond Garneau.

In attendance: *From the Library of Parliament:* Randall Chan, Research Officer. *From E. Wayne Clendenning Consulting 1983 Ltd.:* E. Wayne Clendenning. *From Dennis Madden & Associates*: Dennis Madden. *Consultants:* Brian Carter; Alain Thibault, Actuary.

The Committee resumed consideration of its Order of Reference dated Thursday, April 18, 1985 in relation to the document entitled "The Regulation of Canadian Financial Institutions: Proposals for Discussion". (*See Minutes of Proceedings and Evidence, Wednesday,June 12, 1985, Issue No. 40*); its Order of Reference dated Monday, June 17, 1985, relating to the document entitled "Final Report of the Working Committee on the Canada Deposit Insurance Corporation". (*See Minutes of Proceedings and Evidence, Thursday, June 27, 1985, Issue No. 46*); its Order of Reference dated Wednesday, June 26, 1985, relating to the document entitled "The Regulation of Canadian Financial Institutions: Proposals for Discussion", dated June 1985 (Technical Supplement) (*See Minutes of Proceedings and Evidence, Thursday, June 27, 1985, Issue No. 46*).

The Committee resumed consideration of the Draft Report to the House.

At 9:20 o'clock p.m., the Committee adjourned to the call of the Chair.

TUESDAY, OCTOBER 29, 1985
(117)

The Standing Committee on Finance, Trade and Economic Affairs met *in camera*, at 9:55 o'clock a.m. this day, the Chairman, Don Blenkarn, presiding.

Members of the Committee present: Bill Attewell, Don Blenkarn, Steven Langdon, Paul McCrossan, George Minaker, Louis Plamondon, Nelson Riis and Geoff Wilson.

Alternates present: Jim Jepson and Robert Toupin.

In attendance: From the Library of Parliament: Randall Chan, Research Officer. *From E. Wayne Clendenning Consulting 1983 Ltd.:* E. Wayne Clendenning. *From Dennis Madden & Associates:* Dennis Madden. *Consultants:* Brian Carter; Alain Thibault, Actuary.

The Committee resumed consideration of its Order of Reference dated Thursday, April 18, 1985 in relation to the document entitled "The Regulation of Canadian Financial Institutions: Proposals for Discussion". (*See Minutes of Proceedings and Evidence, Wednesday, June 12, 1985, Issue No. 40*); its Order of Reference dated Monday, June 17, 1985, relating to the document entitled "Final Report of the Working Committee on the Canada Deposit Insurance Corporation". (*See Minutes of Proceedings and Evidence, Thursday, June 27, 1985, Issue No. 46*); its Order of Reference dated Wednesday, June 26, 1985, relating to the document entitled "The Regulation of Canadian Financial Institutions: Proposals for Discussion", dated June 1985 (Technical Supplement) (*See Minutes of Proceedings and Evidence, Thursday, June 27, 1985, Issue No. 46*).

The Committee resumed consideration of the Draft Report to the House.

It was agreed,—That the Committee authorize the printing of dissenting opinions of Simon de Jong, M.P. and Nelson Riis, M.P. in appendix to the Committee's Eleventh Report.

On motion of Paul McCrossan, it was agreed,—That the Draft Report, as amended, be concurred in.

ORDERED,—That the Chairman present to the House the Draft Report, as amended, as the Committee's Eleventh Report to the House.

At 10:45 o'clock a.m., the Committee adjourned to the call of the Chair.

Robert Vaive,
Clerk of the Committee.

[illegible] the House.

At 9:?? o'clock p.m., the Committee adjourned to the call of the Chair.

THURSDAY, OCTOBER 29, [illegible]

The Standing Committee on Finance, Trade and Economic Affairs met in camera, at [illegible] o'clock a.m. this day, the Chairman, Don Blenkarn, presiding.

Members of the Committee present: [illegible] Bob Hicks, [illegible] Langdon, [illegible] Nelson Riis and Geoff Wilson.

Also present: [illegible]

In attendance: From the Library of Parliament: [illegible] Research Officer; [illegible]

The Committee resumed consideration of its Order of Reference dated Thursday, April 16, 1987 in relation to the document entitled "The Regulation of Canadian Financial Institutions: Proposals for Discussion" (*See Minutes of Proceedings and Evidence, Wednesday, June 17, 1987, Issue No. 47*), its Order of Reference dated Monday, May 11, 1987, relating to the document entitled "Final Report of the [illegible] Committee on the Canada Deposit Insurance Corporation" (*See Minutes of Proceedings and Evidence, Thursday, June 25, 1987, Issue No. 48*) and its Order of Reference dated Wednesday, June 24, 1987, relating to the document entitled "The Regulation of Canadian Financial Institutions: Proposals for Discussion", dated June 1987 (Technical Supplement) (*See Minutes of Proceedings and Evidence, Thursday, June 25, 1987, Issue No. 48*).

The Committee resumed consideration of its draft Report to the House.

It was agreed,—That the Committee authorize the printing of dissenting opinions of [illegible] M.P., and [illegible] M.P. as appendices to the Committee's Report.

[illegible]

At [illegible] o'clock [illegible], the Committee adjourned [illegible]