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Notes: This volume is divided into two sections: (1) Lecture Consolidation and (2) McKay Report Summary

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Characterizing Financial Institutions

Introduction (McKay Background Paper)

The Financial Services sector is fundamentally different from other sectors – it is essential and critical to the commercial economy and important for economic growth in society. Canadians entrust their wealth to these institutions often with little knowledge of underlying risk and with confidence that the institutions will honor their promises. This is part of the real problem with the regulation of financial institutions. We are in the business of encouraging individuals to take these risks and, yet, we are trying to put them in a position where it would, in fact, be risky. The commitment that the risk-taker makes is over a fairly long period of time (risk increases with the length of time for which capital is not recouped).

There seems to be a difficulty with allowing for a free-for-all in financial institutions. Why regulate the financial sector? Is there an advantage to saying that we are encouraging people to make an investment with little knowledge of the underlying risk? The more common track in this field is to look at it in terms of trade offs. There is a whole range of things that will result from making choice in any one particular direction. Why would we intervene?

1. Banking – Deposit/Payment
    a. *Intermediation* – one of the reasons banks intermediate well is because deposit-taking institutions can take small amounts of money, consolidate them and develop more capital power – the ability to allocate small deposits into the economy where they would serve the economy best is greatly improved from what individual depositors might do. The aggregate of the small amounts creates large pools of money. A benefit to society in that the pools of money do a much better job of allocating capital in the economy than individuals and corporations might be able to do without financial institutions.
    b. *Payment System* - This encouragement also provides convenient and effective ways of making the payment system work – instead of doing business with cash we make it easier to do business by using financial institutions. You can pay for things by drawing on deposits with the financial institutions. The easier you make that, presumably the more you encourage economic interaction. One of the things that has been holding up e-commerce was that people felt the payment system was relatively insecure. The more complicated the payment system is, the more you inhibit the economy. On the other hand, the more confident people are that they are going to get value by accepting a chose in action, the easier you make it for people to do business.
    c. *Long-Term Savings* - Incentive for individuals to trust financial institutions over a long period of time – over certain cycles there will be times of tremendous earning and loss/dependence. Encourage rainy day savings.
    d. *Liability* – we need social policy with losses that we know will occur. We do this, in part, by making certain kinds of liability insurance. We are making people, for example, who benefit from driving pay the costs of the risks associated with driving. We do have public pay-offs.

At some stage we have to balance off the advantages with the potential costs. We have as a society a stake in encouraging self-help as the preferred way of people taking care of themselves so the welfare system can be a safety net and not a main line of support in a downed economy cycle.

Canada is probably a safer place in dealing with financial institutions than virtually any other place in the world. It leads to a lot of sneering by the proponents of freer and liberalized trade, but it means that the expectations are based on people's history – there must have been some kind of circularity to it: People

demand some kind of security and the legislation has developed a bureaucracy to meet those. However, there are advantages and disadvantages.

Advantages

A. Encouraging people to put their money into a place where it can be aggregated and turned into a larger pool;
B. Give people a sense of security in the payment system; and,
C. Incentive for individuals to trust financial institutions over a long period of time – over certain cycles there will be times of tremendous earning and loss/dependence. Encourage rainy day savings.

Four Pillars to Financial Holding Companies

Canadian Pioneer Management v. The Labour Relations Board Sask. (1980) SCC

Facts	Holding	Ratio
o Canadian Pioneer Management was a subsidiary of a larger institution, but their license was as a trust company doing business in Saskatchewan o Company did not feel they had to live up to the province's labor laws arguing that they're a bank and subject to federal labor law	o The law did not describe the trust company as under federal law – only banks are covered o *Issue*: How can one identify a bank? o It is no longer correct to say that the receipts of deposits and the payment of sums deposits is an essential part of the business of banking o The idea that banking consists of certain essential features with the main exercise of accepting deposits and making payment there from is rejected	o 'Banking' involves a set of interrelated financial activities carried out under an institution that operates under that nomenclature and operates as a bank, in essence: o If you call yourself a bank and do the kinds of things that banks seem to do and you go out of your way to identify yourself as a bank, then you are a bank

Banking – we are trying to regulate entities that hold themselves out to be banks. Anybody can be a debtor/creditor; it is up to the two parties involved. 'Cheques' – a bill of exchange drawn on a bank. The essence is to ask whether the business entity is holding itself out as a bank – which is the key for the regulators to acquire jurisdiction and control.

Gray v. Kerslake (1958) SCC

Facts	Holding	Ratio
o The customer bought an annuity from an insurance company and the nature of the annuity was that the payment was going to be paid so long as the individual was alive and if he died the beneficiary would receive payments for x number of years based on an interest formula o Customer first named his wife as a beneficiary, but under the terms of the *Ontario Insurance Act* he could change the designation	o High Court considered whether or not the former wife should get the annuity or the new woman – the court held that annuities are not like insurance (not contingent or based on a certain event), but payment on an amount of money. Therefore, the *Insurance Act* should not be applicable o Widow Appealed, CA reversed o SCC: Considered whether or not it was insurance and whether *Insurance Act* applied	o Immediately after this case the legislature passed an amendment to the *Ontario Insurance Act* declaring that annuities are and always have been a form of insurance o Normally, insurance must have an element of contingency based on a certain event

○ Subsequently, he divorced his wife and was in a relationship with another woman when he died	○ SCC decided that annuities are not insurance	

The idea of treating regulation as a branch of meta-physics and trying to get into the essential quality of what is done in order to determine whether we are going to regulate has become difficult.

Cdn Deposit Insurance Corp v. Cdn Commercial Bank (1986) Alta

April 4, 1986 In Brief

Facts	Holding	Ratio
○ CCB advanced large sums of money to various borrowers and then 'farmed-out' participants to other entities ○ CCB was in liquidation and CDIC was trying to upset the transaction to increase the amount of money available to unsecured creditors	○ Issue: the validity of various participation agreements entered into by the CCB; did the participation agreements fall within the 'business of banking'?	○ The 'business of banking' includes the utilization of participation agreements when used for the purpose of facilitating loans ○ Incidental activity, which is merely of a limited and an ancillary nature, does not offend the *Banks and Banking Law Revision Act*.

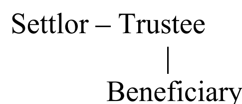
The CDIC is trying to make the case that the activity engaged in by the CCB was ultra vires the *Banks and Banking Law Revision Act* and contrary to what banks are supposed to do.

Who was CCB entering into arrangements with? Insurance companies, pension funds, developers, and the like. The core argument is that the part of the financial institution that calls itself a bank and is in the business of banking will not enter into fiduciary relations and act as a trustee. Normally, banks do not and are not allowed to act as Trustees – banks do not want to know whether the actual trustee is stealing funds, they do not want to back up the choice of the trustee. Acting as a trustee, as something that is incidental, does not put them into violation of the *Act*.

Even before parliament decided to go the route of eliminating the four pillars – the four pillars were eroding. This is the nature of real business, we will have syndicated loans where the lenders will be a number of different types of entities.

Types of Institutions

1. Deposit Taking Institutions
    a. The Banks
    b. Trusts
    c. Co-operatives
2. Fiduciary (Trustee) – where the financial institution is acting as a trustee
    a. Financial institution engaged in intermediation creates a large pool of money and turns it into a larger pool of money – initial investors are entitled to the amount of money owed to on the account. However, if you are a trustee you are making a money for the beneficiary
    b. Trust companies engage in deposit-taking and intermediation as well as acting as trustees (fee for sevices)



As between the trustee and the beneficiary, equity can protect the trustee. However, banks can act with the trustee as if it were the trustee's own money. Banks want to deal with these entities at arm's-length. A problem arises where these mechanisms are being used for something else. A trust is simply a mechanism for achieving specific goals. Traditionally, this might have involved someone setting up a fund for a particular purpose, but this does not stop it being used for other purposes today.

Pension Fund – a pension fund is a trust fund designed to take care of the elderly; the trustee is an administrator who manages the fund and pays out of it.

Mutual Funds – a version of trustee funds: it is fiduciary and their income is relatively high because they are not controlled by any trustee rules. These corporations tend to set their own management expense payments are essentially fiduciary funds. 'Segregated Funds' – mutual funds run by life insurance companies – the life insurance equivalent of mutual funds.

Non-Banks – G.E. Capital, G.M.A.C., Newcourt Credit: outfits that do not want to be banks, though they might have banking licenses. Note: GM might seem to be in the business of making cars, but a lot of their funds are produced as financial institutions. These companies finance the purchase and acquisition of products. The same thing, theoretically, could be done by a bank; the difference is that the non-banks conduct business differently:

1. They do not go directly to depositors and premium holders, but instead the people that collect them
2. A times these institutions may go to money markets

A.B.S.: with securitization you can change who owns what all over the map. What you've done, as compared to the intermediation model is change things around ever so slightly. For example, in a traditional financial services deal a bank collecting a term of accounts and lending money on the security of a home (the secured interest gotten is a mortgage). Supposedly, under this model money is made on the difference between what it costs them to borrow the money and what they charge to lend the money (the spread is how they are making their money). The new style is to say that they will charge for the services in doing things. A number of mortgages may be pooled together along with a bit of the institutions own backing to improve the investment quality of the grouping of mortgages and sell it to a number of wealthy investors. A piece of the pool of secured interest may be sold to a number of purchases who may then use it as a part of their portfolio. This means that we can make the money work a lot faster – as we accumulate these funds we can go out and turn them into more assets. Thus, it does not matter whether it is the right to repossess a car, computer, or CNC lathes, what is being done is lending the buyer money, but the financial institution is going to repackage the deal and turn the actual lenders into people who will get a piece of the action. Acting as the manager who put the deal together, as such, makes money, – an element of the trust arrangement is used to make this work. As monies come in from the purchasers, the funds are assigned as needed.

Insurance Companies – these institutions come in two flavors:

1. Life and Health
2. Property and Casualty

As financial institutions go the big money is with life insurance (these are the long term contracts involving larger sums of money). Moreover, the property and casualty money is fragmented and there are many foreign entities as part of the arrangement that it does not get taken seriously when it comes to saying that reliance will be there brought in competing with banks.

In regulating we are protecting the integrity of the market – the public interest is to do so. Take, for example, the effects of the Bre-X scandal. While devastating financially, we should not that Toronto is

supposed to be one of the more sophisticated gold trading markets in the world. The public interest is in protecting integrity and information – the perfect market is based on perfect information. On this basis, individuals are supposed to work out the best transactions for valuation.

Instead of having a system based on discrete elements raising funds in various ways and, in turn, investing differently and servicing the economy in different ways, there has been a movement in saying that capital is capital. How these pools come together and how the capital is raised might be different, but once consolidated it can be used in the same way. Thus, it hardly makes a difference characterizing how the money is raised. Moreover, if we give an entity the capacity to be increased across the board, we are increasing competition and, thereby, increasing choice for investors and consumers and returning to them better value.

Directions for the Financial Sector

The principles listed in the Blue Paper (page 20) are both timeless and classic. The nine principles listed are those that should be used as a litmus test to determine the efficacy of the sector. Giving special to any one of them will likely be at the expense of another.

Principle Two – 'To Control Self-Dealing'

One might run into a number of problems if an institution is either engaged in dangerous practices because it is not making evaluations of credit worthiness or risk against individuals or entities because they are connected to the financial institution. 'Self-Dealing', for example, may arise where two financial services (insurance companies) expand their operations into other financial services and allow the borrowing of money at discounted rates to 'close' consumers. Two important points:

1. Do not start doing business with yourself under conditions that disguise what is going on; and,
2. Do not engage in activities where you cannot be expected to make honest, clear-headed fiduciary decisions.

Principle Four – To promote competition, innovation, and efficiency

Note that if we continue to do that (innovation) we do so at the expense of strict stability. The biggest defense as to why we have a number of different credit card options and interests etcetera is to enhance the convenience and options available to the customers in the marketplace.

All of the principles are ongoing and none of it is history – it is all unfolding as we speak. Even those things that came into the books recently will be looked at and considered against these principles. The big push was to change structure and institutional powers as described in the Green Paper.

Take for instance the importance of examining the nine principles and applying them to:

1. Japan Banks – the collapse of those banks would throw the world into a panic;
2. Argentina Crisis – the IMF pins their downfall on corruption; and,
3. Canadian Dollar – Finance Minister attacking the currency traders and blaming them on the slide of the loonie claiming that the fundamentals are all good.

The Forces of Change

Things that need to be changed or forcing change are:

1. *Technology* – one of the biggest changes to the world of finance is enormous amount of computing capacity connected to the telephone and Internet. The impact is extraordinary and will

get to be even more so. Canada is one of the countries in the world where there is the most acceptance of emerging technologies. Technology is a double-edged sword as there are advantages and disadvantages. For example, security is going to be a rather large concern;
2. *Globalization* – our lack of a specific identity, but focus on diversity provides a framework where Canadian industry is at an advantageous position to understand the various international business cultures; and,
3. *Demographics* – the boomer generation invests more in GICs and RRSPs (etcetera) than they do in spending. Greenspan contends that 2010 will be a big year as there will be a huge bulge in retirement by that time. The consequences will be felt across the board of the financial services sector. The boomers are at their peak earning and saving years. The general view is that the CPP will not be able to take care of these individuals to the levels that they are accustomed. The other notable change is that the battle between financial institutions has taken on 'wealth management' for the mass affluent. The expectation is that people will live longer and, thus, in order to have enough funds will have to be put aside. What is motivating this change is competition for the wealth management of the mass affluent.

Response to Change

There is a shift away from the four pillars and a trend towards convergence of function. Segregation has been moved aside and different players are starting to have similar products based on asset management for a fee instead of trying to make money on the spread between the cost of obtaining money from savers and the revenue generated from lending. Some firms have relied on a disaggregation of function where corporations are contracting out some things that can be done better by others. Essentially, this means selling off more and more of a firm's back office and contracting the work out to a specialist.

Convergence through mergers and acquisitions, such as the Sunlife and Clarica acquisition, will become more commonplace.

Snapshot of the Financial Sector

In terms of family assets, there has been a trend away from deposits and toward managed funds over the past five and ten year periods. Deposit taking institutions and banks became worried as the money normally deposited into savings dropped from $32.5 to 25.1 billion from 1992 to 1997 while Mutual Fund investment has increased from $5.2 to 14.2 billion in the same time frame.

The two financial institutions that anchor the system are banks and insurance companies. If there is any segment of the financial services sector that is ripe for consolidation it is life insurance weighing in at 130 companies for a population of approximately 33 million (even though they do have international operations).

Distribution of Powers

The Constitutional picture is somewhat solidified. It is unlikely that there will be any real constitutional change that will affect the financial services sector. The actual legalities are not going to change because the distribution of powers as set out in the Constitution is not going to change.

Regulatory Power – the power to regulate banks is given to the federal government. Thus, if the entity calls itself a bank (Canadian Pioneer) the regulatory power rests exclusively from the federal government.

Canadian Indemnity Co et al. v. Attorney General (BC) (1976) SCC

Facts	Holding	Ratio
○ Canadian Indemnity was challenging provincial legislation alleging that it was interfering with the operation of federal companies – since they are federal incorporated, BC is ultra vires its jurisdiction in so regulating ○ The federal government backed the Insurance Co's to a ltd extent	○ Insurance companies failed ○ *Issue*: What is the de facto system of regulation? What should (the picture be) happen? ○	○

Incidentally, the US position is similar but in completely different means. Insurance is a state matter through delegation from the federal government. Insurance in the US is regulated by the states by virtue of delegation from Congress.

Citizens Insurance Co. of Canada v. Parsons (1881) App Cas

Facts	Holding	Ratio
○ Foundational case for the division of powers in the Canadian system ○ Federally incorporated company attempting to sell fire insurance in Ontario ○ Ontario was attempting to regulate the sale of the insurance ○ Citizens refused to conform to the regulations	○ This case identified the meaning of 'property and civil rights', which was enumerated to the provinces, included insurance ○ The power to regulate clearly falls within the enumerated powers of the provinces	○ The provincial legislature may legislate with respect to contract of insurance within a province ○ ○ There has not been a challenge to exclusive provincial control that has succeeded

Why do Insurance Companies get federal charters?

Ontario and Quebec as jurisdictions traditionally championed American providers. Originally, part of the reason for taking the federal government on was pressures from local businesses. The way to compete was to assert provincial jurisdiction and let in other players besides the British federally incorporated companies. The reality is those victories in the court did not necessarily mean that small provinces would have the capacity to live up to their jurisdictional pacts – having the right to regulate insurance companies is not the same thing as having the ability to do so. More than anything, however, it comes down to the utility of obtaining one corporate charter allowing a single transnational company to do business across the country.

Economic Federalism?

B.C. ←—— **Alta** ——— **Man/Sask** ——— **Ont** ——— **Que** ——→ **Mar.**

Consumer Protection – When we are dealing with solidity and consumer protection

Bill C-8 creates a new protection agency, which will underscore the fairness issue.

Citizens Insurance Co. v. Parsons – it is unfair to fool semi-literate citizens with fancy words, so the wording is drawn up for the selling company.

OSFI (Office of the Superintendent of Financial Institutions) – created to provide the soundness and reliability sought under the head of soundness and stability (provincial regulation).

There are a number of factors that may be considered before delineating the service provider (provincial or federal) for any particular function (ranging from consumer protection to harmonization):

1. Distance and accessibility to service provider by party who needs service;
2. Cost to the service provider (provincial versus federal) considering factors such as:
    a. Cost of single overhead versus regional overheads;
    b. Cost of travel;
    c. Cost of marketing and regionalism (ie bilingualism)
3. Inertia – are we better off to let the level with particular expertise to be the service providers;

When we talk about economic federalism we do not have to think of regulation as being one huge indivisible idea – there are a number of different aspects to regulation. Consumer protection, for example, may be an entirely different creature than taxation.

The history of competition has involved the assertion of provincial jurisdiction to promote efficacy. For instance, the virtual monopoly that the Federal government gave British Insurance companies in the late 1800s was broken by Ontario and Quebec pushing for their own jurisdiction and letting in American competitors.

Federal Advantages

You can experiment and innovate by adjusting design and delivery schemes for a number of variables. From an efficiency point of view, economy of scales should by and large make it easier to provide services to a market of 36 million than it would be to in a fragmentation of 10 or 11 markets of various sizes.

One of the reasons for innovation has been necessity – it was out of being abandoned that certain jurisdictions became involved in providing certain services. In other words, a free market does not mean

that the suppliers will work at providing a service to every corner of the market. Take, for instance, the airlines industries and past dealings in financial services.

Who is best able to deliver particular financial services or the principles set out in the Green Paper, the Federal or Provincial Government. Based the discussion on jurisdiction, cost, risk, inertia, etc.,

Federalism versus Regionalism – Financial Institutions

It is difficult to impose the obligation of ensuring the soundness of our financial institutions and the stability of the financial system on fragmented regional interests – efficient regulation takes federal and international power. The issues of financial stability can be as great as issues that are generating multi-national concern (a very large issue). In order to ensure successful regulation, most of the authority must be vested in the federal government.

The promotion of international competitiveness ought to be taken by the federal government. Financial institutions play a number of roles – one the one hand, we may be considering the ability of the financial institutions to operate themselves, such as requiring the requisite people power and expertise to provide an advantage; on the other hand, consider the promotion of other sectors within the Canadian economy around the world where the question becomes whether financial institutions can help the rest of the economy in being competitive (what is good for the exporters is good for the Canadian GDP all around).

Federal Securities Regulation – nobody is interested in pursuing a federal securities regulator because of Quebec's hesitance and its veto power over such a system. As such, the proposed system is for one regulator to be based out of Toronto and both the TSE and OSC are pushing the idea.

Regulators and the Regulatory Map

The Bank of Canada and Financial Stability (David Dodge)

The governor of the Bank of Canada plays an important role primarily through the role he plays in maintaining the value of the Canadian dollar and generally being responsible for the confidence that the world has in the Canadian dollar. We are moving into a world where payments made through systems other than old-fashioned negotiable instruments pervades (such as e-payment systems). The key organization for this development is the Canadian Payments Association. By and large, the CPA will establish the regulatory regime. To the extent that there is public input and public policy stating otherwise, the driving force of the CPA will be the governor of the Bank of Canada. Whenever there are conflicts it will be up to the governor of the Bank of Canada to represent the Canadian public. The role domestically is quite important.

The emerging financial institution is very different than any of those that is already established, such as the OECD or the Basle committee. Common characteristics between the groups is that all the members are rich industrial countries from Europe and North America (except for Japan).

When it comes to certain issues the legislation has to be passed in Canada, but that does not mean that we have entire freedom of choice in legislating. The choice had is either legislating or not participating in the International System. Take, for example, a subsidiary group of the OECD that imposes a number of rules on financial institutions curtailing money-laundering operations. There is no flexibility in considering whether the rules would be passed or not. There are a number of groups that wield such power – Financial Stability Forum, BIS, the Group of 20, etc.,

Canada plays a very important role in building up these such groups and organizations by providing expertise and contributing to them through opinion papers. None of these contributions, however, are going to directly affect our institutions until legislation is passed in Canada at the appropriate level, which is legislated as a result of the rules that these groups suggest. The process would appear to be somewhat circuitous, but the point is this:
International Groups submit policy to member countries requiring the curtailment or encouragement of particular business operations and financial regulations. Canada, as a member, has little flexibility in legislating because there are certain requirements and characteristics that must exist. However, Canada in providing expertise and opinion in formulating the Group's policy and principles ends up legislating a system it helped in a very important way to create. This should illustrate a difference in pressures from US muscle compared to International muscle.

Three Key Issues the governor of the Bank of Canada is working on:

1. Exchange Rate Regimes – spoken in terms of basis points;
2. Financial System Infrastructure – The new financial architecture is a large issue in the New Economy; and,
3. Private Sector Involvement in Crisis Resolution – how much money can be borrowed from the private sector? How much of a hit can the private sector pick up?

The position of regulators is a desire for independence because we do not want people to make political hay out of the money supply system – confidence in the Canadian dollar will not be gotten if the world sees the regulatory regime as mere puppets of the Canadian political system.

In this area, when dealing with the regulation of financial institutions dull and boring is very good – nobody really wants surprises. The ambition is an attempt to cut down on crises.

BIS – Bank of International Settlements

http://www.bis.org

The BIS started off as being a private bank that handled settlements around the world. Essentially, BIS served the purpose of settling accounts between banks domestically and internationally. When these crises occurred, which started off with a very large German bank in 1920, an advisory committee was struck up to determine how to deter these things from happening. The reason the financial infrastructure is so important is because of the problem of *Contagion* – the domino effect, as each of these institutions will be doing business with others. Whenever a very large entity folds, it is inevitably going to effect other parties. For example, all those parties that are on the other side of contracts, counter-parties to various derivatives, etc., If the other bank declares bankruptcy, any contracting party may have to take a hit – for example, having lent the institution money, being invested in the bank, etc., Contagion – an impact of one major collapse is what everybody is terrified of. This is how the BIS has been growing in influence. BIS is not almost an international financial university that does a lot of research into the financial system, and it is also a type of United Nations for following strategies of minimizing problems in the future.

IOSCO – Securities Regulators
IAIS – Insurance
BIS – Banking Settlements

These bodies come together in determining what the best rules are for treading new ground even though they are responsible for different financial services on the premise that some rules should be universal:

1. If that is the best idea that should be used after having put their heads together this is an argument for such harmonization; and,

2. Such determination processes end the whining about the need for a 'level playing field'
    a. For example, the imposition of tougher rules on Banks in the US than Insurance Companies in Europe would be unfair

International Monetary Fund (IMF)

The IMF is the bank of last resort for the banks of last resort. In Canada, where banks are having particular liquidity problems, the Bank of Canada is supposed to enter until such problems are sorted out. Failing those attempts, the IMF enters to help sort out such problems. Governments, too, may fall to rely on the IMF for liquidity relief as a safeguard against bankruptcy. For example, the government of Argentina is currently negotiating with the IMF.

The IMF, however, has created a vague moral hazard in various jurisdictions. The problem with financial bailouts is that the IMF may create 'moral hazard' – this creates the possibility that governments may free ride and take advantage of the IMF reinforcing a mentality that suggests that people will act in an immoral way if the risks associated with such action are reduced. Officials involved might not exercise the requisite prudence to avoid risk because of a reliance on the bailout by the IMF.

On the one hand, the entire world needs (to some extent) those things that the IMF claims that it can and will do. For example, trade needs help for Argentina to prevent downward spirals – contain the problem and mitigate damage. On the other hand, if safeguards are not exerted the IMF may become a form of dependency. For example, officials may steal and commit fraud leaving a jurisdiction with a severe liquidity issue and leave.

The purpose of the IMF is set out in Article One of the *Articles of Agreement of the International Monetary Fund*. These articles may impact on our local rules. For example, the IMF through its own policies has impacted the banking system by placing obligations on the Canadian legislature to impose extra-regulation on the banks through prudential regulation.

Most individuals in financial development who are advocates of the poor in countries that the IMF wields strong power jeer at the idea that the IMF exists to facilitate the expansion and balanced growth of international trade.

Article I(v) is very important: To give confidence to members by making the general resources of the Fund temporarily available to them under adequate safeguards, thus providing them with opportunity to correct maladjustments in their balance of payments without resorting to measures destructive of national or international prosperity.

The safeguards that are extracted tend to be very damage – they cost a lot to the economy in which it is being enforced. Those that pay the price will be public workers, those on government assistance, homeowners, etc.

Canada has a unique relationship with the IMF and the World Bank. The US is the controlling government – the very existence of the IMF is due to the US's position at the end of WWII – transforming itself into the most robust economy on the planet. Since voting and control is based on the contributions to the fund and the biggest contributor is the US, the US tends to control the decision-making. By convention, the head of the bank is generally a European, but this means little in terms of real power.

Canada can play a role because it can take a slight distance from the US in terms of various demands on how member states act in order to qualify for IMF funding. Moreover, Canada can help in the consultative and educational processes that the bank promotes.

Operation and Resilience of Financial Systems

In creating the 'new financial architecture' each task is co-operative and consultative. Canada is very much involved in each step of that process – the discussions and carrying forward the ideas. In order for these principles to become operative within Canada it has to be passed as legislation and, for the most part, it has.

The US is getting attacked from both the liberals and conservatives in the US. Both groups assert that the IMF and World Bank are the problem and not the solution – those organizations must be fixed. The liberal argument is that the poor is paying the price and countries are actually being underdeveloped. For example, the solution to developing a strong state in the US would not be to release 10% of the educators and public workers – why, then, has this been the approach in foreign countries?

Task Force – Chapter 9

Canada's role internationally is reviewed briefly. Canada has been an active proponent of measures to implement best practices in all countries. Canada does not necessarily initiate the moves – but Canada is a good country to deliver some of these initiatives.

Financial Services Commission of Ontario Act, 1997

The pace of change has been quite rapid. In 1997, the FSCO brought together a number of financial institutions – excluding the Ontario Securities Commission, which the finance minister in the 2000 budget called for an inclusion. Convergence of regulators appears to be all the rage these days to form one super-regulatory agency – this is happening in other jurisdictions in Canada. Within this regulatory body, we may have departments looking at different aspects, but they are all being brought together. The current head of the OSC is the former managing partner of Davies, Ward & Beck.

Payment Systems

Standing Committee on Finance (March 1, 2001)

Bill C-8 will establish a new regulatory framework for Canada's private payment systems – this has caused a problem. We now have a new Canada Payments Act having passed and received Royal Assent and will come into effect imminently. The problem (or hold up) was Bill C-8 and the regulations under the Bill. Bill C-8 needs a set of subsidiary legislation and that is working its way through the system. The reason that regulatory changes are being made is because there was a problem.

An effective e-payment system is precisely the type of thing that might replace what we know as 'cash'. All of the new systems (Interac, VISA, etc.,) are private systems – this is where the problem arose. The heart of the problem with Interac is that it is somewhat monopolistic in nature. There was an actual finding that it was unduly interfering with fair competition and so the director of investigations and research for the competition tribunal did accept the fact that they were anti-competitive and violated the Competitions Act, but they were able to get away with a 'consent order'. The parties that were not happy with Interac's pleadings were allowed to argue their case before the board, but they were unsuccessful. The Retail Council of Canada has a rather large stake in the issue and opposed the 'consent order' issued to Interac. The objectors were quite vocal about their opposition and what has happened is that the new legislation takes into account that objection. The 'consent order' will end in 2002.

The rate at which people are switching over is very rapid and growing.

Co-operatives, because they can group themselves into federations, will eventually become part of the association without needing to go through a bank.

Canada Payments would do business with each of these entities and would do business with the bank for international settlements in terms of 5(1)(b). Review the Objects and the Duties of the Association in *Canada Payments Act* section 5.

19(2) is very important by giving the Minister a great number of powers including disallowance – disallowing decisions of the board. This is going to be a fairly complex organism. It is not a Crown agency and, yet, it is not going to be allowed to be a private legislator without any accountability or supervision. There are a number of ways in which the government can be involved as either the guardian of the public interest or through the Ontario Savings Bank.

Stakeholder Advisory Councils – there now has to be stakeholder advisory councils so that the input into this kind of governing of the new money has to take into account broader range of views than Interac's interpretation of the public. A way of forcing the issue to get broader in put into the running of this organization is through such councils.

Canadian Payments Act

Stakeholder & Advisory Council

21.2 (1) – This change to the CPA provided that the stakeholder & advisory council has a statutory role within the Act. The bureaucracy of the association, which has to operate under the old legislation until the new one comes into effect, has already proposed changes in their by-laws to take into account this new provision.

The association, in considering the maximum of 20 members, has proposed that 12 members be representatives of consumers.

The retail sector objected to the CPA's 'consent order' under the auspice that it did not give them fair access. In noting where cash moves in this society, one must necessarily examine the retail sector. The governmental use of the payment system, as well, ties into a number of issues. For example, social assistance funds may be delivered electronically as opposed to actual paper cheque. In considering the sheer volume of cheques that must be processed, it might be more efficient to move them into electronic form. Many companies engage in a very active use of their accounts. These individuals, as well, feature a fairly significant segment of the association who may not be members directly, but are large users indirectly and, as such, should have some level of input.

Designation

The designation of a payment system is very significant. What makes currency valuable?

1. Creation of Legal Tender – For example, if A owes B $1,000, B must accept 10 $100 notes. Designating money, then, is done in order to give legal status to the form of payment; and,
2. The Negotiable Instrument – There are legal provisions requiring the acceptance of particular instruments in both statute and at common law.

The backdrop to this legislation was a finding in 1995 by the director of investigation for the competition board that the old Canadian Payments Association was, in fact, using its market strength to keep out competitors and unduly using its control of the Interac system to lessen competition.

37(2) – The following factors shall be considered in a determination of whether it is in the public interest to designate a payment system:

(a) The level of financial safety provided by the payment system to the participants and users;
(b) The efficiency and competitiveness of payment systems in Canada; and,
(c) The best interests of the financial system in Canada.

PKI – Personal Key Identification (Electronic Signatures)

Security has become a major obsession in the world. There are a number of different problems apart from hackers etc., Part of the problem is that when everything is electronic one might not have any sense of who is who. In other words, who is talking to whom? In order to have a payment system that is going to be the equivalent of money, we must come up with ways of being reasonably sure that the system is secure with creating stringent barriers to access. It ought to be recognized that the system is never going to be 100% fail-safe. We already have electronic title searching and the electronic transfer of documents. The Minister will determine the designation and the other aspects of security.

KYC – Know Your Client

Financial institutions may get into trouble just for doing business – they were not sure whom they were dealing with and did business nonetheless. This gets more complicated when you get into electronic transactions.

Canadian Payments Association – the banks used to make a big fuss complaining that they did not know whom their competitors were, other banks or Microsoft. For example, Bell could very well roll out a national payments system.

Consider section **37(3)**: Before a payment system is designated, the Minister shall consult the manager and the participants of the payment system and may consult interested parties, with respect to the effect of the designation.

Before attempting to implement some payment system an entity should ensure, firstly, that it is legal and that the CPA would give legal status to the types of payments.

In considering the importance of having public input into the rules, the Minister is giving the authority to void any rules issued and issue guidelines and written directives

Director of Investigation & Research v. Bank of Montreal CT 95/02

Facts	Holding	Ratio
o Director found that there was an undue abuse of power o Association came up with a consent-order to be taken to the tribunal for approval o The interveners opposed the consent-order	o The argument was that the suggestion that deposit taking institutions should open up deposit accounts entrusted to them is fundamentally untenable	o

This issue is still ongoing because PKI still has to be unveiled and rolled out. A number of the PKI systems are currently private – based on deals between the various parties so that the lawyers, for instance, can get together and say through the Law Society that a particular system will be accepted and then contract with an outfit like 'Verisign'. Verisign provides a security system for electronic transactions. Out of this we will get a national system being rolled out. The system will certainly have its share of frauds and criminals, however, the ambition will be to make sure that it is relatively safe.

Things One Needs to Know

1. Who you are dealing with – purpose of PKI is to KYC!
2. Who picks up the tab for things that go wrong – need to have some sense of *solidity* (who the key players are in order to make sure that you do not have 'systemic risk'). You cannot afford for the system to fail – mere frauds and criminals does not amount to a system failure. However, given the nature of this kind of payment system we have to have safeguards protecting the risks associated with the system;
3. Identify Liability – who will be responsible and for what kinds of break-downs?

The collapse of a big player may put the system at risk, for example.

Frankel – an individual to be extradited from Germany who set up a phony insurance company. Can any system really guarantee total security? Especially where there is successful collusion between people who appear to have no apparent connection. If you can get a number of people to collude, you can build any system however fraudulent it might be.

Written Directives will, in the course of time, fill out a number of these issues. The big difference between what is happening here as opposed to a private oligopoly rolling out the system is that we are in a strange realm of quasi-legislation. The directives are not quite law and yet the rules will be made public, but it will not have the same path of legislation by going through parliament and the like. Here, the role

of the Minister will be essentially to protect the public interest – presumably questions may be asked in the usual parliamentary vehicle without having to go through the formality of passing legislation.

GAAP – Generally Accepted Accounting Practices

There are GAAP, which may be both Canadian and American. At one point, it looked as thought he entire world would be forced to adopt American practices. This is not going to happen with the same degree of bombastic after these latest scandals and financial events. If there is no trust in the system, then you have lost the basis for a system based on your values. Numbers are, supposedly, how one establishes trust. The idea of GAAP is that the numbers means the same thing to one person. If numbers, when they appear, do not mean anything then conceptually we run into trouble.

All of these debates go on nationally and internationally. We cannot protect Canadians or anybody else for that matter against themselves. We can only come up with rules that are legitimate. Provided that a simple set of ruels are stable and provide the same meaning every time. If one understands the difference in the vocabulary, then it can be adapted to – however, we cannot deal with no rules.

Confidentiality is fairly obvious – we are dealing with proprietary and personal information that may be fairly important. A derogation allows for Ministers to exchange with each other through parts of the government.

Prudential Regulation

Enron and the banks is a good connection between current events and prudential regulation. Prudential regulation aims at ensuring that financial institutions remain solvent. In other words, regulation is an attempt to ensure that financial institutions enjoy solidity so that they may undertake to honour their obligations.

The common thread of regulation is that these institutions are dependent on the trust and confidence of consumers. Without the trust and confidence of consumers it is inevitable that there will be a collapse of one or more of these institutions with very visible consequences (Enron). The other possibility is that the system itself may be broken (Argentina).

Why is it a public problem if there is a failure within an institution? What are those people in the business of regulating prudential factors aiming at? There are two obvious answers:

1. Safeguarding consumers against the risk of institutional failure; and,
2. Protecting the financial system from breakdown that can result from a general loss of confidence if one or more significant institutions fail.

The question is whether anybody can do this. This is the general problem with Enron and another instance in 1998. The first standard argument is that given the nature of financial institutions, individuals who accumulate fairly small amounts of money are not going to be able to do the due diligence themselves to discover if they are dealing with an entity that is going to be around to pay them. The necessity to help individuals to find a 'safe' place to invest their savings is one large reason. Secondly, to curtail any possible systemic risk and encourage long-term capital managemenet.

Note: One of the reasons the US dollar is doing so well against any dollar around the world is because it is considered 'safe'. Money in US dollars is safer, in terms of fluctuations and value, than any other place in the world. However, when it comes to the regulation of financial institutions, Canada has the edge internationally. In spite of this, there is still a way that the US gives a greater sense of confidence in their dollar than the Canadian dollar.

'Enronitis' – people are generally afraid across the board of what is happening to investments because of the types of things that have come to light with respect to the company.

Enron is two crises in one each containing very important issues:

1. Problem of prudential regulation – it connects with a number of institutions in Canada and around the world; and,
2. There are issues of integrity – the question of integrity applies to any number of institutions. When you suffer from contact with unsavoury events it can lead to a fairly rapid unraveling of reputation, which may in turn lead to a collapse of the institution:
    a. Reputation Risk
    b. Market Behaviour
    c. Integrity
3. Too Big to Fail (US Application)
4. Contagion – the impact of hedge funds on other players

Long Term Capital Management

This was a situation that came to its worst possibilities almost involving a global meltdown. Long Term Capital Management was a hedge fund where big name financial institutions purchased partnerships in

the entity (principals were the brightest and best known NY finance names and two Nobel prize winners) and make money by investing on the analysis that they made of where the various markets were going and the extent to which these markets were either overpriced or under priced. Thus, transacting huge volumes of business and making very small amounts on the transaction per transaction resulted in a large net profit yield in the first couple of years (In the range of a 40% return). In 1997, the partnership ran into some problems. Because they had been doing so well their position started to grow and they were taking on bigger and bigger positions. One of the large events that may have thrown things off were:

a) Asian Crisis – there was a collapse in the economies of East Asia, which led to a serious drop in the value of investments and the currency in those countries;
b) Russia was forced to default on its International Debt

The consequences for long-term capital management were massive – the partnership started to run up huge losses. The partnership attempted to raise more capital to invest their way out of the problem, but it was not forthcoming. As a result, the US Federal Reserve System got involved and arranged a bail our that involved both the private sector and the US government.

We live in a world where there may in fact be situations where an entity can be engaged in doing things that are perfectly legal (not Enron, but this entity partnership), without problems dealing with integrity or stupidity, but rather with hubris, may become too big to fit and feel they cannot fail.

Hubris – you cannot get to a discussion of financial institution regulation without hearing about this expression.

The issue became so huge that because of the impact on confidence in markets and currencies around the world was so huge, the agencies of the US government ensured some kind of restructure. The point of this is that at this level the US is, perhaps, better positioned than any other regulatory system in the world. The US can work out a seriously bad deal better than anyone else – because of the size of their economy. They can cushion and gradually bring the system back into equilibrium because they are the world's largest economy. There is a connection between the government and its own solvency and financial institutions within that country and the credit worthiness of the country as a whole.

The debt owed to and by countries is referred to sovereign debt. A countries credit effects the major players within that countries economy and vice versa. As such, the credit worthiness of financial institutions affects the countries ratings. This is because the rating agencies will assume that if they have a big problem with their financial institutions, the government will have to end up picking up some of the tab – numerous costs must be met in order to unravel the problem. At this level of interrelationship, one can see why something like long-term capital management could lead to a public sector government attempt to iron out the problems in the private sector.

The irony exists where the award is given to the high-risk takers, but the really big high risk takers are under the protective umbrella of the government.

This correlation means that for all that people might speak normally about the benefits of having risk friendly system that you allow investors and the financial institutions and others to innovate and make use of the market efficiently, at some level what you are doing is not taking risks for yourself, but because of your size you are taking risk for anyone else as well. Risks for people that did not share in the good times – for example, cheques were not made out to the citizens of the United States. When times are bad the institutions asks for some sort of bail out by alerting the government of particular problems. These are additional reasons for regulatory concern.

Are demographics going to change the emphasis on regulation? Consider Enron as a case study. The government is trying to encourage savings and investment, particularly in the areas of retirement and education. Even entities that were in the business of thinking about risk were not particularly prepared for thinking of that type of risk.

The list of factors is heavily weighted in favour of saying that prudence is a good thing. The counter-argument is in saying that it has a price. However, everything that has a price also has a value. Thus, it is not just jobs for civil servants, but regulation is fairly critical to the economy as a whole.

BASLE I

We are currently waiting for BASLE II, which is some ways away. There have been financial institution failures in Canada:

1. Confederation Life (1994) – a life insurance company that went under because they established a trust affiliate that got itself in big trouble;
2. Principal Trust Co
3. Canadian Commercial Bank

What used to happen was that when one particular life insurance company starts to get shaky, the other insurers take things over. With Confederation Life, nobody was prepared to buy them out and they subsequently went into bankruptcy. The 'Too Big to Fail' mentality failed.

There was a concern not too long ago that those making money recently have not been around long enough to have a sense of what it is like to cope with a world in which things are shrinking. The sense of shrinking is important in the circumstances with these new players. They should understand that hubris is a fact of life in financial markets. Having a sense of why things have gone wrong and why they have gone wrong is significant.

The Canadian system is one of the ebst in the world and is better than the US:

1. Has fewer failures;
2. Proportionately cheaper than the US system

There are two different groups to consider: Investor and consumer. BASLE I essentially said that the investor should bear the brunt of the failure – these are the individuals who stood to gain the most. We cannot afford to let the investors off the hook too much. Otherwise, it would create a moral hazard. In order to minimize moral hazard, the investor must be sacrificed.

The 1980s had it's own share of corporate bubbles. To be specific about Canada, the most prominent were in Ontario with commercial real estate around the Golden Horseshoe, and in Alberta the problem related to oil. The way the bubble happens making its impact on financial services is predictable. In 1974, OPEC created a cartel that was going to control the amount of oil that they would export (Organization of Petroleum Exporting Countries, consisting of mostly Middle-Eastern countries – not all oil exporting countries joined). By controlling supply, OPEC managed to hike the price of oil considerably. When prices are high, this creates the incentive to invest in the discovery of oil. General economic principle: raising the price of a particular commodity results in an expanded push for discovery, an expanded means of retention, and a focus on alternatives.

As a result of the formation of OPEC, a great deal of money began to move into Alberta and the province experienced a boom. Since the banks were essentially controlled in the East, it resulted in the establishment of a number of Western banks.

These companies have a fairly brief existence and by the 1980s they had collapsed. As a result of this collapse, Estey J was commissioned to do an inquiry out of which came certain suggestions for redirecting financial institution regulation in Canada. Meanwhile, there was a lot of money floating around in commercial real estate in Ontario. Part of it might well have come from investors sitting on very liquid pools of 'Petro-dollars'. Note: OPEC countries are generally sparsely, thus the capacity to absorb large revenues is weak and the investor's smartly moved the money around.

Developers were finding it profitable to engage in office construction and multiple unit dwelling construction. It seemed like a good idea at the time. However, if everybody gets into it and you keep piling on, the commodities are pushed. Once investors start leaving the commodity, though, the value collapses. A lot of Trust companies got into trouble and had to be bailed out by CDIC.

The biggest casualty was Confederation Life – a very stayed Life Insurance Company that had had an existence of 127 years. Confederation Life had thousands of individual customers and millions of group insured. In 1986, as a result of the Tory white paper on changing financial industry in Canada, the four pillars began to erode and cross-ownership became possible. Confederation Life Trust was established, which lent money to developers. By the 1990s, the development market had started to crumble.

The Estey Report

Came out with the conclusion that the old ways of dealing with crisis may, in fact, create certain expectations in the public. If it seems that dealing with the problems is to try to shove them around to someone else, it creates an expectation that all kinds of investors would be compensated. Thus, this led to a sense that things should be looked at a little differently. With Confederation Life, starting in 1990, the then superintendent of insurance, Michael MacKenzie,

Considerations for Prudential Regulations

Old Ways

- **Core Capital**

The more core capital there is, the more secure one is that the institution will be around. Ask whether the principles espoused are being met: does setting high barriers to new institutions promote those principles?

- **Control Risk by Directing Use of Funds**

Financial prudence can be achieved by telling institutions what types of investment they can enter into

Recent

- **Basel I**

Tier One – Performance, No fixed earnings, earnings must be subordinate to depositor's rights
Tier Two – Invested for longer term than 5 years. Can only be removed if OSFI says so, cannot trigger bankruptcy
Risk Weighted Assets – those things acquire in the course of using other people's money. The assets might be the security interest had in protecting a loan – the proprietary interests acquired through lending other people's money

Basel II

- **Tier I plus Tier II**

How do you achieve some kind of balance? By coming up with some ration of capital to assets that cannot exceed 8% - Institutions cannot go around lending more than a certain percentage of their own money

- **Assets**

Starting to get prescribed weightings – prescribed by regulation (standards established prior to 1988).

We are not going to get into investment banking or securities regulation etc., Our concern is with the fact that on the one hand we recognize that we need greater flexibility than just creating a payments scheme – the more you demand in terms of dull and boring up front cash, the less efficient the use of the money and it will create high barriers to entry and reduce competition

Through legislation we are improving governance. Thus, the point is "don't tell us the way Estey said it was the regulator's job to protect the shareholder, it is the job of the shareholder to ensure the Board will protect you!"

We are talking about globalization and global entities that may have existed before our own Confederation.

Anticipating BASLE II

Canada is moving into a philosophical direction of Basle II. The approach taken in Canada is an approach that applies to all financial institutions. The reason these types of provisions are standardized for each financial institution is not to help financial institutions manage themselves – they are there to help the organizations be able to ask what the rules are. These provisions exist to help avoid the ability to 'pass the buck'. Keep these provisions in mind when we start talking about the system that will eventually come in as Basle II.

We moved away from the traditional four pillars and our financial services sector now reflects a division of three pillars (entirely different approach).

Basle I ⟶ **Basle II**

Three Pillars

1. ***IRB plus Core Capital*** – one of the problems is *herding*. When things are going well, acceleration occurs by raising the value as everybody within the herd is heading in the same direction. As such, you create your own volatility and potential for crisis. How do we, then, ensure that there are enough people there to put their money at risk to ensure that the system that we are trying to protect is adequately safeguarded? Response: Financial institutions may come up with their own risk weighting. The key players will be the numbers people – those who do stress testing and risk assessment: this is why we have seen a proliferation of credit institutions that are going after the high-risk market. OSFI – the institution says that this is our individual risk to say whether or not our core capital is enough, the OSFI expert on risk analysis will take a look at it and conclude that the scheme is either too clever (will not buy it) or just fine (borne out by the numbers, risk is not minimized with a juggling of figures). Although stress testing is primarily a numbers game, it essentially involves something that cannot be put into words. The regulators are backing down from the mass protection of institutions – we may want to protect systems, but we are not committed to any individual institution. The goal is to minimize the losses to depositers. The point of regulation is not to just keep everybody's money in a sock under the bed. However, we want institutions to be risk-takers – we benefit from having risk-taking societies. Capitalism is supposed to work this way: the first to market what people want are to be awarded.

2. ***Supervisory*** – the supervisory framework is the whole mechanism for looking at an institution as though it were an institution that has dynamic risk exposure. Note page 178 Key Principles: "The level and frequency of supervising will rest on…" This risk assessment is one done by OSFI – it's been put out by OSFI. In order to make things more competitive, we might have to let in more players with less money… these players might not have the sophistication to be sufficiently aware of the type of risk that they are in. This risk assessment and this type of supervision is very different – it feeds into the new Basle system.

3. ***Market Discipline*** – in order to have market discipline we will require 'transparency'. This will be the biggest challenge. TRAC – property and casualty insurance company asked other life insurance companies for information. You can't have these systems work without the market getting involved. In order for the market to get involved there is need for change in Canada. Uniform Accounting Principles – this is an obvious first step. In terms of globalization and the financial services industry, this has become more important than ever. First, within a jurisdiction,

if the GAAP are meaningless and no sets of numbers mean the same thing, then the entire idea of transparency is a joke (a lie). Secondly, there is a clash between the disclosure and retention of information, which has become a very valuable asset in our newly formed knowledge-based economy. Finally, the rating agencies may create certain problems: rating agencies are paid for by the companies that they are rating; they get most of their numbers from the companies they rate; and, they have very guarded language to avoid liability (ie, this is the best we can do and if it is not good enough, tough). Transparency is currently the buzz word to solve all problems – you can see why it would be an obvious word under current crises.

The linkage between the safety net institutions and the advisory frameworks is very intimate.

Rating Agencies in Canada
1. S&P
2. Moodys
3. Fitch
4. Dominion Bond

The whole risk-weighted idea is going to be based on individual risk experience, which has been passed under the nose of a regulatory agency that has approved that weighting.

The Financial Safety Net

CDIC	ComCorp
○ Crown corporation ○ Aim: To insure certain kinds of deposits with federally regulated deposit taking institutions ○ The idea is to protect the unsophisticated ○ Limit: $60,000 for each account that the depositor has ○ Has powers to intervene in the institution	○ Private Ownership – owned by Life Insurers ○ Aim: To develop an back-up for the insurers ○ The idea is that if any life insurer crumbles, another could step in and acquire the policies ○ Limit: $200,000 for life insurance policies; $60,000 for investment products similar to those sold by banks ○ Must take a passive approach – may not intervene

CDIC Considerations – The big banks were not too crazy about CDIC, but the justification for it is that it enables people to feel safe in dealing with the Canadian Payment System. Since confidence in the payment system is crucial to sustain a healthy economy then the justification is warranted. The major banks, which are relatively more stable than the smaller ones, oppose the CDIC in that it deters people who would otherwise invest their money in the larger banks.

ComCorp Scheme – if any particular life insurer is shaky, then any other one may acquire its policies. In the course of the McKay inquiry, McKay was convinced that there ought to be parity between CDIC and ComCorp. In particular, it was recommended that the Government of Canada backstop both of these institutions.

The argument is one for fairness – you cannot expect the two sectors to compete fairly if one is having its risk (at least marginally) reduced by levels of protection while the other is on its own.

CDCI versus ComCorp – the point is this: Life insurers noticed that there was a Crown Corporation established to insure deposits up to a sum of $60,000 in deposit taking institutions. Life insurers offerings, however, were not offered any public protection. In essence, there is an added benefit it investing in deposit-taking institutions in the form of a safeguard. This safeguard, ComCorp argued, creates a market imbalance.

However, deposits and life-insurance policies cannot be insured as if they are the same thing. The government argues that these two things are quite separate and it does not see any reason to backstop the life insurance industry.

The argument in favour of protection is to ensure the protection of the overall payment system. The underlying goal is to affirm consumer confidence in the Canadian Payment System. The government has not bought into the argument of merging ComCorp with CDIC.

McKay Arguments

1. The payment itself is evolving and risk-management is becoming much better;
2. The primary rationale of deposit insurance in today's marketplace is protecting the savings of unsophisticated consumers who cannot make appropriate risk calculations about the safety of the institutions with which they are entrusting their savings; and,
3. Deposit insurance plays a role in leveling the playing field for deposit-taking institutions

Benefits

The bigger debate is whether or not we should be doing anything at all with CDIC. For example, $60,000 has been the insured sum for quite some time. In the US, on the other hand, the FDIC insures up to US$100,000.

If this number is increased, it is argued that individuals will not really care about how their banks behave. Thus, one of the biggest concerns is that increasing the insurable amount we encourage the depositors to act contrary to what their perception is. Moreover, we cannot afford to become obsessed with any one element of the financial services sector – the deposit-taking institutions are not the only ones that exist.

The obvious consequence in terms of the difference between the two institutions is that CDIC has powers to intervene directly in the institution.

Since 1995, the climate has changed and the changes are ongoing. Privacy will not be given to the institution when it comes to CDIC sharing information with OSFI.

Even at the lowest there are three stages of concern about an institution and even at the most routine the two agencies meet monthly to share information. Thus, if CDIC has to come up with a way of making a risk-assessment to determine how much to charge a particular institution for its premiums, that assessment will be based (if there are no problems), by the information supplied by OSFI. The co-ordination between the two agencies is supposed to continue at every level of concern. Even when there is nothing more than early warning signals, OSFI will continue to provide information to CDIC.

Highest Level: Genuine concern about solvency or viability of the institution. Other intervention powers are started, which include sending notices, putting institution on a watch-list, the power to ask the minister to stop them from operating, and etc.,

The great pay-off from the crisis of Confederation Life has been the development of a more explicit statement of the interaction between OSFI and CDIC; and, both authority and duty to share information. The purpose is to minimize duplication and to improve the transparency and effectiveness of the regulations. The improvement is one both in efficiency and in the ability to react.

These elements only highlight how much further ComCorp will be left behind. It is clear that ComCorp is left only as an 'undertaker' as sorts, while CDIC and OSFI may take the role of rehabilitators.

This objective is one of several objectives – however, you can only judge its reasonableness either on its own; or, if discussing competition, by looking into these particular concerns.

Competition

http://www.fin.gc.ca/links.bakse.html

There is agreement in Canada that the key to getting anything done in the financial services sector is primarily in competition. Prudential regulation may interfere with this, however, it should only get in the way of promoting competition to the least degree possible.

State of Affairs - 1997

As a group, the banking sector tends to dwarf all of the other players, including Life Insurance. By an measure, whether we are talking about capital, revenue, employees, or branches, the banks were fairly significant. The unofficial unwritten rule was that big should not buy big. It was in the minds of the players that no matter what was happening in the rest of the planet, mergers and acquisitions within the financial sector should not include the dominant players merging and getting bigger yet. It is difficult to pinpoint what persuaded the banks to think differently, but they did and from time to time one can hear complaints of the trauma of the experience considering the negative public opinion that followed.

Background Paper #1

From the website. Page 69 of the background paper gives you a sense of how Canada was viewed in terms of competitiveness – a comparison of Canada to the US is there provided.

	Canada	US
Degree of Sophistication	4th	2nd
Supply of Venture Capital	5th	1st
Competition from Foreign Banks	41st	10th
Soundness	1st	15th
Adequacy of Regulation	2nd	10th
Ease of Entry	39th	10th

Canada ranks high in many areas, especially the soundness of the banking institutions. This is the snapshot from 1997 and the rules of the game have changed significantly. The new legislative framework makes all of these things vastly different. Our policy at the time was highly protectionist – a policy of giving special privilege to Canadian Institutions. This has changed under threat of two major international agreements: (1) NAFTA; and, (2) WTO. In 1999, WTO on financial services came into play and that has started to have an impact on the shape of the world. The passing of the new legislation has also created change domestically.

Of all the groups that were sheltered, the Canadian public is among the most sheltered by the banks. This assertion can be proved without question by considering the nationalistic phase of the Canadian Economy where an American bank bought out a Canadian bank and it was, in fact, forced to divest so that the Canadian government used its protectionist legislation at the time to actually force the American bank out of being a major player in Canada. By contrast, Canadian banks have had a presence in the US since almost the time that they were established. Today, if you keep an eye out for what the CEOs of the major financial institutions have to say about competition and entry of other missions into the Canadian marketplace, Canadian banks are all for it. The view of the world is that having benefited from protection and developed their size and presence within the Canadian market they are now self-confident enough not to care if the doors are opened. The more recent pitch by Canadian banks is that they are more than

willing to have foreign banks come to do business. Even in 1997, there were at least 44 foreign banks present in Canada. However, in order to be present and do business they were required to set up Canadian subsidiaries.

They kept on complaining that this was one of their major barriers to entry. Recall, one of the criteria that Canada ranked poorest was ease of entry into the market. The WTO ended its round of negotiations on financial services in 1999 and the Canadian government pledged itself to passing the necessary legislation to bring Canada into conformity with that agreement.

Foreign Bank Branching

The upshot is described in the Guide to Foreign Branching in the courseware. This guide gives us an idea as to at least one of the major changes that has happened since 1997. Part of the problems that most countries that want to push for greater globalization in financial services is that under the disguise of prudential regulation they either over-regulate to keep out competition or withhold the entire set of rules. One way of keeping out the competition is to either set absurd standards or not let people know what those standards are – in other words, a lack of transparency. The WTO agreement required both access and transparency – a clear identification of the rules and the ability to set up a branch. There were entities that existed within Canada prior to 1999 as subsidiaries of foreign banks that we established in Canada who have chosen now to run their business in Canada as a branch of the home business – the main country that was pushing for this change was the US.

The presence now established might not be the presence that is easily seen or recognized, but the moves are starting to be made. The one thing through which Canadians will tend to judge competition in banking is in setting up bricks and mortar branches. One cannot quite easily compete with Canada's big six by trying to match them on every street corner – it is not this type of competition the Americans had in mind in setting up business. Americans are in the business of setting up and tailoring niche markets – it is not competition for retail banking. The closest that they want to come in and compete in the retail area is in the credit business.

The big change that has taken place, which is part of a philosophical change, is the preparedness to see competition as global – we are prepared to trust the home (foreign) regulator to ensure that the institution is a viable organization. We are concerned about systemic risk, how does one open their doors without being concerned – you check out who is going to be in charge of keeping an eye on the entity.

This is a dynamic system – these rules connect with what we have been talking about in terms of the road to Basle II. The ambition is to have standards that Canada has accepted for itself to be applied to other jurisdictions. If other jurisdictions can get their legislative frameworks to an acceptable level, then they have the right to come in and do business in Canada – this also assumes that they will open their doors to competition.

Some might argue that this is an opportunity to turn their status of a well-regulated financial services sector into a global exporter. It would make the Canadian market more competitive, but also open up the global market where Canada can wave its soundness of regulation as a bargaining chip. Recall, we are assuming that we are dealing with fairly sophisticated players on the other side. If the game is all about risk, then Canadian entities should be welcome because they present a lower risk than the much coveted US institutions.

Taking into account the fact that the US has possibly an over-abundance of financial institutions, particularly deposit-taking institutions through state-protectionist legislation until only recently, the US

market in financial services is more shaky in terms of its individual members than Canadian players. While Canadian players are few, the Canadian's can say their regulation is better than everybody else's.

Canadians argue that we should be let in with favorable terms because we are backed by our rankings and the prestige of Canadian regulation in terms of efficiency. The benefits are quite considerable.

The minimum capital requirements in order to set up business is fairly low – an authorized foreign bank need only provide $100,000 in assets deposited in Canada (page 250 – 3.0 Statutory Provisions)

The requirement at 4.0(b)(iv) is questionable: 'a controlling parent which is widely-held in its home jurisdiction'.

It is not as easy as one might think to determine the legitimacy of a foreign bank. Every month OSFI publishes a list of institutions that do not meet the legal requirements to be a legitimate foreign bank.

Page 262 – This is the shape of the planet now. Once the license is given to do business, Canada will rely on the prudence of the home regulator. In order to be able to do this, certain minimal legal rights are required, which include the right to speak to the home regulator to share information – including what might have been considered in the past to be proprietary information.

Internal Competition

There is a minimum retail. The retail market in Canada is pretty competitive.

Main Thrust – Let us not use the need for prudential regulation to stifle competition. We can afford to have some risk – some small player to go down. We are, presumably, talking about sophisticated and developed economies that can take small shots. For example, while the demise of Confederation of Life was a shock, it certainly wasn't enough to bring the entire system down. As far as foreign banking is concerned, if the foreign country is regulating and the countries economic condition is working for them, it should be good enough for us. This is a risk, but it is a risk that is manageable.

The point of the regulation is that we do not want people with the sole ambition of amassing wealth to open up a branch from their home nation – there are a number of regulations and qualifications that are required of a bank before it can open up a Canadian branch from its home country.

The financial sector in Canada today welcomes competition because this means that they will be allowed to compete. It will also give Canadian banks the opportunity to show that they can compete on an international scale.

We have a bigger interest in competition both between institutions and between the different services within the sector itself.

Competition in Life Insurance Sector

The shareholders of two large insurance companies have agreed to merge with each other – Sun Life and Clarica. At the time of the last big merger, that of TD Bank and Canada Trust, the process occurred under the old system and happened very quickly.

Historical Context

The Life Insurance sector at the time the McKay task force was sitting could be characterized by a proliferation of life insurance companies in Canada. Approximately 131 life insurance companies existed at the time of the report. Of the top five Canadian insurers in 1997, only one (Great West Life) was a shareholder owned company. The others were all mutual insurance companies. The key to this is that in a mutual insurance company the policyholders are both clients of the corporation, but also the owners of the corporation.

This was, in itself, a barrier to full competition in financial services because while this particular form of ownership has its attractions in certain areas, it also impedes these kinds of companies from competing with banks and mutual funds. There is a difference in the meaning of the word 'mutual' when used with 'mutual' funds than with 'mutual' insurance.

Mutual Insurance – every member of the corporation serves in two capacities, as the insured and the insurer. Everybody is in a relationship to every other policyholder that is similar to his or her own.

Mutual Fund – Either a trust or corporation will purchase assets using money from the investors and then give each investor a unit of the fund that they put together. Some kind of trust is created with the investing public and for a fee anybody can support the fund by purchasing units in the fund. The essential advantage of the mutual fund is that it allows an individual shareholder to diversify his or her own portfolio without investing a great deal of money. Without having a lot of money or having to make personal choices, the individual may invest in a number of organizations.

Mutual – all the unit holders have something in common with each other.

Demutualization

There was an argument that a mutual insurance was an unwieldy form of ownership. Prior to the passing of Bill C-9, legislation was changed to permit demutualization. One of the big stories of the late 1990s in terms of changes to financial services was demutualization, which involved allowing mutual life insurance companies to change their status to shareholder companies. The process involved getting the membership to agree to demutualization and to agree to the value that would be placed on their ownership by giving them either shares or cash for that value that was placed on their ownership.

Prior to demutualization, John Smith would have a policy and the value of the policy would combine both his insurance and his share of the mutual company in which he was a policyholder. The demutualization process results in a statement of the mutual interest equaling some sum in addition to a policy that will have a particular pay-out attached to it. This is an extraordinarily complicated matter – tons of different types of policy products, ages, values, countries, and etc., exist. The process was very regulator intensive in the sense that somebody had to oversee these events on behalf of the consumers. When the trend first started there was some disastrous demutualizations in the US where the management of the companies structured them in such a way that they would profit largely. The fear that management would undervalue the holdings was, thus, prevalent.

Learning from the US experience the Canadian rules were structured in such a way that bonus/payouts were excluded as a possibility. The other way to achieve fairness in the process was to oversee the valuations of the products. Demutualization nevertheless took place for the four major companies. The other thing done at the time of demutualization was that it was made part of the process that nobody else could come in and buy out the companies for two years. Thus, a market was created for the shares that could be listed, but nobody could buy controlling interests for two years. This two-year span was up last year, which is why the marriages have now begun.

The original preference in Canadian law was one of British insurers. It was originally a very marked preference. The very fact of the legislative preference was one of the reasons why provinces took on the federal government over the right of regulation. Much of the constitutional debates started because the provinces wanted to bring in other insurers than the British. Federal authority was challenged in both the life and property and casualty areas – provincial politicians were being told that there were less expensive alternatives being offered elsewhere.

Once you look closer at the 131, you see that there is a fair amount of concentration. The biggest are quite large and with these types of events and the convergence within the sector we saw that the kinds of concerns that gripped the country when the top four banks in Canada decided that they were going to merge and thereby cause greater concentration – those same problems might well be something you have to deal with in Life Insurance mergers as well.

It is not close to being a problem in property, but it is close to there in terms of Life Insurance. Note exhibit 325 in the Background Paper #1 (page 58) – graph of percentage of premium income for the top ten companies and the change between 1991 and 1997. The pace has grown very fast – just between 1991 and 1997 the big companies increased their share in the market from under 60% to just over 75%. With the overall merger process, we see that the things that the entities have to overlook to oversee mergers have the same issues as the companies would have about banks getting together.

Merger Enforcement

(1991 Proposed Guidelines)

Under the unwritten rule of big shall not buy big, these proposals caused a firestorm. The reaction from both the Minister of Finance and the public was one of extreme outrage. The McKay Task Force actually started out under another chairperson.

When the banks decided to do a merger and the public reacted with revulsion, this threw the entire system into a panic. When it comes to mergers, understand by it to mean acquisitions and other ways in which there may be greater consolidation within the industry.

A number of different entities and concerns that might come to bear when financial institutions are going to consolidate:

1. OSFI – in charge of prudential and security issues;
2. Competition Bureau – criminal and non-criminal issues;
3. Parliament – the public outcry gave the legislature an enormous sense of importance; and,
4. Minister of Finance

The entity we have to pay most attention to is the competition bureau, which deals with both criminal and non-criminal issues.

Competition in General

The argument in financial services is that we are in a world of substitute products – how are you going to do anything by being as simplistic as matching postal codes with market share?

Over a give year period 1/3 of Canadians have changed the institution they are dealing with. The types of things that are annoying them are service charges, hours of operation, poor service, etcetera. In making these determinations the director has to consider what is the likelihood of not just current competition but new entry.

The bureau is looking at actual events to see whether there is some kind of local market in order to determine whether the impact would be adverse in particular areas. Any segment of financial services will show that there are variations in the provision of services. This is actually far less in banking, then it is in things like life insurance. The companies do not all do business everywhere.

One might find that different companies go after different markets. Paragraph 46 – Take Note. How does the competition bureau interact with OSFI and the Minister under these circumstances?

Bill C-8 and Banking Institutions

Based on Bill C-8, the large banking institutions must be widely held – over $5 billion in equity. For the Big Five, the rule that has been established is that there should be no shareholder with more than 20% voting or 30% non-voting shares. There is an intermediate category of medium-sized banks with equity ranging from $1-5 billion and also smaller institutions with equity at less than $1 billion. For the intermediate, there should be no shareholder with more than 35% of the voting shares and the small banks carry no general restrictions.

With regards to competition, this prevents the foreigner's ability to control the larger banks. Although this is not stated in a working nationalistic policy, it still has that same type of nationalist impact.

Even though it might serve nationalistic purposes, it seems relatively innocuous because the argument is that we do not want to have the role that the large banks play in Canada be dominated by a single shareholder. You can, on past experience, justify this argument. For example, we saw from the history of some of the institutions that went under in the 1980s that dominant ownership may have led to their demise.

In fact, the 20% maximum voting share for the large institutions might even be a bit generous. Note: We start with the rule that nobody may have significant interest except to the extent that it is committed. The approval of the Minister is required to acquire these significant interests.

We are operating in a world in which the ability of financial institutions to be directly involved in things outside of financial institutions is greatly expanded. The rules have changed to expand the powers of these institutions.

The Intermediate range holds that if 30% of the shares are widely held that is sufficient. At the smallest level, the only restriction is that they can question the status of the dominant shareholder being a 'fit and proper' person. Thus, if you apply for a bank license and you are going to be the exclusive shareholder you might have a lot of questions to answer if you have anything on your record or history that might paint you as risky.

The entire system is predicated on the fact that two kinds of entities do well in the technological order:

1. The super big players; and,
2. The small niche players

The tendency is that you either get big or you stay very focused and small. The lack of restriction on the small institutions makes it easier to have them and encourages their proliferation, thereby creating niche competition.

Demutualization – Life Insurance

In the 1990s, the mutual life insurance companies were allowed to change their status from mutual to demutualized companies. The new ownership rules that have been brought in have tried to equate these demutualized companies with banks. Until January 2002, nobody could acquire any interest in the newly demutualized companies and they were until then widely held by definition. Bill C-8 has a similar grid for these demutualized companies as it does for the banks. The two largest fall within the same range as the big 5 banks (Sun and ManuLife). What is very interesting about this new policy setup is that it excludes one of the big players in the Life Insurance business, it does not impact very greatly on, for example, Great West Life, which has always been a shareholder company.

There might be all kinds of other consolidations taking place, however, there seems to be a covert rule that the Big Five Banks cannot take over any of the Big Two life insurance companies. This unwritten rule becomes fairly important because of the discretionary outlets built into the legislation.

Merger Proposal From Banks

Step One – Initial Screening

Three different groups would screen the proposed merger:
1. OSFI Prudential;
2. Competition Bureau; and,
3. House Banking

The process has become more politicized than it has in the past. An additional political involvement enters the picture – the House Banking Committee. The interaction between the banks and the back ventures during the task force hearings was originally antagonistic. The inclusion of the House Banking Committee makes it a very political process. The Canadian Parliamentary system is different from the US tradition. Currently, there might be more opportunity than normal for the opinions in both the backbenchers and opposition to be heard because of the leadership ballot within the Liberal Party. The reality is that this should not be a great barrier in the future if you assume that if the Cabinet is more or less happy with something then others will be too.

Looking at it from a democratic standpoint, there is no question that this is a democratic innovation as the people get to be heard through the mechanism of the House Banking Committee. However, this might in fact mean that the prospects of actually seeing any of the transactions go through is very limited. Nevertheless, feedback from all three of the groups then goes to the Minister.

Step Two – Minister's Review

Some of the elements that go into the public interest are spelled out and the Minister is to make a public interest decision. However, it is not close-ended as the Minister has the discretion to disapprove, as the proposed merger is not in the public interest for one reason or another. The Minister then responds and sends it down of one of two tracks:
1. No – the transaction is denied because the associated concerns are too great to be remedied; or,
2. Yes – the transaction may proceed, but certain conditions must be set and met

Step Three – Conditions

The same three review agencies take the Minister's conditions and meet to see whether or not they can set remedies to meet those conditions. The three bodies then establish the remedies and propose that the banks follow some assigned process.

Step Four – Proposal to Bank

The proposal as established by the three bodies set up to remedy the Minister's concerns are presented to the banks privy to the transaction. The Banks determine whether to accept or decline the conditions and set the merger down one of two tracks:

1. Merger cannot proceed;
2. Final approval of merger by Minister of Finance

McKay Task Force – Competition of Banking

What we have seen in recent times and what will become more encouraged is without the formality of mergers, we allow for financial institutions to act in concert with each other in marketing and servicing particular products. Instead of saying the only way to go is to become legal entities that are combined or to keep total distance from each other, there is a possibility where an institution may work with what is otherwise a competitor to offer the same service. For example, CIBIC established AMICUS, which in turn will do business under somebody else's brand name.

For example, Investors Group and Great Western are related corporations – a cluster of companies. AMICUS is doing this on both sides of the border. Now, there is a difference between this as competition and the establishment of the white box (a banker box that charges out on the Interac Network for withdrawals) – they allow competitors to do business with each other.

The main point is that however difficult it seems to go the official route of mergers in order to try and get whatever benefits the large institutions think they can get, they have not been completely left high and dry. The assumption in the Canadian public is that there is no room for them in Canada to expand and do better – the future must be expansion outside of Canada. The reality is that they may be doing both. Without merging in Canada they are, in fact, entering into arrangements that are giving them greater efficiencies. Other ways of gaining efficiencies is instead of expanding and then closing down branches is to close down branches on your own. The biggest problem that continues to exist from the standpoint of the institutions is the argument that the process is too politicized.

From the consumer standpoint (the Canadian public) the biggest complaint to having banks and financial institutions having so many 'tentacles' is the notion of 'Tied Selling'. This is a factual question and one that will be dealt with on particular evidence.

The object is to prohibit financial institutions from saying that you may only get X if you also buy A and B. The idea of tied selling is where a certain financing rate would be offered for one thing if the consumer would also tie him or herself into the institutions other financial services offerings.

The other possibility is that if you have a big risk market, the consumer's interest may be served by actually having competition. This is undermined if, in fat, the institution is capable of forcing consumers into not shopping around. The question is whether the services are offered being contingent upon buying a whole number of services or whether the option exists to consolidate.

On the ABM issue, the Payment system is now going to be opened up. For the very first time, we are going to have other institutions become part of the Canadian Payment System. Mutual Funds and

Insurance Companies that were not part of the old Canadian Payments Association and did not share in the control of Interac will now become participants. This is going to make a difference.

KYC v. Privacy – Reputational Risk

While on the one hand we are trying to control individual privacy, there is, on the other hand, pressure from different sources to decrease the amount of information that is available – what is worse, the information available to institutions in electronic forms.

KYC is an increasingly important method for providing financial services. Know-Your-Client had the connotation to it that you have to have some sense, when giving financial advice, whether it is suited to and for your client. KYC, in the rubric of financial institutions, has different meanings and objectives.

Reputational Risk

Things happen to your reputation and as a consequence a firm's very existence is placed under threat. The key to all public financial institutions is public confidence and trust. It is the same deal when we speak of law firms, financial institutions, accounting firms, and etc.,

Arthur Anderson – a major accounting firm that operates in over 80 countries. By any definition it is a multinational corporation and one of the world's best know brand names that might disappear as an entity in the near future. If you are an auditing/accounting firm, being criminally charged is not a good thing.

Personal Information

These concerns coming together create certain tension because:

1. The pressure is to get to know more about clients and protect yourself as an institution; and,
2. The fact that an organization has information is fine, but we want to ensure that it is not used improperly

The analysis must necessarily turn to what reasons there are for acquiring particular information. Why collect information? In the insurance industry, the justification is that there are factors that are private to the individual that affects the insurance industries risk. The risk, even though the firm may make predictions based on other information, in order to assess particular risk the firm's need to have particular information that is quite intimate. Thus, if you are buying health or life insurance, this might include information that is quite personal.

There is in some circles a very strong sense that talking about personal financial information should not be talked about and spread around. However, information about people's earnings is published as though it is a very public matter. It because obvious with respect to insurance (life and health) and other areas as well.

In the banking industry, banks might need to know an individual's credit risk. In order to determine credit risk, the banks need to have a sense of what the individual's earning capacity is or what the individual's 'attitudes' towards repayment are. As such, background checks for credit-worthiness are routine for saving credit. Moreover, providers and receptors of guarantees, which are very similar to insurance, may wish to know the credibility of such guarantees.

Two Important Considerations:

1. The longstanding reason for these organizations to get involved is that of money laundering – a concern because of the narcotics and drug trade (Bank Credit Commerce International example: BCCI got involved in recycling petro-dollars that had accumulated from the formation of OPEC, which provided a base for establishment internationally – the entity started getting involved in

laundering drug money. The amount of money in the illegal drug business is so huge that it has the capacity to undermine legitimate governments and banking institutions. As a threat, money laundering from the drug industry was a very high priority); and,

2.

Money Laundering, Drug, and Anti-Terrorism

Financial Action Task Force (FATF) – the legal profession has become somewhat more familiar with FATF than it used to be in the past. Initially, the attempts to make money laundering something that the financial institutions had a role to play in were restricted to some kind of voluntary model. More recently, the requirements have become mandatory and in this course of making it mandatory, the rules have been extended to financial institutions in general. The regulations with respect to lawyers have been put in abeyance. In any event, the history is somewhat older than our most recent concern. The FATF and the concern with money laundering has been with us for at least a decade, and for at least a decade banks have been subject to this obligation. The money laundering legislation became money laundering and anti-terrorism legislation.

Drugs + Money Laundering + Anti-Terrorism

Chasing through corporate accounts to find the financial connections to international terrorism is not a co-operative global activity. This is an additional reason why KYC is being pushed.

The approach from the FATF is that you cannot afford to have any weak links – the actual details of what lawyers should consider suspicious or withhold, or the potential chilling effect is something that should be taken up somewhere else. The argument is that you cannot protect a legitimate system unless an entity may be reviewed and every entry point. Note: The life insurance industry asked to be brought into the mandatory model – the logic is that if you close off certain groups, the people who are trying to clean up the same money will attempt to go through easier means, other places that they could put money. For example, the US legislation used to provide that the US government share money with other countries that co-operated in deterring the drug trade and associated laundering.

The argument is that it has to be universal and the clout is fairly formidable – you will be precluded from doing business from any country party of the FATF unless you succumb. If you are not part of the countries that are seen to have good regulations and enforce those regulations, you will be put on a list.

NAURU – any transaction from this island, for example, was to be considered with extreme caution.

Types of Risk

There are three obvious types of risk:

1. *Reputational Risk* – guilt by association – very effective in areas where everything depends on trusts, reputation may be protected through an effective KYC programme;
2. *Operational Risk* – risk posed by inadequate or failed internal processes – may include anything making it impossible to get to your information or to manage. The victims here are simply perceived as being sloppy; and,
3. *Legal Risk* – where unenforceability of contracts or judgments may adversely affect the operations or condition of a bank.

These are circumstances where you can change KYC to fit within the context. Banks have always said that they do not need to be bothered by trusts; added in was the requirement for the notice of a

constructive trust, but these are awarded by courts where they think the defendant has acted badly – why include this in the new financial services legislation?

What are the firm's standards for knowing your client? The financial service institution should be liable for breaching the industry standard of knowing your client and dealing with the type of account. The standard must be breached by either one of the following:

1. Not knowing; or,
2. Letting things happen when you did know.

From the regulatory standpoint, institutions are going to be subject to fines and penalties if they do not go through KYC correctly.

Concentration – where through one process or another you keep narrowing down who is going to have to pick up the tab and as a consequence what independently seemed like a safe transaction, might become horrific when you see that all of the entities are connected.

- Retrocessionaires
- Reinsurance
- Retail Insurers

What happened with things like asbestos and such lawsuits was that the retrocessionaires were moving risk up the chain. The risk is concentrated and the underwriters could not pick up the tab.

Legal Changes

Increasing accessibility and ease of access makes KYC a difficult notion. A balance must be found. It is not a North American style to worry too much who you are selling to. However, the institution must be concerned with who you are selling to and where they are getting the money from. The basis of liability will be a lack of KYC policies.

The key to a lot of the regulations is to ask:

1. What are the standards?
2. Who becomes accountable/who approved the account?

These types of questions are going to become more and more pervasive. The banks might have the obligation to look into lawyer's trust accounts.

The system of PKI – electronic documents and personal key identification issues are very current, but the system is not in place yet. Canada and Ontario have joined the other advanced nations in making electronic interaction the equivalent of writing. However, this requires certain actual certification methods – authorities along with PKI are needed to ensure that the infrastructure exists to make this work. The Canadian Payments Association has contracts almost in place, but until they get their new membership, it is slightly in the air. It is not a technological problem, but a timing problem. The world is being prepared for business being done without physical presence.

The Fourth Annual Report on bank fees is available at: http://www.consumerconnection.ic.gc.ca - dealing with extra charges on Interac and so-called white-walls. The public probably does not know that there is a range of choices at various banks. Thus, having this service in itself is an aid to competition – information that makes it simple for people to follow.

Money Laundering

There are a number of reasons that financial institutions are being forced (either out of self-interest or the nature of relevant laws) to get information. The public demands getting information for prudential reasons, or plans for anti-money laundering and anti-terrorism reasons. This should be matched with the attempt to provide privacy and protection for such information where it can cause a lot of damage and be dispersed quite easily. This information is worth money to different individuals for varying reasons.

Part IV of the Anti-Terrorism Act made some very extensive changes to the Money Laundering legislation as it existed. What started off as being legislation focuses solely on money laundering and enterprised crime, with the anti-terrorism legislation is tagged on the ambition to not just track and combat the laundering of proceeds of crime, but also track and attempt to thwart the financing of terrorist activities. Even the name of the Act has changed (page 308): FINTRAC.

The UN had itself determined that this was the course to take in combating anti-terrorism and Canada has passed these regulations and acceded to the treaty. The keeping of this information and the making of reports is meant to be secret, and reporting is not just to the center but to OSFI as well.

The anti-terrorism part of the reforms extended the reporting from suspicious activities and currency movements to having to do searches of all of the accounts that the financial institutions held and to make reports on those accounts in the name of individuals who were subject to this reporting. OSFI, thus, issues updated lists of terrorist organizations and individuals considered to be proscribed because they are determined to be financing terrorism. The financial institutions then have to work through their accounts and figure out with whom they might have accounts and freeze certain ones.

Bill C-22 is applied to nearly every actor in the financial services industry – all the deposit taking institutions and the life insurance companies.

Here the information is about whose accounts have to be checked is public because anyone can go into the OSFI site and see from it what organizations and individuals have been included on the list for the purposes of reporting the individuals pursuant to the UN regulations. Those individuals have their accounts frozen, and is has since been broadened and in more recent times some more well-known non-Islamic organizations have been added to that list. ETTA and LTTE (organization working for political change in Sri Lanka).

The big difference that has been made by anti-terrorism legislation being connected with money laundering is that now the information is being exchanged internationally. Normally, the center is prohibited from disclosing information, but that is subject to sharing of information with both Canadian security agencies and other foreign governments. Thus, if the Centre (Financial Transactions and Reports Analysis Center of Canada) on the basis of its analysis under s.54(c).

What is happening now is that this information is not just Canadian information, it is information that is going to go to a number of other places. Thus, when our Solicitor General talks about bringing information to the attention of the Americans, he is not revealing great secrets. Most in Canada should know that when it comes to what is going on in anti-terrorism activities, everyone is sharing information with everybody else because there is an obvious necessity. In short, there is not too much sympathy for privacy in terms of dealing with anti-terrorism. The preponderance of feeling is that organizations are going to err on the side of avoidance by sharing information.

The element of the anti-terrorism act that Prof is interested in is that which deals with the acquisition and dissemination of information.

Since the protection, prevention, and deterrence is the main objective, this is precisely the main justification for further sharing of this information to police institutions. The necessary immunities in the Act are quite strong.

When money laundering legislation was developed, part of it was not only to deter the action, but also to assist in the forfeiture of assets. The legislation actually allows the state to take over monies and assets that allegedly are the product of enterprised crime. The strategy, in relation to fighting the war against drugs was to say, "Take that money".

Personal Information

Financial Institutions have for their own reasons or public policy reasons have to acquire information. The institutions own reasons for the acquisition include:

1. Insurance Companies
    a. So that they can best assess the individual policy holder's risk and the risk that they are willing to assume – what these firms need to know will be dependent on the type of insurance that is being purchased and so there is an obvious need for personal information;
2. Deposit Taking Institutions
    a. The job is intermediation – all financial institutions are in the business of aggregating smaller accounts and lending out large sums. The system works by making choices on how that money will be lent out;
    b. Credit is generally going to be given on the basis of the individual's ability to convince the institution that the capacity to repay exists – this will be based on credit history, character in relation to making payments, obligations to others… as a consequence, there is a need for information that is quite independent of the public policy legislation that is requiring them to acquire information

The deposit-taking institution might appear fairly casual about moving money around without being too nosy, when it gets to lending out their own money these institutions cannot afford to not know. As such, the institutions' own need and demand for information is based on having to make prudent credit risk assessments. Thus, it is very similar to insurance companies' need to know things about potential policy holders to make insurance assessment risks.

Of all the information that is out there, the information that is eminently marketable. The marketing of information has become big business in itself. Thus, this legislation is geared to responding to concerns that if you have the available market, the available information, and you live in an electronic age where is the public going to get its protection from? This is the basis of the legislation.

Bear in mind the scale of the issue that is being talked about. Anti-money laundering and anti-terrorism is geared at a very small fraction of the public. The laws are not really of major concern to most of us. On the other hand, legislation dealing with privacy can in one way or another impact on everyone's life for a number of reasons.

The protection of personal information is aimed at business to give them a sense of what they need to do in order to meet the requirements of the legislation. The first question that is asked is the impact zone – who does it impact? Federal work, undertaking, or business does not include insurance companies or credit unions. Why is this? The federal government does not want to run into huge constitutional challenges as to what it is that they are legislating and they are moving into matters that are of provincial jurisdiction. The point of the definition is to make it clear that the federal government is not trying to

muscle into things that are of provincial jurisdiction. Since we know that insurance is of a provincial matter, it does not matter that Insurance companies are regulated for prudential reasons by the federal government, the federal government backs off when it comes to privacy legislation.

The EU passed its legislation dealing with a similar matter and the US has passed one version as well has including some protections in other regulations and Acts. There is a battle between Europe and the US. Canada is not facing the same battles because the key to all of this is that the legislation is actually based on previous consensus developed through the Canadian Standards Association.

The legislation is turning into law what had been accepted by business as the 'best way to go' from their own standpoint. If people are nervous about sharing information with an entity, they are not going to do business with them. The ongoing concern is that the public has considerable doubts about doing business on the Internet because they are not sure of the security of the information. The public would rather pass up on the convenience because of these problems.

Consent and Privacy

What is the individual's sense of privacy? It is not important for the moment the concerns about money laundering and anti-terrorism. The views of the public in terms of those matters are quite special – given that they are extreme threats, the public is prepared to deal with a loss of privacy that it takes to deal with such problems. These are special concerns that can be kept aside.

The bigger question is what do people expect in terms of consent. One of the biggest problems is identifiable – if your name is on a number of lists, you are going to get spammed and bugged by a number of marketers. The sheer irritation factor of people thinking that they should be entitled to call you up in the middle of supper and chat to you about your need to chat to anyone else for less money.

Why in Financial Services is there a sense of needing greater privacy? ID Theft is, today, one of the bigger concerns. This is very high up on everybody's mind right now. The fact that if people get a hold of key elements of information relating to an individual economic portfolio, such as PIN numbers, SIN numbers, address, certain standardized questions, etc.,

ID Theft is a problem because after such an occurrence the individual's stake in the financial world can be very seriously upset. By acquiring credit in another individual's name, that individual credit rating can become easily smeared. An option is for people to run credit checks on themselves. For public corporations, the claim to economic privacy had been lost a very long time ago.

KYC – Know Your Client

The industry has a need for information. However, this need must be juxtaposed with a discussion of the protection of personal information legislation. In particular, privacy concerns lead to issues of:

1. The safety of the person – information in the wrong hands can be dangerous, such as ID Theft and account manipulation;
2. Security of property/reputation – the industry, being dependent on trust and confidence, rests largely on Reputational risk;
3. Commercial irritants and harassment – being bombarded with various forms of solicitation;
4. Personal Space – health information

Privacy, in this context, is important based on the individual's own sense as to why it is important. In our society privacy approaches the status of a basic human right and individuals should have the right to establish the limits defining the legitimate use of information.

The idea is that privacy is a cultural space, which varies from community to community. Canadians in general seem to have a sense of being entitled to personal space in which you only enter at their invitation and on terms that they set. The model that was built in the English Common Law made the space argument essentially physical. However, provisions in the Canadian Charter of Rights have made it a more abstract idea. In dealing with privacy legislation there are intrusions and it becomes important to take note of privacy requirements – people have a sense of some aspect of their life in which they are in total control.

Although individuals may have different attitudes regarding privacy, the overwhelming majority opts for stricter privacy rules and less convenience when confronted with a trade off between the two. Personal privacy should be a matter of personal preference, which can only be so if consumers have explicit, understandable choices presented to them at an appropriate time in the purchase process so that they can indicate their preferences clearly and unambiguously. The sense of self might include freedom from intrusion.

The compulsory distribution of information for very particularized reasons is something that the McKay Task Force was advocating against.

Special note should be made of Health Information. People's sense of privacy is most closely connect with their own personal health information, although people would have similar views over their financial status.

Legislative Change

One of the key ways in which the legislation helps individuals is by requiring institutions that collect personal information (federal works) to handle it in particular ways. Amongst other things, individuals should have the right to know what these institutions know about them. Individuals should have the right to require corrections in the information that is had about them. The response time that is set out in the legislation attempts to make these things less vague and open to interpretation by allowing 30 days.

The other thing that institutions are expected to do is provide information as to why the information has been collected. Also, institutions are required to acquire the individual's reasoned consent for the collection of that information.

The guide provides exceptions to consent and access principles. Those exceptions that are included are those clearly in the individual's interest and where collection is required to investigate breaches of law. Information collected for 'journalistic, artistic, or literary purposes'.

In addition to these provisions where things may happen without consent, one would need to get into the other aspect of the legislation. What should be done about problems where the institutions own policy or the Act has been breached? The choice is with the Privacy Commissioner. This is a highly visible office that people can go to if they are not happy through other mechanisms, such as the empowerment of consumers and the setting up of financial consumer agencies.

Nevertheless, when it comes to privacy, the member of public that feels that their privacy has been breached may complain to the commissioner, which is an office that reports to parliament and is, by legislation, empowered to investigate and report on the matter. The Privacy Commission may also seek remedies in court. The next step, then, beyond the commissioner is the Federal Court.

The US seems to be of two minds about this issue:

1. A very strong body of citizens and legislators are for tough standards and low sharing; and,
2. The industry argues that the interference stifles innovation and improvement

The Privacy Commission can hear a number of complaints as established by PIPEDA. Normally, an application must be made within 45 days of the Commissioner's report. The primary approach of the commission is conciliatory and concentral: they start off by trying to get the parties to agree, but if this does not work, then either the complainant or the commissioner can take the matter to Federal Court. At Court, the kinds of issues that can be raised are set out under Schedule 1 and Schedule 1 as modified by Section 5 to 10 of the Act. This legislation does seem to satisfy most sides.

The European Union has given the Canadian system its blessing. The fact that this blessing has been passed must mean that we are substantially ahead of the US, at least in the eyes of the EU. The court can provide financial compensation. The financial compensation can be large enough to have deterrent effects.

This legislation does not stop institutions from sharing data in general. It does not stop them from being able to try to get you interested in other products.

Privacy also exists as a common law right and, so, financial institutions are also bound by the common law. It might not give them protection from these harassment type problems, but if information about the individual's account is divulged, a common law action is available.

Consumer Empowerment, Dispute Resolution & Access

One thing that has changed and has completely gone off the agenda is the expectation that there would be federal financial institutions ombudspersons. This recommendation has been scrapped and a better idea has come along – a coalition of all the financial institution regulators in Canada. The wider initiative is to create a national ombudsperson system that links all the regulators across the country. This system has a number of advantages, the least of which is the avoidance of constitutional issues – everybody contracts into the scheme and, thus, nobody would lose constitutional jurisdiction.

FCAC – Financial Consumer Agency of Canada

The object is to try and protect consumers by making it easier for consumers to protect themselves. The ambition behind the FCAC is, in part, to make the consumer the person who improves the system through consumer education and the development of better standards for protecting consumer rights.

Financial Consumer Agency of Canada

Considering that the subject is not going through the court system, a maximum violation of $50,000 for a natural person and $100,000 for an institution is fairly substantial (Paragraph 19). There are similar civil law punitive damages ordered by the courts. Consider the damages that may be ordered against the financial institutions – after a history of prolonged infringements, $100,000 seems to be an unsubstantial fine.

Section 20 – Considerations for Ordering Fine – There must be a correlation between the ambition/intention to do harm or to be careless to suck a point of being uncaring of the consequences that are to be factored into the penalty

When it comes to punitive damages the order is disassociated with the compensation. In any event, proportionality would seem to be an obvious thing to take into account. Both talking about the seriousness of the harm to the victim and prior acts committed by the person are going to be considered when dealing with proportionality of damages. If these are repeated events, for instance, then things should get more serious.

The emphasis in sections 22 through 27 seem to support keeping this is a civil penalty. Keep it out of the realm of criminal law. The most important thing from the standpoint of the industry is section 28.

Section 24 – There is an appeal and the appeal goes to the federal court.

Section 28 – Due diligence is, in fact, a defense. Unless you have actually gotten rid of the common law defenses, all the common law defenses should be read into the legislation. In addition, being able to raise an argument of due diligence should, in itself, be an adequate defense.

Three are limitations as to how influential across the board one might consider the agency and also the overall strategy of saying that we are going to make things better by making the consumers better.

Order Compliance – Most of the emphasis seems to go into education and targeting voluntary compliance. In the absence of achieving voluntary compliance, an order may be made.

In talking about the 'public accountability statements'

Throughout the McKay Task Force hearing there were lobbyists who organized themselves under various names. They were pushing for the equivalent of the American *Community Reinvestment Act* and they mimicked a lot of the terminology. This Act requires financial institutions to report their performance based on a number of criteria. On that basis obligations are imposed on them or potential lawsuits are brought.

"Red Lining" – Suppose someone as an insurance company or bank has a map of a city and they map out certain locations in the city that, because of the ownership mix within the areas, are not stable and one would not want to do business in. How likely is the institution likely to be correct in their prediction that the areas will begin to deteriorate and the housing values will begin to drop? It is almost a guarantee that if such institutions engage in such 'red-lining' practices that the community will deteriorate.

Should a financial institution, however, have the right to say that they should not be giving credit to people that do not deserve credit? In 2002, a lot of things have changed and two sets of factors are at work. For instance, they continue to monitor and prosecute institutions that are racially discriminating. This, however, requires very sophisticated proof.

Financial Institutions and Lending to Aboriginals

The worst statistics usually belong to First Nations people. The biggest problem tends to be with the legislation itself. The legislation is the result of blind paternalism. The easiest way to distance persons from their land is to lend them money and then foreclose. Through this technique, you can actually get a large number of people off of their lands. In order to avoid this problem, the *Indian Act* does not permit financial institutions to take band assets as collateral. This is, essentially, the basis of the problem. In order to be effective and fully experienced members of the Canadian economy, first nations people require financing. In order to give them financing, financial institutions require them to have the requisite ability to repay the loans and provide some kind of collateral as security. This is the bind that on the one hand to preserve First Nations culture and communal integrity, we have to continue to have restrictions on

the freedom of individual members of these groups acting as though they have autonomous rights to property. On the other hand, if they do not have access to financing and a whole range of services that could be provided, their economic status will continue to fall behind that of other Canadians. The problem is real and solutions are urgently needed. Things are happening:

First Nations Bank

The Aboriginal people have their own bank – TD Bank and the Indian Equity Foundation is helping them to run it. There are First Nations bands that are very wealthy. The picture tends to be somewhat lopsided: the types of statistics we are likely to be exposed in law school show the price of deprivation. However, there are groups that have (by virtue of having a good resource base) very substantial economic holdings. All the major banks and, to some extent, even International banks do have contact with First Nations Groups. For good reason, if a wealthy band has money, you want to be the one collecting fees in helping them invest their earnings and wealth.

There are emergent First Nations born financial institutions. The problem, though, is much more complex.

Proposal One – Nobody wants to let the right to lend and royalties slip away due to foreclosure and allowing them to use their land for collateral probably should not be the first line in changing the system. However, there is no reason that they cannot use chattels as security. Loosening up the rules to allow similar mechanisms within First Nations reserves as operate outside of them would seem to be an obvious first step. Note: The problem is caused by the law, so why not adjust it by adjusting the law?

We have not run into a lot of references as to the structural changes' impact on this particular group, who are the worst off. This is where the problem is and the problem is legal – the Black Letter Law.

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General Overview

Introduction

For financial institutions, their customers and public policy, reliance on the status quo is no option. Because of the speed of change, we urge the government of Canada to deal promptly with the public policy issues here defined. Existing businesses of all sorts are affected by the information revolution. Financial institutions more than most are profoundly challenged by the changes because they rely to such a great extent on information and on information processing. Complacency and failure to adjust and respond will most certainly lead to problems. A healthy, dynamic, innovative and competitive financial services sector is fundamental to our individual and collective well-being. Our financial institutions employ more than a half million Canadians directly. They play a major role in allocating the savings of Canadians and producing investments. May Canadians also have a direct financial stake in the health of financial institutions as shareholders. For Canada, therefore, we must face the challenge that change presents squarely, honestly, and promptly. We want to stay ahead of the whirlwind and not be caught up in its tail.

Four Main Themes

1. Enhancing Competition and Competitiveness

We present a focused four-point strategy to enhance competition:

1. Enhancing the ability of existing institutions to compete with the chartered banks;
2. Removing barriers to entry;
3. Increasing opportunities for foreign banks; and,
4. Empowering consumers

Government has the responsibility to ensure that business strategies are compatible with public interest and bring benefits to Canada.

2. Empower Consumers

The current framework for consumer protection is not as effective as it should be in reducing the information and power imbalance between institutions and consumers. We make recommendations to improve disclosure and transparency so that better information will be available to customers. A stricter privacy regime and a legislative bank on coercive sales practices are also important. We also suggest that the Government establish a financial services ombudsman to provide easily accessible, independent dispute resolution to consumers who have complaints.

3. Canadians' Expectations

It is legitimate for Canadians to hold high expectations of their financial institutions and it is in the best interests of the institutions to recognize this legitimacy. Institutions should be more sensitive to community needs and more active in partnerships to help meet them.

4. Improving the Regulatory Framework

It is important that the relevant regulatory structures support broad public interest goals, such as enhancing competition and protecting consumers. The federal prudential regulatory framework can and should be further improved.

Some Basic Premises

We found it useful to identify some basic premises that helped shape our approach to the issues before us and to our recommendations:

1. Managing Change – The forces of change are global but their impacts will be local – public policy must ensure that change is managed in a way that recognizes the uniqueness of Canada;
2. Technology and Change – Direct access will provide greatly enhanced consumer choice and competition in most markets, but will lead to difficult adjustment issues for institutions and for some consumers;
3. Entrepreneurial Culture – We need to encourage those with the foresight and courage to seize opportunities;
4. The Basis for Regulation – Prudential regulation is very important because it provides some assurance that the institution will be able to redeem its promise. Market conduct regulation provides some assurance that consumers can make informed choices and have access to appropriate redress mechanisms when they are aggrieved. Public policy must be focused on achieving the best balance between allowing innovation and efficiency that come from unfettered competition and intervening to ensure that public policy goals are met;
5. Prudential Regulation – Focused on the safety and soundness of the institutions – strive for a better balance between safety and soundness and facilitating competition and innovation on the other;
6. Market conduct regulation – Regulatory intervention can make markets and competition more effective even though it imposes costs on some participants. This requires that consumers make efforts to inform themselves well about the options available;
7. Ministerial Discretion – The government must play a key role, generally the recommendations here do not limit the decision-making authority of the Minister;
8. Need for Flexibility – The policy, legislative, and regulatory framework will have to contain considerable flexibility;
9. Importance of people – Innovative and focused leadership will be critical. It is people who will make the difference between success and failure and excellence and mediocrity.

The Forces of Change

In General

The ascendancy of global capital markets is one of the important forces leading to the reshaping of Europe under one currency. These broad forces of change have been enabled by technology. The spread of information and ideas has provided the fertile ground in which leadership and innovation have taken root and flourished. The development and use of new technology is providing a broader range of choices and opportunities, but also challenges as traditional industries lose ground to new, lost-cost competitors. The financial services sector is being fundamentally reshaped by the forces of technology, globalization, and demographics and by new innovative approaches.

1. Technology

Information is at the heart of all financial transactions. The continuing increase in computing power and the decrease in information processing costs are having profound effects on the financial services industry. Technology provides an unprecedented platform for entrepreneurial innovation. Consumers are accessing financial services in new ways – ATMs, telephones, Internet, debit cards, and smart cards. New products and services are available, such as mutual funds and index-linked GICs. For established providers, technology is a double-edged sword. It can give advantage to new competitors and threaten existing franchises. "Mono-Line Companies" are new sources of competition. By focusing on one or a few products and by extending their geographic scope broadly, they can concentrate their technology resources in one area rather than many and defray the costs over a very large number of customers and exploit market niches. Multi-product financial institutions are investing heavily in information technology to offer consumers options in how they choose to be served. Further developments in technology will lead to new and innovative ways of producing, distributing and accessing financial products. According to IBM, 'human-centric' technologies, intelligent agents, and datamining are three emerging technologies to watch. In future, intelligent agents will learn consumers' tastes, preferences, and buying habits. These developments are likely to result in a major shift of power and relationships away from traditional providers to consumers and to new, innovative firms that can best assess how to meet consumer demands in a radically different environment.

2. Globalization

Financial services markets are becoming more global. The furthest corners of the world are within easy reach. Globalization thus offers new opportunities to domestic financial institutions; to serve Canadian customers more intensively in their international operations; and, to secure new customers around the world. The hallmark of a global market is a single price for the same product. For example, the lack of arbitrage profit on substantial transactions indicates that the market for foreign exchange is an efficient, global market with what is essentially a single price, worldwide. The world is moving toward a truly global capital market. The impact will be profound. Personal financial services are primarily domestic as are most retail and small business services. We are already seeing the beginnings of efforts to develop specialized niches in particular product areas and to achieve economies of scale in order to become low-cost global providers.

3. Demographics

Within the next decade or so there will be a substantial intergenerational wealth transfer to the boomer population. There will be greater focus on retirement income together with a sustained period of low inflation and low interest rates, which is a key factor in encouraging consumers to shift away from

deposits toward securities. An additional trend is that of self-employment. These changing trends have implications that will increase over time, for the provision of pensions, benefits, retirement planning, and easy and convenient access to financial services.

The Responses to Change

The changes will create unprecedented opportunities and challenges for all involved:

1. Consumers

Technology is empowering consumers and enabling them to access electronically the information to compare offerings, and providing them with the ability to access providers who no longer need to be locally based. Canadians can deal directly with providers anywhere in the world. While these changes are positive, there are always risks: information and basic education may not keep pace with what is happening in the market; customers may find traditional ways of doing business disappearing before they are comfortable with new ways; those will low incomes may be faced with new barriers to financial growth; and, institutions will be challenged in training their workforce to explain and deliver complex new services. Moreover, consumer protection legislation may lag behind technological innovation and increasingly aggressive, potentially abusive sales practices. Two contradictory trends are emerging:

1. As technology empowers the consumer, traditional customer loyalties are becoming less important and consumers are increasingly willing to shop on the basis of price and convenience; and,
2. Consumers are increasingly reliant on brand and reputation as at least implicit value guarantors.

2. Financial Institutions

Existing firms are responding to the challenges of technology and globalization in a number of ways:

1. *Convergence of Function* – most financial institutions are in each other's business. Asset management drives convergence. May take the form of different institutions offering virtually identical products (such as deferred annuity by life insurers and GICs by banks) or the offering of products of competing institutions either directly or indirectly or through subsidiaries. Convergence of function has lead to conglomeration.
2. *Disaggregation of Function* – some institutions are becoming more focused on one or a few business lines and selling off activities where they feel they do not have a sustainable competitive advantage.
3. *Mergers and Acquisitions* – going on through the world. Within a decade it is predicted that a small number of significant, global financial institutions will emerge.
4. *Changes in Culture* – the focus is on building a total relationship with the consumer. Important to ensure that salespersons are well trained, understands the client's needs and work in the best interest of the customer in an open, transparent way. Eventually distribution channels and financial institutions will change so significantly and becomes so integrally intertwined as to completely revolutionize the public's conception of financial service providers.

This transformation will raise many challenges for financial institutions. One of the most difficult will be retraining and maintaining employees who have the professional skills that will be needed in this new environment.

3. Policymakers

One implication of convergence is that banks become less special – public policy treats banks differently. Such differences in public policy are less sustainable as functions continue to converge and financial obligations become more prevalent. A second concern is to ensure that consumers reap the benefits of

technology and globalization. One issue is how to manage the transition in a way that protects acceptable service standards for those who cannot easily cope with the changes. Another issue is whether privacy concerns can be effectively addressed in an increasingly electronic age. Also, there will be a need to re-assess the regulatory framework. The pace of change is so great that policymakers should put a premium on flexibility and maintain an ongoing review of their legislative and regulatory structures.

4. Regulators

Heavy-handed regulation and protected markets stifle innovation and competition that can bring benefits to customers and provide a health, growing economy. The nature of prudential regulation must change. New form of regulation and supervision are being developed, relying to a much greater degree on international cooperation and on the effective internal governance of institutions.

Summary

Technology, globalization, demographics and new ideas will continue to affect the financial services sector and to challenge consumers, institutions, policy-makers and regulators, in ways that cannot be easily foreseen. Change provides opportunity, but it also requires careful management by all concerned in order to secure maximum benefits to Canadians.

The Financial Services Sector and Its Challenges

The Importance of the Financial Services Sector

The effectiveness of any economy depends on how well its financial services sector functions. In a world of rapid change, individuals and businesses look to the financial sector. Individuals require speedy transactions, efficiency, and cost effectiveness as well as sound advice. Businesses look to the financial service sector to be at the leading edge – to serve them well at home and markets abroad. The importance of the financial services to our economic life goes beyond the services it provides. Note the following about the sector:

1. Directly produces over 5% of Canada's GDP;
2. In 1997 it held more than $1.4 trillion in Canadian assets with revenues of $155 billion and profits of almost $11 billion;
3. Paid more than $8.4 billion in taxes to federal, provincial, and municipal governments in 1996;
4. The largest five banks in 1997 donated more than $78 million to charitable causes;
5. Major banks and insurers are internationally competitive attracting more than 30 percent of their revenues abroad; and,
6. Over 550,000 Canadians are employed in the industry in jobs that are increasingly highly skilled and well-paying.

A Snapshot of the Sector

There has been an extraordinary growth in household financial assets over the past 20 years from $307 billion to $1.7 trillion. The big gains have come in managed and pooled funds such as mutual funds and pension claims. The trend has been away from deposits and towards managed funds, which have accelerated during the past five- and ten-year periods. The trends have significant implications.

1. Deposit Taking Institutions

The Banks – There are five large Canadian controlled banks, six smaller Canadian controlled banks, and more than 40 foreign banks. The sector in 1997 earned $7.5 billion of net income on revenues of $84 billion. Compared to other countries, Canada has the second highest number of ATMs and the third-highest number of point-of-sale terminals. The large banks have been the principal consolidators. All of the major banks, in one way or another, are now active participants in the securities, insurance, and trust businesses. The Canadian banks have significant international operations. Banks employ 195,000 Canadians. The biggest Canadian banks are dominant players in the financial services sector holding assets in excess of $165 billion. The biggest Canadian banks have always had international operations. If they cannot grow in Canada, then it is likely that they will find their base elsewhere.

The Credit Unions and Caisses Populaires – There are more than 2,200 across Canada. Almost 10 million Canadians are members. In Ontario, the credit union movement has a much less significant market presence. More than 61,000 Canadians are employed in the credit union systems.

Trust Companies – Constitute a small market segment with only 34 firms. The sector includes one large company, Canada Trust, and smaller companies. They employed about 23,000 Canadians in 1997.

2. Insurance Companies

The Life Insurance Industry – The industry is in a period of significant consolidation. Of the five biggest companies only one is a publicly held stock company and the other four are mutual companies owned by

their policy holders (This is no longer true as they have now all demutualized). More than 100,000 Canadians were employed there in 1997.

The Property and Casualty Insurance Industry – More than 230 property and casualty insurance companies operate playing the vital role or spreading and absorbing risk. This sector is experiencing substantial consolidation.

3. Mutual Funds

Mutual Funds - 78 Mutual Fund companies operate in Canada offering more than 1000 different funds to choose from and represents the fastest-growing subsector of the financial services sector. The majority of the industry is independent.

Other Market Participation – Securities dealers, specialized financing companies, money managers, and advisers. Both GE Capital Corp and Newcourt Credit Group are asset-based financing companies that have carved out important market niches in business financing in recent years.

The Changing Face of Competition

There have been significant changes in the competitive position of institutions over the decades and particularly in recent years:

- Over the past 10 years the fastest-growing institutions have been mutual fund companies and trusteed pension plans;
- Bank loans have fallen from 44 percent to 34 percent of corporate debt outstanding
- Large Canadian businesses increasingly source their long-term debt financing needs in capital markets – corporate bond issues have grown four times as fast as bank loans over the past 10 years;
- Specialized asset-based financing companies had 16 percent of the small business credit market in 1996, up from 9 percent in 1994;
- Many new competitors have entered Canada since 1996:
- Nine percent of new individual life premiums is sold through non-traditional means such as direct response and independent marketing organizations

Markets are dynamic, new competitors and new forms of competition in both products and the ways in which they are delivered are emerging. Issue: What new forms of competition are likely to take and how contestable will traditional markets turn out to be?

The Growing Importance of Mutual Funds

Mutual funds are a new and growing form of intermediation. Mutual fund companies now accept funds and use the pools of money to make investments in securities through capital markets. Individuals are placing their savings in mutual funds – a new growing form of intermediation. Trust companies accept funds and use the pools of money to make investments in securities through capital markets. Since 1991, mutual fund assets have grown almost sixfold and exceed personal deposits in banks. When buying unit in a mutual fund, the investor takes all the risk with respect to the future value of the investment. Mutual fund companies do not promise to pay a pre-specified amount to an investor. As a result, they can be started with relatively little capital and require little or no prudential regulation. There is a debate as two whether, when markets correct and interest rates rise, money will flow back into deposits in significant amounts. There have been two types of response to the rapid growth of mutual funds:

1. Banks have offered their own mutual fund products; and,
2. Deposit-taking institutions have turned increasingly to markets to securitize their assets.

Securitization

Securitization allows lending institutions to economize on capital by selling their loans to a trust or special purpose corporation, which then issues marketable securities that are sold to investors. This is a far-reaching innovation for two reasons:

1. Allows lending institutions to use their capital more efficiently by transferring the loans from their own balance sheet; and,
2. Permits separate financial institutions to originate, fund, service, and assume risk related to a portfolio of loans or other assets – allows for the development of specialized expertise in different areas of activity.

Securitization has not yet developed in Canada to the same degree as in the US – there has, recently, been rapid growth.

For instance, if there are investors interested in the income from credit card debt they can put the income stream from debt obligations into a trust and add value and security to it by guaranteeing its repayment. This trust may then be divided into units and investors may commit to it and become beneficiaries.

Depositor → Bank
Bank → Sm. Business

This has been the traditional model of lending over the past couple of decades.

Factors Affecting Continued Business Success

It is instructive to remember that many financial institutions are not many years away from a period of much lower profitability and significant asset impairment. Performance has been helped by steady economic growth, declining interest rates, and low inflation rates. Fortunes can shift quickly, and they will. Well-publicized profits mask some important challenges that our domestic institutions will have to face and manage if they are to continue to prosper in a much more competitive global environment and marketplace, for example:

- Canadian Financial Institutions generate only average profits compared with European counterparts;
- Canadian banks are more highly leveraged than many of the stronger banks around the world;
- The Canadian bank numbers are less impressive compared with recent efficiency results achieved by some of the world's most competitive banks – Canada's financial institutions will have to work hard to become more efficient in the future. If they do not become more productive, their competitive position is likely to erode;
- Consumer demand for multiple channels of access to banks and other financial services providers is imposing cost pressure on deposit-taking institutions. Canadians want the latest electronic channels. On the other hand, large numbers of Canadians are not yet willing to abandon their traditional channels. As a result, financial institutions currently provide overlapping points of access to their customers with the consequence of increased costs without a commensurate increase in aggregate revenue. Not surprisingly, banks are looking to sustain profitability through sources of revenue such as service charges; and,
- All of the institutions face heavy spending requirements for new technologies, staff retraining, and brand recognition – relative to their size these expenditure are enormous.

The recent and relatively short period of robust economic performance and very healthy profits of our major financial institutions should not leave Canadians with a false sense that the current strength of Canada's financial institutions, or their resulting contribution to Canada, is necessarily destined to continue. Our institutions will have to pursue vigorous strategic initiatives to maintain their financial

health. Weak financial institutions do not serve their customers well and do not play the role they should in fostering economic growth and employment.

Consolidation

Consolidation is a worldwide phenomenom aimed at achieving efficiencies by eliminating excess capacity and capture synergies that come from larger size and more varied product offerings.. In Canada, there has been a fairly rapid consolidation process at work in the insurance sector. Consolidation also continues in the deposit-taking sector as well as the proposed bank mergers.

Second-Tier Institutions

Some have contended that Canada does not have a well-developed second tier – there is considerable truth to this assertion. There are difficulties in raising capital to support infrastructure development and business growth, and there is too often a lack of concerted action on significant business issues because of disagreements among self-governing member institutions. The Task Force believes that the credit union movement presents a framework for the effective delivery of community based financial services to individuals and small business. The enhancement of the credit union movement alone will not be sufficient to provide the second-tier institutions that will be important for Canada in the years ahead. A number of the recommendations are directed at making it easier for new financial institutions to start up and to enter the country from abroad. The existing non-bank institutions need to become more competitive and provide greater competition to the banks.

Life Insurance Companies

The life insurance sector stands at the edge of further challenges and potential growth. Over time, some insurers are likely to become leaders of major financial services conglomerates. Public policy should ensure that there are no unnecessary barriers to full participation. The Task Force recognized three areas where policy change would be helpful:

1. Life insurance companies should have full access to the payments system;
2. Insurance companies (CompCorp and CDIC) should be integrated; and,
3. The four major mutuals should demutualize
    a. Demutualization will entail the distribution of billions of dollars with of shares to policy-holders. Will also provide access to capital markets and seize more readily that opportunities that come with that change
    b. Will require significant amounts of time and executive energy, and it may prove difficult for some of these organizations to adapt to the aggressive, value-insistent culture of the public markets

Are Canadians Well Served by their Institutions?

Individual Consumers

In most respects, individual Canadians receive good service at reasonable cost from their financial institutions when compared to other countries:

1. Interest rate spreads are the second-lowest of those for a group of industrial countries examined;
2. Canadian deposit-taking institutions are near the average for 10 countries examined;
3. The availability of payment services in Canada is excellent compared to other countries;
4. The Canadian payments system is very efficient;
5. Canada's financial institutions price their services, including credit services, at the same price across Canada

Overall, Canadian financial institutions stack up well by most quantitative measures in the delivery of financial services to individual Canadians. Canadians have a high degree of confidence in the safety and soundness of their financial institutions and "for the most part, the current level of competition in the banking and insurance sectors is seen as adequate by most Canadians. Notwithstanding these positive factors, there is continuing serious concern among the public about the level of service charges and about convenience of access to branches.

Small Business Community

Most of the positive factors noted above apply equally to small business customers. However, there is significant dissatisfaction with banks in the small business sector as it related to credit. There is also widespread perception that Canadian deposit-takers may be more risk-averse than institutions in other countries.

Summary

On balance, we conclude that the Canadian financial services sector does serve the Canadian public reasonably well compared to other countries. But, this does not mean that all is fine and that there is no room for improvement. An effective public policy framework can help create a climate for better customer service, but ultimately good service has to come for the institutions and it will be a reflection of the culture and attitudes that are instilled by committed leadership.

Positioning for Challenges

Financial institutions worldwide are pursuing many different strategies to position themselves to succeed in a more complex and turbulent environment. On the one hand, there is a wave of consolidation around the world in three categories:

1. In-pillar mergers – mergers among firms in the same business line;
2. Cross-pillar mergers – mergers among firms in complementary product lines; and,
3. Cross-border mergers – mergers among firms internationally.

At the same time as many companies are merging, others are shedding business lines to focus on activities where they can be profitable and build scale. None of the Canadian banks has shed major business lines in domestic operations. Finally, new players are appearing and some are growing with surprising speed using the latest of modern finance techniques and new technologies. Information technology companies are increasingly active in the financial services area, with a view to positioning themselves as intermediaries between the customer and a range of financial service providers.

Implications for Canadian Institutions

The major Canadian banks and life insurance companies have strong domestic franchises. Despite periods of intense competition, the major banks have been unable to move significant amounts of market share from each other, thus demonstrating the strong position each enjoys. Deposits, which have been the tradition low-cost source of financing for banks' lending activities, are not growing nearly as quickly because of sharply increased competition from mutual funds. Traditional deposit takers will have to compete more aggressively to retain deposits. Banks are responding to these challenges. Banks are increasingly becoming active players in capital markets where funding is being sourced. Banks are shifting their operations to rely more of fee-based income than on spreads. As they do so, the traditional notion of what is a bank is changing. They have become full-service financial organizations as they have pursued ways to maintain their customer base by continuing to expand into new business areas.

Criteria for Success

Canadian institutions will have to be well-capitalized, nimble, and innovative. Above all, they will need strong and bold leadership, capable of visionary thinking and making tough choices. They will also need a regulatory framework that is flexible in accommodating change. Financial institutions will need the support of the communities they serve. If our institutions are to prosper, they must put customers first in whatever they do, and they must work to build solid relationships of trust and respect with the people they result on to support them. Success does not depend only on the institutions. Public policy will make a difference. So will public support that is based on recognition of the challenges and opportunities arising from a changing environment.

Competition and Competitiveness

Ownership Policy

The Current Policy Regime

Current ownership policy is different for banks and other federally regulated institutions. Canadian banks must be widely held – no individual can own more than 10 percent of any class of shares. There is no widely held rule for federally regulated trust companies or insurance companies owned by shareholders. The Minister must approve and shareholding in excess of 10 percent, but there is no legislative restriction. There are two main policy reasons requiring banks to be widely held:

1. The absence of a controlling shareholder facilitates continued Canadian control of banks regardless of ownership. The 10 percent restriction together with certain requirements in the Bank Act ensure that the mind, management, and principal location of economic activity of our Canadian chartered banks remains in Canada. There are a number of reasons why Canadian control of our major financial institutions is important. For instance, it provides benefits to communities through philanthropic contributions and community leadership, they are the basis for domestic financial centers, they provide high-quality and skilled employment opportunities, and higher revenues that result in greater taxation for Canadian governments;
2. The absence of a controlling shareholder facilitates the separation of financial and commercial activity.

In most countries there are no formal requirements that banks be widely held. The ownership of banks has traditionally been regarded as a special concern because of the important roles that banks played in the allocation of credit in the economy through business lending, and in facilitating payments.

Reconsidering Ownership Policy

A further consequence of the wide-ownership provision is that is seriously restrains the potential for new entrants into banking. It is theoretically possible for anyone to start a bank in Canada, but after 10 years, regardless of how well the bank was doing, the owner would have to divest enough shares to come within the 10 percent restriction. The most significant regulatory barrier to entry is the inability of entrepreneurs to enjoy the fruits of their investment. We believe that if competition is to be encouraged, those willing to take risk should be permitted to reap the rewards when they are successful. If we are to enjoy the benefits of increased competition in our marketplace we need to encourage the entry of additional institutions and the most effective way to do this is to relax the current restriction on commercial and financial separation for smaller banks. It is inevitable that some small institutions will fail – this should be regarded as a normal consequence of the workings of a dynamic and competitive system.

A More Flexible Ownership Policy

A Single Ownership Regime for All Institutions

Ownership should vary by size of institution rather than type of institution, with heavier weighting toward prudential considerations for larger institutions.

Wide Ownership for Large Institutions

The objectives served by wide ownership – Canadian control and separation of finance and commerce – continue to be valid objectives. We believe that our financial services sector should remain Canadian-controlled although it does not follow that every major institution be Canadian-controlled. The separation

of financial and commercial activity is to be encouraged. We recommend that all federally regulated financial institutions with shareholders' equity that exceeds $5 billion be widely held. As is the case with Canada's current wide-ownership policy, there should be no discrimination on the basis of nationality.

Ownership of Smaller Institutions

Institutions with shareholders' equity of greater than $1 billion and less than $5 billion would be required to have a minimum 35 percent of their voting participating shares widely held and publicly traded.

Definition of Wide Ownership

We believe that the benefits of wide ownership can be obtained by allowing the Minister of Finance in certain occasions to authorize individual shareholdings of up to 20 per cent of any class of shares so long as all shareholders so authorized do not collectively own or control more than 45 percent of any class of shares. The purpose of the 20 percent threshold is to accommodate significant transactions which are in the interest of the financial institution, its stakeholders, and Canada. The purpose of the 20 percent threshold is to facilitate strategic transactions that benefit Canada. Any widely held institution that is incorporated in Canada should be able to own up to 100 percent of any other financial institutions regardless of its size.

Ownership of Multiple Institutions

Smaller Schedule I Banks

At the moment, all Schedule I banks must be widely held. Our view is that these banks should have the greatest possible flexibility to restructure themselves, but that they should control their own destiny.

Demutualized Insurance Companies

Demutualization offers many benefits to policyholders and to the economy. These benefits include:

1. The ability to obtain liquidity for their share of the value of the company;
2. Greater flexibility in the type and acquisition cost of capital;
3. Potential to use equity as currency;
4. Ability to provide equity-based compensation; and,
5. Market discipline of being a publicly traded company

Many insurance companies that have demutualized in other countries have been granted a transition period during which they have been immune from takeover. We would not like to see any of the companies swallowed up in the early stages of their life as public companies, while their market values may still be adjusting to full recognition of worth. Large demutualizing companies will have to remain widely held during the transition period beyond by virtue of their size. We recommend that where a demutualized company proposes, and its board approves, a transaction that might violate the transition guidelines, the Minister be prepared to approve it if it is clearly demonstrated that it would be in the public interest and that it is desirable to proceed before the transition period has expired.

Flexibility

The Government should have the power to be used only in exceptional cases to approve the acquisition of a large Canadians institution by a widely held, regulated foreign financial institution, free from the impact of the widely held rules. Because this flexibility is intended to be the exception, not the rule, we recommend that the approval required by from the Governor-in-Council and not the Minister of Finance.

Summary

We believe that the ownership policy outlined above will provide significant benefits to Canada:

1. It will preserve Canadian control of our largest institutions;
2. It will facilitate alliances that can bring benefit to Canada;
3. It will encourage new entry to banking; and,
4. It will provide breathing space for demutualized insurance companies.

Business Powers

An important aspect of the vision for the financial services sector is that there should be a fully open and competitive trading and investment environment. There are a number of major areas that we have considered:

1. Access to the Payments System

At the center of the system is the Canadian Payments System (CPA), which has the mandate under the Canadian Payment Association Act to operate a national clearing and settlement system. The payments system is an invisible but critically important part of our financial services sector. Currently, the CPA has about 140 members including chartered banks, trust and loan companies, government savings institutions, credit union centrals and the Caisse centrale Desjardins. With the increasing acceptance of electronic payment and the development of easily accessible electronic networks, access to the payments is becoming a more important way of providing customer value, and a way for institutions to build long-term relationships with their customers.

The issue of access to the payments system is complex. Canadians anywhere in the country typically receive funds the same day they deposit a cheque, even though the cheque has not physically cleared the institution on which it was drawn. It is possible because the participants in the system have reasonable assurances about the creditworthiness of all the other member institutions that are issuing payment instruments. If new institutions join and are felt not be as creditworthy by the existing members, the latter might refuse to make funds available until cheques presented to them actually clear, and consumers would be inconvenienced. There is, therefore, a delicate balance to be achieved between offering more choice to consumers by expanding access and risking more inconvenience to consumers by reducing the efficiency of the system.

We believe that access to the system is currently too restricted, and that the benefits to consumers from carefully controlled expansion of participation will outweigh possible inconvenience.

2. Access to Other Networks

The development of networks, such as Interact, has served Canadians well, but it is clear that given the size of the country and our relatively small population, we are unlikely to have competing networks as is the case with other countries. One particular issue was have considered is the suggestion that functionality in the Interact system be broadened by allowing deposits to be made to any deposit-taking institution through any ATM, exactly as cash can now be withdrawn through any ATM. This suggestion has considerable merit, and we recommend that the numbers of Interac act to implement it.

3. The Retailing of Insurance

The power to retail insurance has been hotly debated. Deposit-taking institutions argue that distribution through branches, and the ability to use customer information to market insurance, would provide

consumer benefits in the form of lower costs, more choice, increased access to insurance services and more convenient service delivery. Insurance companies, agents and brokers argue that the banks will cut prices, drive competitors out and then raise prices. They claim that banks are likely to engage in coercive sales practices, such as tying insurance purchases to loan requests. On balance, we believe that consumers will benefit from more choice and that to deny choice would be contrary to the public interest. There are a number of conditions:

1. Problems with coercive tied selling should be dealt with directly and not indirectly;
2. The adoption of the privacy regime will ease concerns about the potential negative impacts of allowing deposit-takers to retail insurance; and,
3. New jobs are likely to be created as the share of new competitors grows – consumers will have more options available at better prices.

The Entry of Foreign Banks

The entry of foreign banks has been regulated since 1980. Foreign banks have been allowed to operate bank subsidiaries in Canada since 1980. Clearly, there is greater potential for foreign banks to serve Canadians, and the regulatory regime should remove protectionist barriers to their ability to operate in Canada. We believe it is important that the Government move expeditiously to allow foreign banks to operate through branches in Canada, as well as through subsidiaries. Well-capitalized smaller institutions should be encouraged to do business in Canada. We do not believe that it is in the interests of consumers or the efficient functioning of the Canadian economy to impose prudential regulation on foreign competitors simply to level the playing field. Prudential regulation should not be used where it is not required.

A Framework for Merger Review

Experience and Rationale for Mergers

The number of mergers in the financial services sector worldwide has continued to grow. Consolidation is going on in most countries, in an attempt to reduce costs and increase efficiency to prepare for what is seen by all participants as an increasingly competitive global marketplace. Mergers are driven by individuals. The expected benefits that such individuals and their boards of directors seek to derive from mergers are varied. Merger proponents point to the following:

1. Economies of Scale – Spreading costs to achieve lower average costs;
2. Economies of Scope – Cost reductions that come through sharing overhead and technology in the production of different services;
3. Operating Synergies – Success depends on entrepreneurial innovation, leadership, cultural fit, and change management skills – revenue gains through the ability to broaden the product range;
4. Technology Spending – Duplicate systems can be eliminated;
5. Access to Larger Capital Base – Greater diversification of total portfolio allows an institution to make trade-offs between higher returns and lower risks. Large amounts of capital are also necessary to participate in large bought deals and global public offerings;
6. Defense against Acquisition – Size acts as a defensive measure against takeovers;
7. Platforms for Growth – Acquisition of strategic assets where an increase in size that creates a platform for further acquisitions; and,
8. National Platforms – ‘National Flagships’ – international experience demonstrates that many firms view consolidation as a valid business strategy, and stock markets have applauded many, though not all, of the announced transactions

The Importance of Size

Size is not correlated with revenue growth directly. Size can help in spreading fixed costs. However, there is no firm evidence that larger institutions are any better at reducing their costs than smaller institutions. Being able to leverage the balance sheet more efficiently, does not always mean doing so with attractive assets or with good returns to shareholders. Larger institutions have the ability to absorb shock and the credit risks of a single counterparty or country and the market risks of their entire portfolio.

Benefits and Concerns of Mergers

Whether mergers work well or not ultimately depends on people. Mergers can be opportunities for creative and innovative leadership that can take an organization to new levels. Alternatively, they can become destructive and debilitating, where the wagons circle and all the guns point inwards. Concerns generally fall into three categories:

1. Employment Impacts
2. Decreasing Competition
3. Concentrating Economic Power in the Hands of the Few

Conclusions on the Evidence

In the banking industry the research appears to demonstrate that economies of scale are important for particular functions over asset size ranges that appear to be increasing. It does not hold that larger institutions always capture the opportunities. On the other hand, the size of the capital base of a financial institution does appear to be important in providing more opportunities for companies to increase their leverage and to diversify their risk. This can increase profitability with do diminution in safety. It is also important to look beyond efficiencies and synergies to the strategic platforms that mergers may create for their proponents and the country. The challenge for the merger proponents will be to demonstrate, and ensure, that the community is not asked to pay an unacceptable price to realize those opportunities.

The Canadian Context

Despite the geographic and population challenges of the country, Canadians have benefits from a national market for financial services, with national pricing and efficient coast-to-coast clearing and settlement systems, even though this has resulted in a system that is highly concentrated compared to that of many other countries. Canada has the most highly concentrated baking sector using the five-bank ratio, and the fourth most concentrated using the three-bank ratio.

Consolidation is also increasing in the banking sector, but from a much higher base. It is interesting to note that although the five largest banks account for almost 86 percent of personal deposits in banks, their share of total personal deposits is much lower at 58.1 percent. As Canadian financial institutions consider their own strategies in response to the forces of change and to new actual and potential competitors, they are faced with serious questions about how to position themselves in changing markets. It is the Government's responsibility to review the public policy aspects of mergers and to ensure that they are in the public interest.

Merger Review Process

The interim report considered the question of whether big financial institutions should be barred from buying other big financial institutions as a matter of policy. A big shall not buy big policy as it affects transactions between entities other than two Schedule I banks, should not have the general application and that any such proposed transactions be reviewed on their merits. No transaction should be automatically

rejected. Each should be reviewed on its merits. The process to be recommended ought to be transparent, efficient, and cooperative. It is important that undertakings be required to assure that mergers meet the public interest and be strictly enforceable in law. We recommend two additional measures:

1. Mergers that do not meet the size criteria that make a public interest review necessary can proceed without the formal tabling of public documents; and,
2. Any transaction so small that they do not require pre-notification under the Competition Act may be rejected or accepted by the Superintendent of Financial Services and not necessarily the Minister.

For any merger the Minister should be empowered to exempt the transaction from the review process set out when, on the Superintendent's recommendation, an expedited process is in the best interests of the financial system.

Empowering Consumers

Introduction

The approach to the consumer issues is driven by a wider vision of the sector. A desirable financial service sector should provide the following characteristics:

1. Choice with the absence of coercion;
2. Transparency and disclosure;
3. Accessible and effective redress mechanisms;
4. Access to and control by consumers over personal information

Two sets of benefits flow from these characteristics:

1. Assurance that in a marketplace where there are imbalances of information, resources, and power in commercial relationships, basic consumer rights are protected; and,
2. Actual improvement in the functioning of the market place through protection of consumer rights

Consumer Protection Responsibilities

Consumer protection is shared between both federal and provincial governments. The federal government ought to implement our proposals to the full extent of its jurisdiction, and the provincial governments move their legislation toward best practices where these are not already reflected.

The Changing Environment

As technology and globalization lead the nature of the relationship between institutions and consumers is changing. Emphasis is now placed on the 'total customer relationship' which from a provider's perspective entails cross-selling products to maximize the 'share of the wallet'. Financial services are not easily compared. This makes shopping around difficult. Many customers have ongoing relationships with providers that can make moving business costly. Innovations, facilitated by technology, promise to offer consumers more choice of product, provider, and delivery channels. The challenge of public policy is to build a framework that can ease concerns of complex product offerings, the desire to cross-sell products, and the ability to keep information private, without stifling the innovation that will lead to consumer benefits.

Disclosure and Transparency

Disclosure governs what information is provided. Transparency is concerned with the clarity of that information. Information disclosed should be comprehensible and sufficient to enable a consumer to make an informed decision relating to the financial product, and should be consistent with that for similar products regardless of which institution offers them. In Canada statutory requirements for transparency are rare. The message is clear: transparency can be achieved with leadership and commitment. There are two aspects of disclosure in Canada that warrant particular comment:

1. Many financial services contracts in Canada allow the financial institution, unilaterally to amen the contract by changing, adding, or deleting any terms and conditions;
2. There is no consistent regime in Canada governing the disclosure of fees and commissions on transactions.

Canada is far from where it should be, or can realistically be, in terms of disclosure and transparency. Improvements over the transparency of financial services documents should include the production of documents that are clear in language, presentation, and organization, that are as brief as possible, and that present all essential information to the consumer before the purchase is made. Increasing transparency and the allocation of resources to this task ought to be committed to by industry leaders. Also,

governments ought to give weight to the desirability of transparency. Finally, governments ought to require the disclosure of all transactions-related commissions and fees to financial intermediaries, and it should be illegal to have contractual terms that permit institutions to unilaterally amend consumer contracts.

The Protection of Personal Privacy

Privacy includes the right of individuals to determine for themselves when, how and to what extent information about them is communicated to others, as well as the right to negotiate their relationships with others in order to establish limits defining the legitimate use of information. The overwhelming majority of Canadians asked opt for stricter privacy rules and less convenience when presented with a trade-off between the two. In 1996, the CSA developed the CSA Model Code setting out 10 privacy principles. The protection of privacy under these codes is voluntary and based on industry self-regulation. The federal government has announced its intention to introduce, in 1998, legislation that would apply to the private sector and set clear and predictable rules governing the protection of personal information (PIPEDA). Through this legislation, for instance, customers must consent specifically to the financial institution's using personal information to market products and services to its customers, either directly through the bank or through its existing subsidiaries or affiliates. Personal privacy should be a matter of personal preference. It can only be so if consumers have explicit, understandable choices presented to them at an appropriate time in the purchase process so that they can indicate their preference clearly and unambiguously. As the financial system becomes more integrated, however, and the use of technology becomes more widespread, the possible abuse of personal information inherent in a relatively loose privacy protection system will multiply. It will be important to have high standards of behaviour to preserve the integrity of the relationship between customer and institution. Individual sectors, such as the financial sector, should be required to develop binding sectoral codes consistent with the legislated minimum standards and going beyond them where appropriate. There should be a redress mechanism for consumer complaints and a right of civil remedy.

Basic Minimum Standards

The identification of the purpose for which the information is being collected should be specific to the relationship desired by the customer. The consumer should be asked clearly and explicitly what relationship is being sought with the institution. Consent to the collection, use or disclosure of personal information should be express, not implied. Any customer should have the right to revoke or alter consent at any subsequent time. Any customer should be entitled to access his or her information file. If access to any information in the file is denied, the customer should be informed in writing of the specific grounds for the denial of access.

Designated Coverage

The federal government should legislate a privacy regime that would apply to all federally chartered financial institutions, and should consult with provincial governments in order to arrive at a proposed legislative package that could form the basis for harmonized legislation across the country, while maintaining minimum standards at least as high as those set out above. Provincial governments should set out a similar regime that is harmonized with the federal regime.

Coercive Tied Selling

There has been considerable debate over the practice of coercive tied selling. Tied selling is widespread in our economy, and is generally considered a good thing as it can offer consumers more choice and

convenience. Tied selling itself is a neutral concept. What is abusive is coercive tied selling. Unfortunately, there is no simple black-and-white definition of when coercion occurs that will serve for all purposes. Institutions do not condone coercive tied selling and there is broad agreement that it is unacceptable business practice, yet it does occur.

As convergence continues to occur within the financial sector and as institutions and intermediaries offer a broader range of products, which they will wish to present to consumers in attractive packages, tied selling is likely to increase. The basic premise is that all consumers are entitled to expect freedom from coercion by the businesses with which they deal, including financial institutions. There are four basic ways to strengthen the legal regime that applies to coercive tied selling:

1. Legislate a general proscription against coercion;
2. Regulators should be given the legislative authority to designate other specific products or services to which the coercive tied selling prohibition would apply;
3. Products ought to be itemized and priced as different components so that consumers can make comparisons to stand-alone products and other combinations; and,
4. Remedies should be legislated, including the right of rescission of contract and the possibility of private actions that would include punitive damages.

Consumer Redress: Financial Sector Ombudsman

The hallmark f a well-functioning system is the way that it deals with mistakes. Consumers may require different redress options depending upon the nature of their concern. A general forum should satisfy four principles: it should be accessible, independent, transparent and efficient. A system that provides a good model to build on is the office of the Canadian Banking Ombudsman (CBO). The federal government should establish a single financial sector ombudsman office, and membership for all federally chartered financial institutions and their regulated subsidiaries ought to be mandatory. The office should be structure so that provincially chartered institutions could belong as well, either voluntarily or as a requirement should provinces choose to make membership mandatory.

Strengthening Consumer Organizations

The measures recommended in this chapter will provide a stronger and more effective framework of consumer protection. Documents will become more readily available and easier to read and understand. Consumers will have clear choices about the use of personal information. In clear and simple language, consumers will be advised at the point of sale what coercive tied selling is and that it is illegal. And consumers, if they are aggrieved, will have ready access to a single, comprehensive ombudsman system that will deal quickly and effectively with complaints.

The Task Force has considered two options:

1. Utility-Funding Model – in this model, utilities include in their mailing to customers a notice that allows customers to make contributions to a ratepayer' group that represents their interests at regulatory hearings. Financial Consumers Organizations (FCO) mandate would be to educate consumers about financial service industry issues, provide comparative shopping services and help with complaining about products or services, and advocate for consumer interests before the legislatures, regulatory agencies, and the courts. The key functions of an active consumer advocacy group should be to educate and inform consumers, to promote comparison shopping, and to advance their interests in exercises of policy or regulatory reform.
2. Office of Consumer Protection – created at the federal level OSFI would take on new responsibilities. The federal consumer protection functions should be left with OSFI but

changing its mandate to reflect this role and enhancing its governance structure by adding a board of directors.

It is important to move forward to strengthen consumer advocacy groups and to enable them to participate in the multipartite exercises that have been recommended to be carried out with respect to improving transparency and developing stronger privacy codes. The voice of consumer groups ought not be lost to public debate in Canada. It is important that the Department of Finance, in considering financial sector policy issues that would benefit from considered consumer input, should work with Industry Canada to ensure that resources are available to support project research.

Improving the Regulatory Framework

Introduction

There are two rationales for prudential regulation:

1. Safeguarding consumers against the risk of institutions failure – individual consumers cannot be expected to be aware of the risks; and,
2. Protecting the financial system from breakdown that can result from a loss of confidence.

The federal system of prudential regulation is administered primarily by OSFI. In addition to OSFI, the CDIC protects individual deposits to the extent of $60,000 per insured deposit. Provincial governments also have prudential regulators. On balance, Canada's regime works will and is effective. On a size-adjusted basis, it costs about one ninth as much as the regulatory regime in the US. There are new challenges to the regime, however, as recent international regulatory and coordinating activities raise specific issues that need to be addressed.

International Activities

Basle broke new ground by recommending minimum capital adequacy tests and standards for banks regardless of which country they operated in. By 1992, all major industrialized countries had adopted those standards and their regulators continue to apply them. The Basle Committee has extended its work in three directions:

1. Capital Standards and Adequacy Requirements;
2. 25 Core Principles for Effective Banking Supervisions suggestions; and,
3. Principles and standards for the regulation of financial conglomerates.

Canada has been a very active player in international regulatory and coordinating forums, particularly for banking and insurance. A sound financial system is fundamental to healthy economic performance. International coordination and regulation is not a substitute for a strong national regulatory system. Canada has been an active proponent of measures to implement best practices in all countries.

Implications for Canada

There are two implications that flow from our review of international efforts to strengthen regulation:

1. Complexity – how ought financial service provides be regulated which considers bundling together of risks that were previously isolated, the emergence of new types of risk, and the increasing need to understand how risk is being managed on a global basis. National regulatory regimes should develop in ways that are consistent with and reinforce international cooperation;
2. Effective international cooperation will be slower in coming than is desirable. It will be imperative to ensure that our own system remains strong and supportive of national objectives.

The Role of OSFI: Mandate and Governance

Broadening OSFI's Mandate

The Task Force believes that OSFI's mandate needs revision in three areas:

1. The responsibility to administer consumer protection provisions of federal financial institution legislation should be an explicit part of OSFI's mandate;
2. It is imperative that the impact on safety and soundness be weighted against the particular contribution to competition that such new entrants or innovations might bring to consumers, and that an appropriate balance be struck. OSFI's role should be to actively promote or foster

competition. It is, first and foremost, a prudential regulator. There ought to be discretion for the Minister to reduce the amount of capital now required to start a new financial institution, on the basis of an assessment by OSFI of the business plan; and,

3. The obligation of OSFI to protect the rights of creditors is inappropriate. OSFI may be able to sustain greater focus if its obligations are confined to policyholders and depositors.

OSFI's governance should consist of a mix of experienced business people independent of institutions supervised by OSFI, people familiar with consumer issues, and persons from professional disciplines who are familiar with issues confronting the sector and its regulators.

OSFI now regularly deals with conglomerates with complex corporate structures, global activities, and a broad and constantly changing range of products. In that environment regulation becomes more complex, and more reliant on the assessment of the risk management techniques and capabilities of the regulated institutions.

More Effective Governance of the Payments System

At present the governance of the payment system is in the hands of the Canadian Payments Association, which is governed by a board of directors with equal representation from bank members and non-bank deposit-taking institutions. In order to ensure that payments system decisions are consistent with the public interest, the Minister ought to have the authority to review and revoke changes in the rules of the CPA.

Streamlining Regulatory Processes

It is important that approval processes be efficient and as transparent as possible, and that overlap and duplication be eliminated where possible through delegation or harmonization. Three areas to consider:

1. Intergovernmental Overlap

Strides have been made in harmonizing regulation among the provinces and introducing more effective federal-provincial operating procedures. Initiatives that could be taken to make further progress toward reducing duplication and achieving harmonization include:

- Developing common capital adequacy tests
- Establishing centralized reporting databases
- Delegating solvency regulations

2. OSFI and CDIC Overlap

CDIC has no direct supervisory role. It requires that it be instrumental in the promotion of standards of sound business and financial practices for member institutions. This overlaps with part of OSFI's mandate to promote the adoption by management and boards of directors of financial institutions of policies and procedures designed to control and manage risk. We believe, however, that the insurer and the regulator have different purposes that are clearly distinct and should remain so. The regulator's interest is in rehabilitation and the insurer's interest is in minimizing exposure.

3. Streamlining Approvals

OSFI has put forward two broad proposals: reducing the number of situations requiring approval, and improving the efficiency of the approval process.

Deposit Insurance Regulation and Policy Holder Protection

The CDIC insures deposits at banks and most trust companies. CDIC is a federal Crown corporation and the federal government guarantees its obligations, although payments made by CDIC are recovered from deposit-taking institutions by way of premiums and there is no cost to the taxpayer. ComCorp, on the other hand, provides compensation coverage for policies issued by the life insurance industry. It is funded by the life insurance industry. The life insurance industry has been arguing for some time that insurers are disadvantaged in the marketplace when selling products similar to those of deposit-taking institutions. The perception is well-founded. CDIC does provide potential strength, because of the federal guarantee, that ComCorp cannot. This market reality creates a disadvantage for life insurance companies in competing against banks and trust companies – competitive inequity.

In order to correct the competitive inequity we support the facilitation of demutualization and the provision of access to the payments system. These initiatives will place life insurance companies in a better position to offer meaningful competition for wealth management services. Equality of treatment should be reconsidered for three principal reasons:

1. Risk Management – the risk management characteristics of the payment system are being strengthened through the Large Value Transfer System and the regulatory role of the Bank of Canada – life insurance companies ought to become members of the payments system immediately;
2. The primary rationale of the CDIC is to protect the saving of unsophisticated consumers. As such, we see no reason why a consumer wishing to invest through a deferred annuity issued by a life insurer should have second-class coverage compared to those purchasing a GIC through a bank; and,
3. If deposit insurance serves to support second tier banks who do not have the branding of the major banks, then there is no reason not to extend such support to other products through some similar arrangement.

ComCorp and CDIC should be put on a common footing. Both organizations should have a federal guarantee and the ability to borrow from the Consolidated Revenue Fund. Moreover, convergence at both the product level and the institutional level requires a parallel convergence of compensation plans.

These proposals can be met in a number of ways. First, ComCorp may be integrated into CDIC with supervisory responsibilities transferred to OSFI. Second, an independent insurer may be legislated to take on the responsibilities of both organizations.

Regulating Market Entry without a Physical Presence

As technology increases the ability of foreign players to operate without a physical presence, the gap in the regulatory regime becomes clearer. International cooperation is required for effective action, and premature domestic regulation may stifle innovation and experimentation. Three basic objectives:

1. There should be no restriction on Canadians' ability to choose from the widest possible selection of financial service providers and products;
2. Information should be easily available about providers in order to make informed choices; and,
3. Any regime must be workable and not discourage entry into Canada

It is desirable that providers of services to Canadians follow Canadian consumer protection rules and submit to Canadian jurisdiction, to the greatest extent possible. Three requirements are necessary:

1. The class of potential providers must be identified and authority assigned to deal with them;
2. Potential providers should be divided into those that wish to lend money to them and those that wish to take money from them; and,
3. Appropriate measures should be developed to deal with each category of provider.