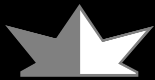

Task Force on the
Future of the
Canadian Financial
Services Sector

Report of the Task Force

change challenge opportunity

September 1998

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September 14, 1998

The Honourable Paul Martin, P.C., M.P.
Minister of Finance
House of Commons
Ottawa

Dear Mr. Minister:

We have the honour to enclose the Report of the Task Force on the Future of the Canadian Financial Services Sector. The report responds to the terms of reference which you established on December 19, 1996. It sets forth our unanimous conclusions and recommendations in respect of the issues that you placed before us.

With the report we are delivering five background papers, each of which discusses in detail the reasoning which has led us to our conclusions. We are also delivering to you today 18 research studies which the Task Force commissioned and which underlie our work.

We wish to thank you for giving us the opportunity to serve Canada by participating in this challenging review. We hope that our recommendations will provide you with helpful information and guidance.

We have titled our report *Change, Challenge and Opportunity*.

We are living in a turbulent period. Change is a hallmark of our times and the pace of change seems to be accelerating.

Change presents challenges to all of us – to our financial institutions, which are facing new forms of competition in markets that are increasingly global; to consumers, who are presented with increased choice but also new risks and different relationships with providers; and to policymakers and regulators, who require flexibility and skills that have not previously been necessary to fulfil their important public policy responsibilities well.

Our report sets out these challenges in some detail. It also points to the significant opportunities that change is bringing. Canada is, on balance, well positioned to benefit from a healthy, dynamic, innovative and competitive financial services sector into the next millennium. For a small country in population terms, Canada has many relatively large and successful financial institutions. We believe that they, along with new entrepreneurs in the financial services sector, are capable of positioning themselves so that they will be positive forces in the Canadian economy in the years ahead.

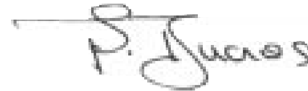
A strong financial services industry, based in Canada and capable of carrying on successful operations both at home and outside our borders, is clearly important to Canadians. We believe that it is within our reach, and that our recommendations will assist Canadian institutions, consumers, policymakers and regulators to meet the challenges of change and to realize the opportunities.

The changes are inexorable and we cannot ignore them or pretend they do not exist. For financial institutions, their customers and public policy, reliance on the status quo is no option.

Because of the speed of change, we urge you and your colleagues to deal promptly with the public policy issues we have identified.

Yours sincerely,

Harold MacKay, Chairman



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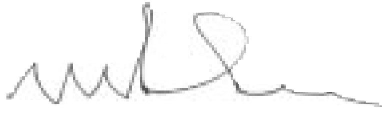

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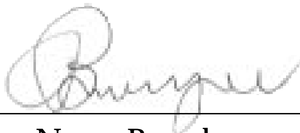

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Lynne Toupin

Acknowledgments

We wish to thank those Canadians who took the time and made the effort to inform us of their views. Through your participation you have made an important input into critical issues of public policy for our country.

We extend our appreciation to those who authored our external research studies. The authors, a full list of whom is set forth in Appendix 3, have done research that has greatly assisted us. We are sure that this work will also provide valuable input to action planning by governments, financial institutions and others in the community.

The members of the Task Force are particularly grateful to the hard working staff with whom we have been blessed. Their energy, dedication to the task and unfailing good humour and collegiality produced, in a short time frame, a team effort of impressive proportions. Our schedule was an aggressive one. Given the breadth of our task, we needed people not only with knowledge and experience, but also with curiosity and creativity to look beyond the known. Our staff met and exceeded these expectations.

We owe particular words of appreciation to Fred Gorbet, the Executive Director of the Task Force. His formidable organizational and writing skills were strong pillars on which we have built our work. His substantive wisdom, intellectual rigor, and insights into the issues, from both public and private sector perspectives, have been invaluable to us and have been of great value to Canada.

Our senior research staff, Michael Andrews, Beth Atcheson, John Chant, Louise Pelly and Kevin Wright, led our research efforts and were the principal authors of the five Background Papers which underlie this Report. We thank them for taking leave of their tasks elsewhere to help us with our work. We also owe a special debt to Michel Caron who reviewed and commented on the Background Papers and the Report as they were written.

The remainder of our research team and staff worked hard and effectively together, despite the sometimes tight deadlines and what must have appeared tedious rounds of edits, to allow us to complete our work. They have made it possible for us to meet our schedule and to do so, we hope, in a way that will allow us to make a solid contribution to Canadian public policy. We gratefully acknowledge the support of Danielle Bryden, Jim Callon, Françoise Charlebois, Stephen Frank, Bob Hannah, Neil Mohindra and Alva Smith. We want to say a special word of thanks to Christine Daniel who provided unflagging administrative support to the Chairman and Executive Director and other members of the Task Force.

We recognize the contribution of James Baillie, Barbara Rae and Guy Saint-Pierre who served as Task Force members, and in the case of Mr. Baillie as Task Force Chair, during a portion of the work of the Task Force.

Finally we would be remiss if we did not express our gratitude to Frank Swedlove of the Department of Finance, who was a helpful source of background information when we needed it.

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Chapter 1

Overview

The last decade has been a period of great turbulence and massive change.

Extraordinary advances in technology and knowledge have enabled entrepreneurs and innovators to develop new products, new services, new ways of doing things, new distribution channels and new industries. We are living through an information revolution that is expected to continue well into the next century. This revolution is providing an exploding range of choices and opportunities to individuals. The rapidly spreading use of the Internet, for example, offers the possibility of accessing information, news, opinion and – increasingly – goods and services from around the world almost instantaneously, without leaving one's own home.

Existing businesses of all sorts are affected by this information revolution, and new businesses are being created. They are challenged to meet diverse and sophisticated consumer demands in a marketplace that is increasingly global and constantly changing. Financial institutions, more than most, are profoundly challenged by these changes because they rely to such a great extent on information and on information processing.

These waves of change have already led to great success stories and some notable failures. Change can present overblown expectations – for both institutions and individuals. It will be ignored at the peril of any nation. Complacency and failure to adjust and respond will most certainly lead to problems.

As a society, we are all coping with change, trying to manage the challenges and seize the opportunities that change presents. Our report aims to help this process in the context of Canada's financial institutions. We attempt to provide an independent and objective look at what this era of change means to Canada and Canadians. An objective look is certainly important because this is a "noisy" environment in which special interests and particular agendas abound. We provide a context, weigh the evidence, set out some directions and make specific recommendations that we believe can help governments, financial institutions and consumers work together to build a financial services sector that will serve Canada well.

It is critically important that we do so. A healthy, dynamic, innovative and competitive financial services sector is fundamental to our individual and collective well-being. Our financial institutions employ more than half a million Canadians directly. They play a major role in allocating the savings of Canadians to productive investments – providing a return for individual Canadians, while contributing to economic growth and job creation throughout the country. As well as managing people's savings, they offer protection against risk through various types of insurance. Canadians deal with banks, trust companies, credit unions, insurance companies and other financial institutions on a regular basis, and trust them to manage some of their most sensitive and personal affairs.

Many Canadians also have a direct financial stake in the health of financial institutions as shareholders, either directly or through mutual funds or pension plans. Some estimates suggest that half of all Canadians, directly or indirectly, own shares in Canadian financial institutions.

When financial institutions work well, our economy functions better and our personal lives are made easier. When they don't, financial institutions and economies can deteriorate. Opportunities disappear. The savings and sometimes the net worth of individuals can evaporate overnight. The experience of recent months in Asia and Russia makes these points in a dramatic way. Suddenly, and unexpectedly for the most part, individuals, enterprises, entire industries and governments have been profoundly shaken in these Asian societies and, more recently, outside the Asian region as well.

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.

We believe that Canada should have some benchmarks to determine where it wants to go and to assess how well change is being managed to that end. The Task Force has forged a vision that we propose for the financial services sector. This vision is the touchstone we have relied on in developing the 124 recommendations we set out in Chapter 10. We think it is important, too, for Canada to have such a vision. We hope that our vision can be embraced by the broader community.

Four Main Themes

Our recommendations range broadly but they cover four main themes, consistent with our vision.

Enhancing Competition and Competitiveness

We believe that Canadians will be best served by a dynamic, competitive marketplace, open to the world, with many successful Canadian providers and

with opportunities for many new entrants. We believe that individual Canadians and small businesses, in particular, are not as well served as they should be and can be. We present a focussed four-point strategy to enhance competition. Recommendations are directed at:

- enhancing the ability of existing institutions, particularly life insurance companies, credit unions and caisses populaires, and mutual fund companies to compete with the chartered banks;
- removing barriers to entry for new domestic competitors;
- increasing the opportunities for foreign banks to enter Canada and provide financial services in our marketplace; and
- empowering consumers so that they can act as a disciplining force in the market and make competition more effective.

We recognize that as competition intensifies worldwide, spurred on by globalization and technology, our domestic institutions will have to adjust to remain vibrant and healthy. It is important to all of us that they do so.

Examples abound of many different strategies that are being pursued. Business leaders have the responsibility to develop strategies that can position their institutions to compete with the best and succeed. Where the nature of the strategy selected requires government approval (mergers being one example), government has the responsibility to ensure that business strategies are compatible with the public interest and bring benefits to Canada. We make a number of recommendations that will increase the range of strategic options open to institutions. We also recommend a review process for merger proposals. In our view, this process presents an opportunity to assess in an open, transparent and timely way whether merger proposals that meet institutional objectives are consistent with the public interest.

Empowering Consumers

Consumers provide an important discipline to competition when they understand what is being offered to them, can comparison-shop, are in a position to make informed purchases, and have effective redress mechanisms when they are not treated properly. 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. Empowering consumers is an important part of our strategy to enhance competition and make it more effective, for the benefit of all.

But beyond this, there are reasons to seek greater protection for individuals who are often entering into significant financial transactions with inadequate advice or understanding of the consequences of the transaction or the

alternatives available. Protecting consumers is important for individual Canadians, as well as for society.

We make recommendations to improve disclosure and transparency so that better information will be available to customers. We recommend a stricter privacy regime than now exists and a legislative ban on coercive sales practices that is both broader and stronger than the current provision. We also recommend that the Government establish a financial services ombudsman to provide easily accessible, independent dispute resolution to consumers who have complaints.

Canadians' Expectations and Corporate Conduct

A critical part of our vision for the financial system we see as desirable is that all major participants enjoy the confidence and support of Canadians. That is not the case today. We examine the rationale for the high expectations of Canadians with respect to how their financial institutions, and particularly the banks, respond to community needs, including the important need to adequately finance and support creditworthy small businesses. We conclude that it is legitimate for those high expectations to be held and that it is in the interests of institutions to recognize this legitimacy.

We make recommendations with respect to a number of specific issues, including access to basic financial services, that have been raised as examples of areas where institutions should be more sensitive to community needs and more active in partnerships to help meet them. We recommend that all financial institutions produce annual Community Accountability Statements as a basis for dialogue and discussion about ways to enrich and strengthen the relationship between our institutions and the communities they serve.

Improving the Regulatory Framework

We have a strong prudential regulatory framework that, in many respects, is a model that many other countries are now emulating. But the world is changing quickly, and new and complex types of risk require new approaches. In addition, it is important that the relevant regulatory structures support broad public interest goals, such as enhancing competition and protecting consumers. We believe that the federal prudential regulatory framework can and should be further improved.

We make a number of recommendations to strengthen the governance and broaden the mandate of the Office of the Superintendent of Financial Institutions (OSFI) and to streamline regulatory processes. We also address the need to amalgamate the deposit insurance plans that apply to banks and trust companies, and the policy holder compensation plans that apply to life

insurance companies, as the functions of those institutions continue to converge and become increasingly associated in financial conglomerates. Finally, we address the issue of electronic entry of providers without a physical presence.

Some Basic Premises

Through the balance of this report we elaborate our conclusions and recommendations in these four areas. Taken together, they represent an integrated and cohesive approach to providing a renewed public policy framework within which governments, institutions and consumers can work constructively to build a strong, vibrant financial services sector that will serve Canadians well, into the next millennium.

As we studied the many submissions we received, met with Canadians, reviewed our research, reflected on our own experience and deliberated among ourselves, we found it useful to identify some basic premises that helped shape our approach to the issues before us and to our recommendations. We set them forth here because we believe that they will assist readers in understanding our perspective on the issues covered in this report.

Managing change: In a period of rapid change worldwide, Canada – its institutions and people – cannot be immune from change. But recognizing the need to accept change does not mean that Canadians are without power to influence and shape the ways in which change will affect them. The forces of change are global but their impacts will be local. There is a role for public policy and for government action to ensure that change is managed in a way that recognizes Canada's unique history and geography, and respects Canadian priorities.

Technology and change: We expect that, over time, there will be an increasing reliance on technology in the creation, production, distribution and regulation of financial services. We believe it is inevitable that direct access, increasingly through electronic channels, will take a far greater share of the market and that this will happen sooner rather than later. This will provide greatly enhanced consumer choice and competition in most markets, but will lead to difficult adjustment issues for institutions and for some consumers.

Entrepreneurial culture: It is important to foster a more dynamic and innovative culture in Canada, one that values and rewards risk-taking. We need to encourage those with the foresight and courage to seize the opportunities presented in a world of rapid change in order to enrich our economic, social and cultural well-being.

The basis for regulation: There is a strong public policy rationale for regulating the financial services sector, both for solvency and for market conduct. Deposit-taking institutions and insurance companies, when they take deposits and premiums, are making a "promise to pay" in the future under specified

terms and conditions. Prudential regulation is very important because it provides some assurance that the institution will be able to redeem its promise. Market conduct regulation, which includes consumer protection regulation, provides some assurance that consumers can make informed choices and have access to appropriate redress mechanisms when they are aggrieved. Public policy must focus on achieving the best balance between allowing the innovation and efficiency that come from unfettered competition and intervening to ensure that public policy goals are met.

Prudential regulation: Prudential regulation has typically focussed on the safety and soundness of institutions. We believe that prudential regulation should strive for a better balance between safety and soundness, on one hand, and facilitating competition and innovation on the other.

Market conduct regulation: We begin from the premise that effective competition demands informed and vigilant consumers. If consumers have clear, understandable information, the ability to make meaningful choices, and access to redress mechanisms when they are treated unfairly, only then will markets work as well as they should. Regulatory intervention can, in this sense, make markets and competition more effective even though it imposes costs on some participants. This requires that consumers be empowered to a greater extent than they now are. It also requires that consumers make efforts to inform themselves well about the options available.

Ministerial discretion: Government must continue to play a key role in the regulation of the financial services sector. Currently, the Minister of Finance has considerable discretion over how the sector can evolve. In some instances we recommend processes and criteria that we believe will assist the Minister in the exercise of that authority. But generally our recommendations do not limit the decision-making authority of the Minister of Finance and in some areas they increase it.

Need for flexibility: Looking ahead to the need to manage change, we believe flexibility and great imagination will be essential. Institutions and consumers will have to be willing to accept new ideas and to adapt to new ways of implementing traditional ideas. In particular, the policy, legislative and regulatory framework will have to contain considerable flexibility – certainly more than currently exists.

Importance of people: Innovative and focussed leadership will be critical throughout our institutions and within government. At the end of the day, it is people who will make the difference between success and failure, between excellence and mediocrity.

Chapter 2

Approach of the Task Force

Background and Terms of Reference

In 1992, Parliament made comprehensive revisions to the legislative framework governing federally regulated financial institutions. Prior to 1992, the Bank Act had been regularly reviewed on a 10-year cycle, but there was no regular review process for the Acts governing other financial institutions and several of them had not been revised for many years. The 1992 legislation effectively eliminated most of the historical distinctions between what had been called the "four pillars" (banks, insurance companies, trust companies and investment dealers) and allowed these institutions to compete directly with one another by expanding their business powers and allowing cross-ownership. All the legislation contained a sunset clause requiring a review within five years.

The period since 1992 has been one of sweeping change in financial services, in Canada and around the world. Against this background, the Minister of Finance appointed this Task Force in December 1996. Although several amendments to the financial services legislation were enacted in 1997, the Government indicated that a more comprehensive review would await our report.

Our terms of reference were broad. They are reproduced in full as Appendix 1. In brief, we were asked to inquire into public policies affecting the financial services sector and make recommendations to enhance:

- the contribution of the sector to job creation, economic growth and the new economy;
- competition, efficiency and innovation within the sector;
- the international competitiveness of the sector in light of the globalization of financial services, while at the same time maintaining strong, vibrant domestic financial institutions;
- the ability of the sector to take full advantage of technological advances as they occur and to meet the competitive challenges resulting from the introduction of new technologies; and
- the contribution of the sector to the best interests of Canadian consumers.

Our Approach to Our Mandate

The Task Force was established to make an unbiased assessment of the current situation and future prospects, and to make recommendations for change. Over the past 20 months, we have heard from many interested institutions, associations and individuals. It is not always easy to distinguish the private and the public interests. But that was our role.

In interpreting our mandate, we indicated in a Discussion Paper, released in June 1997, that we would seek to rely on effective competition and disclosure to the greatest extent possible, and to propose regulation only where competition and disclosure fail or are inadequate to achieve a specific public policy purpose. We also indicated a preference for a minimalist approach to regulation in that its scope should be crafted so as not to exceed the need. We emphasized the need for flexibility in regulation and warned against regulatory straitjackets that prevent institutions from adjusting to the rapidly changing world. And we noted that we would examine the issues before us from the viewpoint of whether the responses we are recommending to address the changes, challenges and opportunities facing our financial institutions and consumers will ultimately benefit Canada and Canadians.

Our responsibility was to recommend changes to current policies, legislation and practices. We have focussed on the legislative framework and regulatory practices and policies, but we have also examined the practices and policies of institutions. The bulk of our recommendations are directed toward governments, and primarily the federal government, which created the Task Force. But these recommendations are set out in a context where we explicitly acknowledge that government alone cannot create the dynamic, vibrant financial services sector we believe Canadians expect and deserve. Our recommendations are therefore framed in a context of shared responsibility

How We Did Our Work

Our report reflects a process that was enlightened by broad consultations with Canadians, through submissions and meetings, and by an extensive program of research both internal and external. We produced an Interim Report in July 1997. Throughout our process we maintained a World Wide Web site, where we posted information relevant to our work.

Consultations

The Discussion Paper of June 1997 set out a number of questions, derived from the terms of reference, that we thought of sufficient importance to seek comment. Interested parties were invited to make submissions in response to the Discussion Paper, and we received more than 250 submissions. From

September to November 1997 we travelled across Canada, visiting 11 cities and meeting with more than 100 individuals and groups who indicated a desire to speak with us. A list of those who made submissions and met with us can be found in Appendix 2.

Research

We commissioned 18 external research studies. These ranged broadly and included, for example:

- a broad review of the changing landscape for Canadian financial services, focussing on new forces, new competitors and new choices;
- a study of consumer protection practices in the European Union, five European countries, the United States and Australia;
- issues related to privacy;
- issues related to competition policy;
- the taxation of financial institutions;
- financing small businesses and knowledge-based industries; and
- automobile leasing.

We also undertook a major piece of public opinion research to understand better the views of Canadians on a range of issues. These research studies were invaluable in assisting us in our work. A full listing of the studies and their authors can be found in Appendix 3.

Interim Report

In June 1997, in response to proposed mergers in the Canadian financial services sector, the Secretary of State (International Financial Institutions) asked the Task Force to provide preliminary views on the appropriate criteria which the Government should take into account in reviewing particular transactions, and their relative importance. The request made it clear that the Government was not asking, at that time, for views on the 10 percent widely-held rule for domestic banks, or the appropriateness of a merger of Schedule I banks.

We submitted an Interim Report on July 11, 1997, which concluded that mergers of the type considered (that is, excluding Schedule I banks) should be assessed on their merits and according to a procedure and criteria that we identified in the report. A copy of this Interim Report is attached as Appendix 4.

Communication with Canadians

From the beginning, we sought open and ongoing communication with Canadians. To that end, we established a Web site and maintained, for public view, the Discussion Paper, the Interim Report, submissions, speeches, a list of research projects, news releases and other relevant information, including information on how to contact the Task Force.

This report, the supporting background papers and the research studies are available on the Web site.[1]

Bank Mergers

During our mandate, two mergers of Schedule I banks were proposed. The Royal Bank of Canada and Bank of Montreal announced their intention to merge on January 23, 1998, followed by Canadian Imperial Bank of Commerce and Toronto-Dominion Bank on April 17, 1998. The Minister of Finance responded, in respect of both mergers, that he would take no action until our report was tabled.

The Task Force does not have a mandate to review these specific transactions and we have not done so. We have reviewed merger policy generally, and we have reviewed our Interim Report from the perspective of Schedule I bank mergers. We do not make recommendations on the transactions, but we do make recommendations on the public policy framework that should apply to mergers and on the appropriate process and criteria that should be used to assess and rule on merger transactions.

The Structure of Our Report

This report sets out our main findings, conclusions and recommendations.

The report is supported by five background papers, prepared by Task Force staff and endorsed by the Task Force. These papers reflect our internal research, the external research, views received from submissions, and discussion and review within the Task Force. They provide arguments and evidence for the conclusions reached, as well as further details with respect to many of the Task Force recommendations. The five background papers are:

[1] The Web site can be accessed at <finservtaskforce.fin.gc.ca>. The report, background papers and research studies are also available from the Department of Finance. To receive a copy, write to Distribution Centre, Department of Finance, 140 O'Connor Street, Ottawa, ON K1A 0G5.

1) **Competition, Competitiveness and the Public Interest;**
2) **Organizational Flexibility for Financial Institutions: A Framework to Enhance Competition;**
3) **Empowering Consumers;**
4) **Canadians' Expectations and Corporate Conduct; and**
5) **Improving the Regulatory Framework.**

The first two background papers deal with our first theme of competition and competitiveness. Each of the background papers has been prepared so that it can be read as a stand-alone document. This report provides appropriate references to sections of the background papers that provide more detail on our conclusions and recommendations.

Chapter 3

The Forces of Change

As we approach the year 2000, the world is already very different from the one we knew only 10 years ago. Democracy and market capitalism are becoming increasingly recognized and embraced. The communist regimes of Eastern Europe have disappeared and democracy is making further, important inroads in Latin America. China is poised to have a major impact on all of us in the next century. The ascendancy of global capital markets is one of the important forces leading to the reshaping of Europe under a common currency. It has also led to the ongoing turmoil in Southeast Asia and Russia, which is having a significant impact in that area and also in the rest of the world, including Canada.

It is extraordinary how quickly the world has changed. As the President of the World Bank recently commented:

> Ten to 15 years ago, one country in four had a democratic government. Today it is two in three. Ten years ago, a billion people lived in a market economy. Today, 5 billion people live in a market economy.[2]

The changes taking place in the world are deep and pervasive. They will continue into the next millennium in ways that are difficult to see from our present perspective.

These broad forces of change, manifesting themselves in the spread of democracy and more open, competitive capital markets, have been enabled by technology. The innovative application of technology has made travel faster and more affordable. Information can now be shared instantaneously, anywhere in the world, at reasonable and sharply falling cost. The spread of information and ideas has provided the fertile ground in which leadership and innovation have taken root and flourished.

People everywhere are being affected. In countries that are undergoing a transition to democracy and a market economy, the promise of a better life often seems frustrated by intensely painful adjustments. In industrialized countries, 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.

[2] James D. Wolfensohn, "Remarks at the Council of Foundations Luncheon," Washington, D.C., April 28, 1998, p. 3.

These changes are also affecting commerce. A new breed of active global financial entrepreneur, increasingly armed with the latest in technology and new advances in financial theory – particularly in the theory of risk management – is introducing new and different ideas about products and markets. The financial services sector is being fundamentally reshaped by the forces of technology, globalization and demographics, and by new, innovative approaches.

This chapter reviews some of the ways in which the forces are changing the financial services landscape, and it discusses some of the challenges that they raise for consumers, financial institutions, policymakers and regulators.

Technology

Information is at the heart of all financial transactions, whether one is using information on expected future prices to create a derivative product to control risk, or information about past and projected cash flows necessary to approve credit, or health information required to buy insurance. It is therefore not surprising that the continuing increase in computing power and the decrease in information-processing costs are having profound effects on the financial services industry. Since 1982, the cost of a microprocessor with a computing capacity of one million instructions per second has fallen from almost $1,000 to $1.30; within a decade, it is expected to cost only about $0.001.[3]

The availability of powerful, user-friendly computing technology at very low cost provides an unprecedented platform for entrepreneurial innovation. Talented and inventive people have applied technology to develop new ways of creating and delivering financial services products, leading to a revolution in how we think about and access financial services.

The results are all around us. Consumers are accessing financial services in new ways, through automated teller machines (ATMs), the telephone, the Internet, debit cards and smart cards. New products and services are available (from mutual funds, to index-linked GICs, to complex derivative products) that would not have been possible to produce, sell and service economically without the advances in computing technology we have experienced.

Canadians appear to be openly embracing much of this new technology. Over the past decade, the number of households with home computers has more than tripled, climbing to more than 36 percent,[4] and two recent studies put the number of Canadian households with access to personal computers at more

[3] McKinsey, *The Changing Landscape for Canadian Financial Services: New forces, new competitors, new choices*, Final Report for the Task Force on the Future of the Canadian Financial Services Sector (Ottawa, September 1998), p. 24.

[4] Statistics Canada, 1997 Household Facilities and Equipment Survey, as reported in *The Daily*, March 20, 1998.

than 50 percent.[5] Thirty-seven percent of Canadians report having used the Internet in the last three months and 28 percent indicated they have access to it through their home.[6] In financial services, Canadians adopted debit-card technology more rapidly and use it more intensively than the citizens of most other countries. In 1997, Canadians used direct payment through Interac for more than 1 billion transactions, up from 185 million in 1994.

For established providers, technology is a double-edged sword. While it offers new opportunities to serve consumers better, it can give advantage to new competitors and threaten existing franchises. This is especially true for institutions with legacy technology and distribution systems requiring complex and costly re-engineering or replacement.

Technology is enabling the mass customization of financial services products to better serve the needs of particular sets of consumers. The creation of complex derivative products to manage risk is one example of such personalization that would have been inconceivable without the increase in computing power and the emergence of new financial theories we have witnessed. Another example is the credit card market, where specialized credit card companies now offer literally thousands of different affinity credit cards to different customer segments.

So-called "mono-line companies," which specialize in a single product such as credit cards or mortgages, are providing new sources of competition to traditional suppliers through the application of technology and new ways of thinking about these products. By focussing 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. This allows them to achieve substantial economies of scale and to exploit market niches. For example, Countrywide Home Loans, which started business in 1969 and specializes only in residential mortgages, is now the largest independent mortgage lender in the United States. From 1990 to 1997, its volume of new lending grew 13-fold and its loan portfolio grew 14-fold.[7] Similarly, MBNA is a U.S. bank that specializes in credit cards by offering customized affinity cards to specific groups. The company is now active in the United Kingdom and Canada. MBNA, which was started in 1982, is the largest independent credit card lender in the world, with more than

[5] Ekos Research Associates, *Information Highway and the Canadian Communications Household: Overview of Findings*, February 1998, p. 2. A.C. Nielsen, "A.C. Nielsen Happenings: Canadians Embrace Technology for Business and Pleasure," news release, March 4, 1998.

[6] Ekos, *Information Highway*, p. 2.

[7] Countrywide Credit Industries, Inc., 1998 Annual Report, p. 4.

25 million customers, 14.4 million of whom are active borrowers with outstanding balances totaling U.S. $49.4 billion. In 1997, MBNA's portfolio grew by 28 percent, compared to an industry growth rate of 6 percent.[8]

Multi-product financial institutions, faced with these challenges, are investing heavily in information technology to build and operate state-of-the-art systems and to offer consumers options in how they choose to be served. This leads to a paradox: although the cost of information processing is falling dramatically, the expenditure on technology required within institutions continues to increase. In particular, major full-service financial institutions such as Citicorp and Chase are now spending approximately US$2 billion each, and many other U.S. and European banks are estimated to be spending well over US$1 billion annually.

As we look ahead, further developments in technology will continue to 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.[9] Human-centric technologies include advances that will make computing technology more user-friendly by innovations such as natural language recognition systems, pen-based handwriting systems, and simultaneous language translation software. An intelligent agent is a software tool that will seek, filter and package information on a customized basis. There are already intelligent agents in the financial area. For example, PrimeRate[10] allows consumers to search the Internet for the best rates on personal banking products, such as car loans, mortgages and deposits. In future, intelligent agents will learn consumers' tastes, preferences and buying habits. Data mining provides the ability to analyse customer and transaction data in order to identify new business opportunities and to individualize customer relationships.

These and other 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.

Globalization

As economies and societies are becoming more open, financial services markets (like many other markets) are becoming more global and are changing more rapidly by orders of magnitude. The spread of market economies, the breaking down of trade barriers, increases in travel, the spread of education, the

[8] MBNA has more than 4,500 endorsing organizations to whose members it offers affinity cards. See <www.mbnainternational.com>.

[9] IBM, "Banking in the Network Economy," 1997.

[10] See Web site at <www.primerate.com>.

availability of low-cost, fast transportation and, of course, the dramatic impact of applied technology are all responsible for placing the farthest corners of the world within easy reach. Many more Canadian firms are now active in export markets,[11] and as they grow and become active in more and more countries they can benefit from the support of domestic financial institutions that have more global reach, expertise and influence.

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. But it also brings new competition from financial services providers based in other countries.

Lowell Bryan and Diana Farrell, in a recent book, distinguish globalization from internationalization. International markets are largely bilateral or multilateral; global markets transcend national markets. The hallmark of a global market is a single price for the same product, in any country in the world.[12] They argue that we now have global foreign exchange markets. For example,

> Using the prices shown on a typical day in *The Wall Street Journal*, the conversion of U.S. dollars to yen, yen to Deutsche marks, and Deutsche marks back to dollars, results in virtually the same price as would have been achieved by converting U.S. dollars to Deutsche marks directly. In other words you would have to trade over a million dollars of foreign exchange value to make a $10 dollar arbitrage profit.[13]

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. Bryan and Farrell go on to illustrate that money markets are almost fully global, bond markets are rapidly globalizing[14] and the globalization of the world's equity markets has begun. The world is moving toward a truly global capital market.

The impact of these trends for financial institutions will be profound. Wholesale and investment banking are globalizing quickly, as many of the products and services are already global in nature. Today, large Canadian companies can access many, if not most, financial services from providers anywhere

[11] The number of small and medium-sized businesses that are exporters grew from 33,000 in 1986 to 86,000 in 1995. From 1992 to 1995 the value of their total exports increased by 24.3 percent, from $16.9 billion to $21 billion. See Industry Canada, *Small Business Quarterly Report*, fall 1997, p. 8, and *Small Business in Canada: A Statistical Overview*, 01-03-96, p. 11.

[12] See Lowell Bryan and Diana Farrell, *Market Unbound: Unleashing Global Capitalism* (John Wiley & Sons, Inc.: New York, 1996), p. 22.

[13] Ibid., p. 26.

[14] In 1996, total net debt issues (worldwide) on international markets accounted for 22 percent of total net debt issues, up from 16 percent in 1994. More than 50 percent of Canadian corporate bond issues are issued abroad. See McKinsey, *The Changing Landscape*, Exhibits 3-17 and 3-18.

in the world at prices that are determined by global competition. Companies such as Goldman Sachs and Merrill Lynch are operating in virtually all countries in the world and are truly global investment banking firms. Even though London is one of the world's major financial centres, the globalization of wholesale banking has resulted in the disappearance of U.K. investment banks.

Personal financial services are primarily domestic and, indeed, most retail and small business financial services are local. But even in these areas, movement is occurring that suggests the nature of the business will change over the coming decades. We are already seeing the beginnings of efforts to develop specialized niches in particular product areas and to achieve economies of scale, aided by technology, in order to become low-cost global providers. American Express and VISA are operating global credit card businesses. A new Canadian banking subsidiary of a major Netherlands banking and insurance conglomerate (ING Canada) has developed a platform to take deposits, issue credit cards and make loans throughout Canada with no branches. Specialized U.S. credit card banks are now offering credit cards to Canadians, and Wells Fargo, a California bank, is providing loans to Canadian small businesses from the United States. These institutions are targeting Canada as only one of many countries around the world that they hope to penetrate with focussed offerings based on sophisticated technology.

Demographics

Demographic trends are a third major force of change affecting the Canadian financial services sector. The baby boom cohort is composed of some 9.8 million Canadians. These Canadians are now moving into their pre-retirement years and expectations are that within the next decade or so there will be a substantial intergenerational wealth transfer to the boomer population. The combination of increasing life expectancy and resulting pressure on the ability of governments to sustain and enhance the social safety net have put greater focus on the adequacy of retirement income. This, together with a sustained period of low inflation and resulting low interest rates, has been a key factor in encouraging consumers to shift away from deposits toward securities, and toward mutual funds in particular.

An additional demographic trend that will increasingly affect financial service providers is the trend to self-employment. The self-employed now account for almost 18 percent of total employment, up from 13.3 percent in 1986.[15] Eleven percent of employed Canadians report that they work primarily from home; almost half say they work out of their home regularly or some of the time; and

[15] *Collective Reflection on the Changing Workplace*, Report of the Advisory Committee on the Changing Workplace (Human Resources Development Canada, June 1997), p. 9.

a strong majority believe they will be working more of the time from their homes.[16] These changing employment 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 forces of change discussed above create unprecedented opportunities and challenges.[17] The following section highlights some of the key issues affecting consumers, financial institutions, policymakers and regulators.

Consumers

Technology is empowering consumers as never before. Technology offers convenience. The ability to conduct routine financial transactions by telephone, by personal computer or through easily available ATMs results in a tremendous saving of time and effort for most Canadians. Beyond convenience, however, technology is also enabling consumers 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. For example, it is now possible to use the Internet to compare credit card and service fees at different Canadian deposit-taking institutions, to get comparative quotes on insurance, and to obtain comparative, up-to-date performance information on mutual funds. Canadians can deal directly with providers anywhere in the world by telephone, personal computer or, in some cases, by Internet.

Canadians have embraced the convenience and broader range of choice that technology provides. Since 1994, telephone banking has grown by 50 percent per year, personal computer banking by 10 percent per year and point-of-sale debit by 91 percent per year.[18] Over the next decade many observers expect smart cards to replace cash to a substantial degree, and new forms of money to be developed to facilitate electronic commerce.

Jeffrey Chisholm, speaking about mbanx, gave a dramatic example of how technology improves service for consumers:

> We became the first direct bank in the world to deliver mortgage approval over the Internet....
>
> In a typical transaction, the client logs on to the mbanx internet site, selects the desired options, and submits a completed transaction to the bank ...

[16] Ekos, *Information Highway and the Canadian Communications Household*, p. 6, note 9.

[17] Their impacts are discussed in Background Paper #1: *Competition, Competitiveness and the Public Interest*. See particularly pp. 19-33.

[18] McKinsey, *The Changing Landscape*, Exhibit, 3-6.

> which in turn runs it through the credit-scoring process. The system then does an on-line check with outside credit-rating agencies ... and assuming the client clears the hurdle, processes the applications through the Bank's core systems.... On average ... and for about 80 percent of our mortgage products ... this entire approval process takes just 30 seconds ... from application to approval.[19]

Another example that many consumers have personally experienced is the convenience that comes from using a payment card or credit card to access local currency in a foreign country when travelling – a transaction that can be verified and concluded from many countries in the world in a matter of seconds, and at low cost.

By and large these changes are positive, often leading to more choice, lower costs and better quality. But there are always risks and inconveniences in a period of rapid change. Information and basic education may not keep pace with what is happening in the market, and products may become increasingly complex and risky without customers' understanding or being properly advised about the risks they are incurring or the choices available to them. Many customers may find traditional ways of doing business disappearing before they are accustomed to, or comfortable with, the new ways. Those persons with low and modest incomes may be faced with daunting new barriers to participation, and innovative approaches may be required to expand the ability to gain access to and use computers. Large, increasingly complex and sophisticated institutions will be challenged in training their work force to satisfactorily and reliably explain and deliver complex products and services. In this situation there is a greater risk that institutions or individuals may be tempted to abuse customer relationships by tying sales of one product to another, or by misusing customer information. Consumer protection regulation may lag behind technological innovation and increasingly aggressive, potentially abusive sales practices.

As the opportunities available to consumers are increasing, so too is the importance of the financial decisions they are called on to make. The ageing of the baby boomers, the large intergenerational transfer of wealth that is taking place, and the erosion of social safety nets as governments come under continued fiscal pressure are all combining to make individuals' financial decisions more important to their future well-being. Is the advice that consumers are receiving up to the challenge? Are consumers starting to suffer from information overload?

[19] Jeffrey S. Chisholm, "Building a Virtual Bank for Real People," presentation to the Canadian Society's Conference on the Future of Financial Services in North America, New York University, November 6, 1997, p. 6.

Two contradictory trends are emerging. On the one hand, as technology empowers consumers, traditional customer loyalties are becoming less important. Many more products are becoming commodity-like and consumers are increasingly willing to shop on the basis of price and convenience. At the same time, as the marketplace becomes more confusing and as more complex products are introduced, consumers are becoming increasingly reliant on brand and reputation as at least implicit guarantors of value. The market is tending to divide along product lines with consumers occupying positions of both relationship-seekers and value-shoppers simultaneously, depending on the nature of the product or service. Loyalty toward the institutions themselves is vanishing.

These are important issues. There can be no question of trying to stop change. But as we develop our conclusions and recommendations, we will return to the subject of how best to deal with the many questions and challenges that change raises, while reaping the benefits.

Financial Institutions

The shape of the industry is changing quickly. The introduction of new competitors was discussed above. Existing firms are responding to the challenges of technology and globalization in a number of ways.

The first of these is *convergence of function*. Around the world and in Canada, the boundaries separating the traditional four pillars (banks, trust companies, insurance companies and securities dealers) are gone or fast disappearing. Indeed, a new pillar (mutual fund dealers) that was not regarded as a major force a decade ago has come and, as a distinct pillar, gone. Increasingly, most financial institutions are in each other's business.

Convergence is largely driven by the growing importance of asset management. All financial institutions are seeking ways to position themselves to gain an increasing share of the asset management business. There is intense competition between mutual fund companies and deposit-taking institutions; life insurance companies are also competing successfully for asset management business and in 1996, 50 percent of premium income of Canadian life insurers came from asset management rather than traditional insurance sales.[20]

Convergence sometimes takes the form of different institutions' offering products that have virtually identical characteristics. An example is a deferred annuity offered by life insurance companies and a guaranteed investment certificate (GIC) offered by banks. But convergence can also take the form of institutions' offering the products of competing institutions either directly or through

[20] Canadian Life and Health Insurance Association (CLHIA), *Canada's Life and Health Insurance Industry: Consumer Compensation Arrangements*, Submission to the Task Force, October 1997, p. 17.

subsidiaries. For example, most deposit-taking institutions now offer insurance through subsidiaries, and mutual funds in direct competition with mutual fund companies. Insurers have traditionally competed with mutual fund companies by offering segregated funds, which have the same investment profile as mutual funds with an insurance component. Insurance companies now offer mutual funds as well, and three Canadian mutual fund companies[21] are now competing with insurance companies by offering mutual funds with an insurance feature.

Convergence of function has led to conglomeration, with major banks and insurance companies, in particular, building full-service financial groups through acquisition and/or creation of subsidiaries, and at least one mutual fund company acquiring a deposit-taking subsidiary.

The second reaction, which is in some sense contrary to the first and proceeding alongside it, is *disaggregation of function*. Some institutions, in response to the forces of change, are becoming more focussed on one or a few business lines and selling off activities where they feel they do not have a sustainable competitive advantage. For example, some Canadian banks have sold their payroll businesses to more competitive mono-line companies. Lloyds-TSB, in the United Kingdom, which is one of the most profitable banks in the world, is focussed only on retail banking. Bankers Trust in the United States has sold its retail bank and focusses only on wholesale banking.

We expect both trends – convergence and disaggregation – to continue. Individual institutions will decide, in light of their own strengths and weaknesses and expectations about the future, which strategy or combination of options makes most sense for them.

A third response to these changes is found in the *wave of mergers and acquisitions* of financial institutions that is going on around the world. International merger and acquisition activity in financial services has grown significantly over the past 17 years.[22]

Many observers are predicting that, within a decade, a small number (perhaps 10 to 15) of significant, global financial institutions will emerge. Very large regional (North American, European or Asian) players will complement these institutions, as will a large number of local players and many niche players, some of them operating globally. All institutions, facing this paradigm, are trying to determine their own strategy, as a matter of survival and value-enhancement.

[21] As of mid-July, the companies were CI Mutual Funds, BPI and Trimark.

[22] The number and value of financial sector mergers have increased over the past 17 years by annual average growth rates of 10.5 and 24.3 percent, respectively. See McKinsey, *The Changing Landscape*, Exhibit 4-4.

In addition to changes in structure, ***changes in culture*** have been taking place within institutions. As competition intensifies, financial institutions are increasingly focussed on building a total relationship with the customer. Employees are becoming more proactive in selling a wide range of products, rather than simply responding to customer demands. It will be increasingly important to ensure that salespersons and other employees are well trained, understand the client's needs and work in the best interests of the customer in an open, transparent way. All of this is made even more challenging as electronic channels become more prevalent.

The Task Force believes that we have only begun to witness the impact of the forces of change on the structure of the financial services sector. Allowing life insurance companies and money market mutual funds to offer payments services will create new and powerful competition for banks and other deposit-taking institutions. As we cast our minds forward, we can easily imagine the introduction of smart cards that could allow individuals to totally bypass financial institutions for payment purposes. And the increasing use of integrators such as Quicken and I|Money[23] could well change the nature of existing providers from retailers to wholesalers looking for shelf space in an electronic mall. Not all such changes will happen quickly, but eventually distribution channels and financial institutions will change so significantly and become so integrally intertwined as to completely revolutionize the public's conception of financial services providers. What we now describe as banks, trust companies, credit unions, insurance companies, mutual fund companies and securities dealers may well be unrecognizable within the coming decade.

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.

Policymakers

The forces of change are also having an important impact on public policy.

One implication of convergence is that the Task Force expects banks to continue to become less special. At the present time, the public policy framework treats banks differently from insurance companies and trust companies with regard to ownership and some business powers. We believe that such differences in public policy are less sustainable as functions continue to converge and financial conglomerates become more prevalent.

[23] Integrators bring together in one place a number of products from approved financial service providers, and offer to find the best-suited product for an individual's particular needs. The concept is like an electronic shopping mall, with a salesperson who brings you the two or three best choices after hearing your requirements. Quicken can be accessed at <www.quicken.com>and I|Money at <www.imoney.com>.

A second implication is a heightened concern to ensure that consumers in fact reap the benefits of technology and globalization. One issue is the speed of transition to new, electronic, user-friendly distribution channels and 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, and other market conduct considerations such as transparency and redress, can be effectively addressed in an increasingly electronic age unless there is further action by all concerned, including legislators.

There will also be an ongoing need to re-assess the regulatory framework and structure. Canada has been well served by a regular process of review of the Bank Act and, since 1992, of all financial institutions legislation. This Task Force represents a major step in assessing changes that are needed to maintain a strong, dynamic financial sector into the next millennium. The recommendations we make are important in securing that result. But the pace of change is so great, and the future so difficult to read, that policymakers should put a premium on flexibility and maintain a regular, ongoing review of their legislative and regulatory structures.

Regulators

Regulators around the world are increasingly challenged by complex conglomerate groups operating across national borders, and taking on new and different types of risk.

At the best of times, financial institution regulators face an uneasy trade-off between the dictates of stability and competition. Everyone wants a safe and sound financial system. And yet, heavy-handed regulation and protected markets stifle the innovation and competition that can bring benefits to customers and provide a healthy, growing economy. It is becoming increasingly clear that the nature of prudential regulation must change. The models of the past, relying primarily on assessing credit risk through extensive examination of loan files, are no longer adequate to deal with diverse types of risk increasingly incurred instantaneously across borders and in multiple markets. New forms of regulation and supervision are being developed, relying to a much greater degree on international cooperation and on the effective internal governance of institutions.

The challenge is to retrain and retain a cadre of professional regulatory staff able to cope with the rapidly changing world we foresee. This is even more daunting than the challenge that financial institutions are facing to recruit, develop and retain the people they will need to be successful.

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.

This is an era of turbulence in the financial services sector everywhere in the world. Changes are taking place elsewhere and are inevitable in Canada. Change provides opportunity. But it also requires careful management by all concerned in order to secure maximum benefits to Canadians.

Chapter 4

The Financial Services Sector and its Challenges

This chapter describes the current state of the financial services sector in Canada as the Task Force has observed it. It reviews:

- the importance of the sector to Canada and Canadians;
- the current structure of the sector;
- some trends and key issues;
- how well-served Canadians are by their financial institutions; and
- the challenges which confront the sector.

The Importance of the Financial Services Sector

The effectiveness of any economy depends significantly on how well its financial services sector functions. Economic growth and job creation require the efficient intermediation of capital from savings to investment, and allocation of capital among investors. Trade and commerce depend upon a reliable and efficient payments system. Individual consumers rely on the smooth working of the financial system to support them in their daily transactions as well as in their major lifestyle decisions, such as buying a house or deciding to start a business.

In a world of rapid change, individuals and businesses look to the financial sector for even more help than they have in the past. They want to deal with their financial institutions in the most convenient and efficient ways, using the latest technology, and at reasonable cost. They now expect financial institutions to be networked to provide them with access to cash, in any currency, as they travel around the world, and with many other products and services as well.

For individuals, the question is not simply one of speed of transactions, efficiency and cost. It is also increasingly important to manage one's own resources well. Canadians look to their financial institutions to provide them with clear, effective and sound advice as they purchase investment products and pursue retirement planning and other wealth management objectives.

Businesses of all sizes look to their financial institutions to be at the leading edge in innovative products and services, whether these be derivative products for sophisticated businesses looking to manage risk, or sweep accounts to help small businesses effectively manage their cash flow. Businesses expect financial institutions to serve them well at home, and to help take them to new and growing markets abroad.

What the financial services sector must do well – every day – is serve its customers. But its current importance to our economic life goes beyond the services it provides. The following facts highlight the importance of the financial services sector to Canada and to the lives of Canadians:

- The financial services sector directly produces over 5 percent of Canada's gross domestic product (GDP).[24]
- In 1997, the sector held more than $1.4 trillion in Canadian assets, domestic revenues were $155 billion and after-tax Canadian profits were almost $11 billion.[25]
- The financial services industry paid more than $8.4 billion in taxes to federal, provincial and municipal governments in 1996. The financial sector paid nearly 20 percent of federal income tax paid by the corporate sector, a higher share than its proportion of total corporate profits (approximately 17 percent).[26]
- Financial institutions are active in the community. For example, the largest five banks were the top five corporate givers in Canada in 1997, donating more than $78 million to Canadian charitable causes.[27]
- Major banking and life insurance companies are internationally competitive. In aggregate, more than 30 percent of their banking and life insurance revenues (some $40 billion) were derived from operations outside Canada in 1996.[28]

[24] Statistics Canada, *Gross Domestic Product by Industry*, Cat. No. 15-001-XPB, December 1997, Table 1.

[25] Statistics Canada, *Quarterly Financial Statistics for Enterprises*, Cat. No. 61-008-XPB, first quarter, 1998. The Statistics Canada definition of the financial sector includes the major financial institutions such as banks, trusts, credit unions, life insurers and specialized financing institutions. It also includes market intermediaries such as securities dealers, insurance agents and brokers, as well as property and casualty insurance companies. It does not include profits earned by money management firms or trusteed pension funds. It also excludes profits earned outside Canada.

[26] Kimberly Birkbeck and Pierre Vanasse, *Supporting Governments: Transfers from Financial Institutions to Governments, 1997 Edition*, Report 230-98 (Ottawa: The Conference Board of Canada, 1997).

[27] Canadian Centre for Business in the Community, reported in the *Globe and Mail*, January 29, 1998.

[28] Estimated from the following: Total bank revenue (interest income plus non-interest income) was $76.6 billion in 1996 (OSFI Web site data for fiscal year ended October 31, 1997). Total bank operating revenue in Canada for calendar year 1996 was $59.3 billion (Statistics Canada 12-046-D). Difference is international revenue. Life insurance company total revenue for 1996 was $58.2 billion (CLHIA). Total insurance operating revenue in Canada for calendar year 1996 was $35.6 billion (Statistics Canada 12-053-D). Difference is international revenue.

- Over 550,000 Canadians are employed directly in the financial services industry and analysts have estimated that a comparable number of jobs indirectly depend on the sector.[29] The percentage of the work force in the sector is higher in Canada than in other medium-sized countries such as Australia and the Netherlands. The jobs in financial services are increasingly highly skilled and well-paying. This shows up in the average weekly salary in the sector, which at December 1997 was $801, or 33 percent higher than the industrial aggregate weekly salary of $602.[30]

By any measure, these are impressive facts. The challenge for Canadian policy will be to ensure that when the scorecard is drawn up in 2005 and again in 2015, a similar record of accomplishment and contribution to Canada and the Canadian economy can be presented.

A Snapshot of the Sector

The Task Force has reviewed the recent evolution of the financial services sector and its current structure. Chapter 3 of Background Paper #1, *Competition, Competitiveness and the Public Interest*, outlines our findings in detail.

This section of the chapter reviews trends in the composition of household financial assets over the past 20 years and provides a snapshot of the players that make up the sector. The remainder of the chapter then discusses some trends and key issues that are posing challenges for the sector, and how well our major institutions are positioned to deal with these challenges.

Changing Asset Preferences

As context to understanding some of the trends in the sector, it is helpful to focus on a number of aspects relating to the evolution of Canadian household financial assets by product over the past 20 years.

[29] Statistics Canada, *Earnings Employment and Hours*, Cat. No. 72-0002-XPB. Total employment in the financial, insurance and real estate sector was 712,500 at December 31, 1997. Estimated employment for the financial sector alone is approximately 550,000 (712,500 less 97,600 real estate operators and an estimated 65,000 employees of real estate agencies). For an estimate of indirect employment effects, see The Boston Consulting Group, *Financial Services at the Crossroads: The Current and Potential Role of Financial Services in the Greater Toronto Area* (January 1997), p. 4.

[30] Statistics Canada, *Earnings Employment and Hours*, Cat. No. 72-0002-XPB, December 1997, Table 2.

Exhibit 4.1
Household Financial Assets by Product
(percentage of total Canadian household financial assets)

	1977	1982	1987	1992	1997
Mutual funds	1.0	0.9	3.0	5.2	14.2
Pension claims	9.6	12.4	15.4	17.6	21.6
Shares	19.6	22.1	20.8	16.7	14.2
Bonds and money market instruments	11.1	10.5	10.9	8.0	5.3
Deposits	31.0	34.1	30.0	32.5	25.1
Life insurance	10.5	10.0	10.6	11.4	10.7
Other[1]	17.2	10.0	9.3	8.6	8.9
Total financial assets ($ billions)	307.2	570.1	916.3	1,333.7	1,791.0

[1] Other includes, for example, currency and mortgages held by individuals.

Source: Statistics Canada National Balance Sheet Accounts, Bank of Canada.

Exhibit 4.1 shows the following:

- An extraordinary growth in household financial assets over the past 20 years, with an almost sixfold increase. To some extent this reflects the high inflation rates in the 1970s and 1980s, but there has still been an increase of 34 percent from 1992 to 1997. Financial assets now account for about 55 percent of total household assets, up from about 45 percent in 1977.
- Life insurance assets have remained steady in relative terms, at about 10 to 11 percent of household financial assets.
- Deposits have fallen in relative terms, from a peak of 34.1 percent in 1982 to 25.1 percent in 1997. Indeed, most of the decline has been in the past five years, with the share of deposits falling by 7.4 percentage points.
- The big gains have come in managed and pooled funds, made up of mutual funds and pension claims. Since 1977 managed assets (including mutual funds and pension claims) in total increased from 10.6 percent of total household financial assets to 35.8 percent, representing an increase of 238 percent in their share. Over the same period, the share of household financial assets held in the form of deposits declined by almost 20 percent.

These longer-term trends away from deposits and toward managed funds actually accelerated during the past five- and ten-year periods.

These trends have significant implications for the evolution of the sector, which are explored below.

The Players

The sector includes foreign and domestic banks, life insurance companies, general insurance companies, insurance agents and brokers, trust companies, credit unions and caisses populaires, mutual funds, securities dealers, pension managers and investment advisers, as well as specialized finance companies. Exhibit 4.2 provides an overview of the sector.

Exhibit 4.2
Financial Services Sector Overview, 1997

	No. of companies	Total assets ($ millions)	Capital ($ millions)	Total revenue ($ millions)	Net income ($ millions)	Employees
Banks	55	1,321,930	55,667	83,718	7,491	194,800
Canadian	11	1,229,902	50,651	77,976	7,087	N/A
Foreign	44	92,028	5,016	5,742	404	N/A
Trusts (excl. bank subs.)	34	53,538	2,348	5,406	557	22,900
Credit unions and caisses populaires	2,289	106,988	6,825	7,947	488	61,600
Life insurance companies[1]	131	233,365	28,002	58,288	2,633	60,770
Canadian	45	208,411	23,629	N/A	2,432	N/A
Foreign	86	24,954	4,373	N/A	201	N/A
Independent life agents	N/A	N/A	N/A	N/A	N/A	40,400
P&C insurance[2]	236	53,310	15,513	21,578	1,839	37,055
Canadian	89	N/A	N/A	6,953	N/A	N/A
Foreign	147	N/A	N/A	14,625	N/A	N/A
Insurance brokerages	N/A	N/A	N/A	N/A	N/A	56,885
Independent adjusters and appraisers	N/A	N/A	N/A	N/A	N/A	3,865
Securities dealers (incl. bank subs.)	187	158,200	3,526	8,478	769	32,900
Mutual funds	78	280,100	N/A	N/A	N/A	35,000
Asset-based financing and leasing[3]	130	50,000	N/A	N/A	N/A	N/A

Note: Net income is after tax and excludes preferred share dividends of $481 million for domestic banks, and an estimate of $16 million preferred share dividends for trusts and $52 million for life insurance companies. Net income for life insurance companies is after policy holder dividends of $2,387 million.

[1] All life insurance data are for 1996.

[2] Number of companies and employment data for property and casualty insurance are for 1996.

[3] Estimated by the Canadian Finance and Leasing Association, based on its 1996 member survey.

N/A is not available.

Source: Background Paper #1, p. 38.

Deposit-Taking Institutions

The Banks

There are five large Canadian-controlled banks, each with shareholders' equity of more than $5 billion and assets in excess of $165 billion. There are six smaller Canadian-controlled banks, with aggregate assets of $82 billion, and more than 40 foreign banks, with total Canadian assets of $92 billion.[31] In 1997, the banking sector (including subsidiaries) earned $7.5 billion of net income on revenues of $84 billion.

The largest banks have extensive branch networks, with more than 8,000 branches across Canada. There are more than 14,000 bank-owned ATM machines operating across the country.[32] Compared to other countries, Canada has the second-highest number of ATMs at 6.17 per 10,000 people, and the third-highest number of point-of-sale terminals.[33]

The smaller domestic banks are niche or regional players. Foreign banks, which have been operating in Canada since 1980 through regulated Canadian subsidiaries, have mainly concentrated on providing wholesale financial services in urban markets. Of those banks, only Hongkong Bank of Canada is engaged in extensive retail branch banking activities. It should be noted that, contrary to the understanding of many Canadians, present Canadian law does not restrict foreign banks from conducting retail branch operations in Canada through Canadian subsidiaries. But this has not been their business pattern.

The large banks have been the principal consolidators in the industry as the distinctions between the traditional "four pillars" have disappeared. 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, which vary among the individual institutions, both in relative importance and in strategic direction. In aggregate, 37 percent of the assets of the six largest banks were employed in international activities in 1997.[34] On average, 35 percent of net income was derived from non-Canadian business, with a range from 58 percent for the Bank of Montreal to 16 percent for the National Bank.[35]

The banks employ 195,000 Canadians, excluding employment in non-banking subsidiaries such as investment dealers. The Canadian Bankers Association estimates total bank employment, including subsidiaries, as 221,400.

31 OSFI Web site data for December 31, 1997.

32 *Canadian Bank Facts, 1997/1998 Edition* (Toronto: Canadian Bankers Association, 1998).

33 McKinsey, *The Changing Landscape*, Exhibit 6-41.

34 See Background Paper #1, Ch. 3 for more detail on the domestic and total assets of Canadian banks.

35 McKinsey, *The Changing Landscape*, Exhibit 5-23.

The Credit Unions and Caisses Populaires

There are more than 2,200 individual credit unions and caisses populaires across Canada carrying on principally retail financial services businesses. Each of these is a separately constituted, member-owned business enterprise with its own management and governance structure. The credit unions and caisses populaires, which are regulated under provincial law, are supported through central provincial organizations that provide liquidity support and other services. Almost 10 million Canadians are members of credit unions and caisses populaires.

The business importance of the credit union movement varies substantially from province to province. In Saskatchewan and Manitoba, the credit union movement accounts for about 35 percent and 25 percent, respectively, of the assets of all deposit-taking institutions in the province. In Quebec, the Mouvement Desjardins is a dominant market force. It accounts for more than 36 percent of the assets of deposit-taking institutions in that province and has a strong market position in many product lines, accounting for 44 percent of deposits, 39 percent of residential mortgages, 32 percent of consumer credit and almost 45 percent of agricultural credit. In other provinces, such as Ontario and Alberta, the credit union movement has a much less significant market presence.

More than 61,000 Canadians are employed in the credit union and caisse populaire systems.

Trust Companies

Trust companies now constitute a relatively small market segment, with only 34 firms, other than those owned by banks, carrying on business. Collectively they generated revenues of $5.4 billion in 1997 and earned profits of $557 million. The sector includes one large company, Canada Trust, and many smaller companies, most of a regional nature and including subsidiaries of a number of life insurance companies and mutual fund managers. Trust companies employed about 23,000 Canadians in 1997.

Insurance Companies

The Life Insurance Industry

There are some 130 life insurance companies carrying on business in Canada. There are 107 federally regulated companies which together account for 93 percent of the assets of the industry. More than 85 percent of the industry, measured by assets held, is Canadian-controlled.[36] The industry, which is in a

[36] The share of Canadian companies was 84.6 percent in 1996 (see *Canadian Life and Health Insurance Facts, 1997 Edition*) and this will increase with the acquisition of Metropolitan Life, a U.S. company, by Mutual Life, a Canadian company.

period of significant consolidation, had assets in 1996 of $233 billion, and total revenues and profits of $58 billion and $2.6 billion respectively.[37]

The business of the life insurance industry has changed substantially. Today, only about 30 percent of premium income is derived from traditional life insurance products, with the balance attributable to wealth accumulation products and health and disability insurance. Of the five biggest companies, only Great-West Lifeco (which owns Great-West Life and London Life) is a publicly held stock company. The other four are mutual companies owned by their policy holders, although all four have announced their intention to convert their ownership structures to stock companies.

The Canadian life and health insurance industry has had a long and successful history in international markets. Some 44 percent of premium income in 1996 was derived from operations outside the country.

In 1997 more than 100,000 Canadians were employed in the life insurance industry, including those working as independent agents and brokers.

The Property and Casualty Insurance Industry

There are more than 230 property and casualty (P&C) insurance companies operating in Canada, with 74 of the largest 200 general insurers in Canada being Canadian-owned.[38] Canadian-owned companies account for 36 percent of all property and casualty insurance company assets in Canada. The majority of premium income in Canada is earned by subsidiaries or branches of foreign companies.

Unlike the other components of the sector, the property and casualty industry does not perform an intermediation function but instead plays the vital role of spreading and absorbing risk. The sector, which is also experiencing substantial consolidation, generated premium revenues of $21 billion in 1997 with profits in excess of $1.8 billion. Employment in the sector stood at 97,000 in 1996.

Mutual Funds

In 1997 there were 78 mutual fund companies operating in Canada, with assets of about $280 billion at year-end. These companies offered Canadians more than 1,000 different funds to choose from. Total assets under management grew at an average annual rate of 30 percent from 1992 to 1997, making mutual funds the fastest-growing subsector of the financial services sector.[39] The majority of the mutual fund industry is independent. At the end of 1997,

[37] Data supplied by the Canadian Life and Health Insurance Association. Data for 1997 were not available at the time of writing.

[38] Insurance Council of Canada.

[39] McKinsey, *The Changing Landscape*, Exhibit 2-58.

banks accounted for 25 percent of assets outstanding, other deposit-takers accounted for 5.5 percent and life insurance companies for 3.7 percent.[40] The top four retail mutual fund managers have averaged a return on equity of 22.6 percent from 1987 to 1997.[41]

Other Market Participants

There are a number of other participants in the sector, most of which carry on business outside the scope of federal regulation. Among these are securities dealers, specialized financing companies, money managers and advisers. Some of the institutions in these sectors are among the most innovative and successful in the Canadian financial services marketplace. For example, both General Electric Capital Corporation and Newcourt Credit Group are asset-based financing companies that have carved out important market niches in business financing in recent years.

Trends and Issues

Statistical information does not fully capture the dynamism of these markets or the significant structural changes that have occurred in them over recent years, both within Canada and abroad. The forces of change, described earlier in this report, have been very much at work in Canada. Institutions have been forced to reposition themselves for continued business success and growth. That process is ongoing.

A research study prepared for the Task Force by McKinsey & Co. examines the forces of change, analyses the performance of the Canadian institutions, evaluates their competitiveness in the face of a rapidly changing and globalizing marketplace, and assesses their strengths, weaknesses, challenges and opportunities.[42]

In addition to this research, we received many submissions from financial institutions and from their industry associations. We have met with industry executives and have candidly discussed the opportunities they believe their businesses have and the challenges they face, including challenges arising out of the present public policy framework. We have also discussed these same issues with regulators, community interest groups and many individual Canadians.[43]

[40] Investment Fund Institute of Canada, *December 1997 Monthly Statistics*.

[41] McKinsey, *The Changing Landscape*, Exhibit 2-33.

[42] Ibid., particularly Ch. 5.

[43] The evidence we have received and our findings with respect to the challenges and opportunities facing the sector in Canada are summarized in Background Paper #1.

We have been impressed with the constant theme of unprecedented change that runs through all the research, submissions, meetings and discussions. Against this theme of change, we explore below:

- the changing face of competition in the financial services market;
- the growing importance of mutual funds;
- securitization;
- factors affecting continued business success;
- consolidation;
- the role of second-tier institutions in our marketplace; and
- the particular role of life insurance companies.

The Changing Face of Competition

Although the Canadian financial services marketplace may appear static to many, there have in fact been significant changes in the competitive position of institutions over the decades and particularly in recent years. Following are some examples:

- In 1933, when the MacMillan Commission conducted the first examination of Canada's financial services sector, there were 10 chartered banks operating in Canada. By the time of the Porter Commission in 1964, consolidation had reduced this number to eight with the three largest banks holding 70 percent of banking assets. Today, there are 11 Canadian-controlled chartered banks and more than 40 foreign-owned banks active in the Canadian market. The three largest banks have 52 percent of the banking assets in Canada.
- The aggregate share of total financial sector assets of the life insurance sector fell from 33 percent in 1933 to 10.5 percent in 1987 and 9.2 percent in 1997. The chartered bank share, inclusive of subsidiaries, fell from 45 percent to about 34 percent in 1987 but has risen since then to 37 percent. Credit unions and caisses populaires, which were in their infancy in 1933, today account for about 5 percent of total financial sector assets and are even more significant in deposit-taking, accounting for about 10 percent of the assets of all deposit-taking institutions in Canada and more than 35 percent in Quebec and Saskatchewan.[44]
- Over the past 10 years the fastest-growing institutions have been mutual fund companies and trusteed pension plans. Mutual fund companies increased their share of total financial sector assets from 2.9 percent in 1987 to 11.5 percent in 1997. The share of trusteed pension plans increased from 14.6 to 17.0 percent over the same period.

[44] The comparative information on 1933, 1964 and 1997 is drawn from the Porter Commission Report, Royal Commission on Banking and Finance (Ottawa: Queen's Printer, 1964), and from Statistics Canada, National Balance Sheet Accounts.

- Large Canadian businesses increasingly source their long-term debt financing needs in capital markets. Over the past 10 years bank loans have fallen from 44 percent to 34 percent of corporate debt outstanding. Corporate bond issues now account for 31 percent of corporate debt, and have grown four times as fast as bank loans over the past decade.[45]
- In the small business market, credit unions and caisses populaires accounted for some 14 percent of small and medium-sized enterprise (SME) business credit financing in 1996, whereas they were not in the marketplace in any significant way at all in 1964. Specialized asset-based financing companies had 16 percent of the small business credit market in 1996, up from 9 percent in 1994.
- Since the Task Force was established in December 1996, many new competitors have entered the Canadian financial services market, some large and active across Canada and others pursuing more narrow opportunities. For example:

  Two new virtual banks have started up: Citizens Bank, a subsidiary of Vancouver City Savings Credit Union; and ING Bank, a subsidiary of a major Netherlands financial services conglomerate.

  MBNA Corporation and Capital One Financial Corporation, two U.S. banks that specialize in credit card products, have entered Canada.

  A number of specialist finance companies, including Finova and Heller Financial, have started operations in Canada or applied for permission to do so.

  Nine new mutual fund companies have started business in Canada. From September 1996 to May 1998, the number of mutual funds offered in Canada increased from 954 to 1,079, and total assets invested in mutual funds grew from $211.7 billion to $329.7 billion, an increase of almost 56 percent.

  Merrill Lynch has announced its intention to acquire Midland Walwyn, giving it a major presence in the Canadian securities market.
- There is a shift well under way in the marketing of insurance products. In 1989 almost all such products were sold through agents and brokers. Now it is estimated that insurance amounting to 9 percent of new individual life premiums is sold through non-traditional means such as direct response and independent marketing organizations.[46] With respect to general insurance, direct response marketing in 1997 accounted for about 20 percent of direct premiums from personal lines, up from about 12 percent in 1994.[47] Industry expectations are that these trends will continue and even accelerate.

[45] McKinsey, *The Changing Landscape*, p. 31.

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

[47] Direct response sales include sales through call centres and the Internet. See Background Paper #2, p. 93 and Exhibit 4.8.

In sum, the markets are dynamic and we are witnessing new competitors and new forms of competition in both products and the ways in which they are delivered. One of the major issues to be faced as we look ahead is what new forms competition is likely to take, and how contestable traditional markets will turn out to be. As discussed in Chapter 3, technology and globalization are moving the yardsticks and leading to changes that within a decade are likely to make the financial services sector, as we know it today, barely recognizable.

The Growing Importance of Mutual Funds

Changing consumer preferences, combined with technology and aggressive marketing programs, are resulting in extraordinary growth in mutual funds. As consumers have shifted to mutual funds, banks and other deposit-takers have found themselves in a position where they risk losing a substantial part of their traditional savings business.

Historically, individuals have saved through deposits in banks, trust companies or credit unions. Those institutions accept deposits, commit to repay them on demand or at a fixed point in the future, with interest, and lend the money to individuals seeking personal loans or mortgages, or to businesses seeking financing. The solvency of the financial institution, and therefore the ability to honour its promise to pay, has depended on the loans being good loans. To protect depositors, regulators require the institutions to keep substantial capital on hand as a cushion against some loans going bad.

Today, individuals are increasingly placing their savings in mutual funds. Mutual funds are a new, growing form of intermediation. Rather than banks, trust companies and credit unions collecting deposits and using the pools of money to make loans, mutual fund companies now accept funds and use the pools of money to make investments in securities through capital markets.

About 35 percent of Canadian households now own mutual funds, and the amount of mutual funds they own exceeds $300 billion. We have already noted the rapid growth of mutual funds and the high profitability of mutual fund companies. Since 1995, total personal deposits of Canadians have actually declined, from $449 billion to $429 billion in 1997. Since 1991, mutual fund assets have grown almost sixfold, from $50 billion to $283 billion at the end of 1997. Mutual funds already exceed personal deposits in banks, and industry experts expect that within three to four years, mutual funds will exceed all personal deposits in banks, credit unions and trust companies. There are now at least 85 mutual fund companies in Canada, offering more than 130 fund families and with more than 1,000 different funds.

When buying units in a mutual fund, the investor takes all the risk with respect to the future value of the investment. Unlike banks, trust companies or credit unions, 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.

Money market mutual funds invest in short-term high-quality securities, mostly issued by governments. They are relatively safe investments and provide a return that is considerably higher than that available on demand deposits in banks, trust companies or credit unions. There is a debate about how much of the very rapid growth in mutual funds is due to buoyant stock markets and low interest rates and whether, when markets correct and interest rates rise, money would flow back into deposits in significant amounts. Many observers suggest that the trend away from deposits is largely irreversible and most consumers in such a situation would turn to money market mutual funds rather than bank deposits. In the United States, many money market mutual funds offer chequing privileges that make them even more attractive substitutes for bank deposits. Americans now hold more of their household assets in mutual funds than they do in deposits.[48]

There have been two types of response to the rapid growth of mutual funds. Banks and other traditional deposit-takers have offered their own mutual fund products and used their distribution systems to network the products of other suppliers, in order to maintain customer relationships and profitability. In addition, as deposit-taking institutions found it more difficult to rely on retail deposits as a source of funding, they have turned increasingly to markets to securitize their assets.

Securitization

Securitization is a growing and important element in global capital markets. Essentially, 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. The underlying asset, held by the trust, provides an income stream that services the securities. Securitization is a far-reaching innovation for two reasons. It allows lending institutions to use their capital more efficiently by transferring the loans from their own balance sheet, usually retaining a management fee for administering the loan. Spread income becomes converted to fee income, and capital is conserved. Second, securitization permits separate financial institutions to originate, fund, service and assume risk related to a portfolio of loans or other assets. This allows for the development of specialized expertise in different areas of activity and can be effective in bringing new sources of competition to

[48] In 1992, U.S. households held about $2.7 trillion in mutual funds and $2.8 trillion in deposits. By 1997, they held $3.3 trillion in mutual funds compared with $3.2 trillion in deposits. See McKinsey, *The Changing Landscape*, Exhibit 4-15.

the different functions involved in credit granting, as well as bringing additional funding from non-traditional sources to certain activities.

In discussing the spread of securitization in the United States, the Chairman of the Federal Reserve Board commented:

> Numerous types of assets are now routinely securitized, including residential mortgages, commercial mortgages, auto loans, and credit card loans. In addition, medium- and large-size businesses, including some that are below investment-grade, regularly access the commercial paper market by securitizing their trade accounts or other assets. Recently, securitization and credit-scoring are beginning to be applied to small business lending.[49]

Securitization has not yet developed in Canada to the same degree as in the United States. Recently, however, there has been rapid growth, with total asset-backed securities outstanding increasing from $9.6 billion in 1995 to $27.3 billion in 1997, a 183 percent increase in just two years.[50] By the end of June 1998, total asset-backed securities outstanding had increased to $40.9 billion, a further growth of 50 percent in six months. In April 1998, two banks concluded transactions of more than $1 billion each.[51]

Factors Affecting Continued Business Success

All sectors of the financial services industry are currently robust and profitable. It is instructive to remember, sitting at or near the top of a cycle in these markets, that many financial institutions – including the banks – are not many years away from a period of much lower profitability and significant asset impairment in the early 1990s. Recent performance across the financial services sector has been helped by steady economic growth, declining interest rates and low inflation rates. Fortunes can shift quickly, and they will. History is clear about this.

What we can say is that the well-publicized profits of recent years mask some important challenges that our domestic institutions will have to face and manage well if they are to continue to prosper in a much more competitive global marketplace. For example:

[49] Alan Greenspan, "Remarks by Chairman of the Federal Reserve Board at the Conference on Bank Structure and Competition of the Federal Reserve Bank of Chicago," May 1, 1997, p. 2.

[50] Dominion Bond Rating Service, ***Securitizations: Year-end Review of Canadian Asset Backed Securities, 1997 Annual by DBRS*** (December 31, 1997). Most of the growth in the market has come at the short end, from asset-backed commercial paper. The term market was relatively flat and is still down from its 1994 peak of $5.5 billion outstanding.

[51] CIBC and Royal Bank securitized credit card receivables in the amounts of $1.325 billion and $1.1 billion, respectively.

- Canadian financial institutions are in recent years generating only average profits when compared with efficient North American and European counterparts.

  For example, the overall profitability of the five largest Canadian banks, measured as net income divided by total revenue, increased from 9.7 percent in 1992 to 19.5 percent in 1996. The 1996 numbers compare with profitability ratios for the five largest banks in the United Kingdom and the United States of 22.2 percent and 20.2 percent, respectively.[52]

  The profitability of the five largest life insurers, measured by the ratio of net income to total premiums, is somewhat above the international average for eight countries considered (6.4 percent compared to an average of 5.1 percent in 1996) but is less than the comparable figure for the United States (7.4 percent).[53]

  Credit union returns are modest and may well be insufficient to permit growth and investment.

- Canadian banks are more highly leveraged than many of the stronger banks around the world. Recent estimates for the average Tier 1 capital of Canada's five largest banks was 6.79 percent of risk-weighted assets, compared to 7.67 percent of assets for the five largest banks in the United States.[54]

- Financial institutions around the world, under competitive pressure, are working hard to improve the efficiency of their operations. Without world-class productivity, over time a company will have difficulty prospering.

  Measured against industry efficiency norms, the largest Canadian banks stack up fairly well against a sample of institutions from other countries: the large Canadian banks' average NIX efficiency measure of 0.63 in 1996 lagged behind the average of the largest five U.K. banks of 0.59 and was virtually identical to the U.S. largest five banks' measure of 0.64.[55]

  However, looked at more closely, the Canadian bank numbers are less impressive compared with recent efficiency results achieved by some of the world's most competitive banks, which now have NIX efficiency ratings of 0.50 to 0.55. Assessing this data, the McKinsey & Co. study concluded, in relation to Canadian banks:

[52] McKinsey, *The Changing Landscape*, Exhibit 2-51.

[53] Ibid., Exhibit 2-56.

[54] Data supplied by OSFI. For U.S. banks, data are at December 31, 1997; for Canadian banks, data are at January 31, 1998.

[55] The NIX ratio measures operating non-interest expense per dollar of operating revenue. It is a standard measure of efficiency in the banking industry. For comparative data see McKinsey, *The Changing Landscape*, Exhibit 2-52.

> Compared to the best operating companies, Canada's banks lack a true performance ethic. Their cost efficiency, while collectively competitive, lags the leading performers in the United States and the United Kingdom.... They have only recently tied their compensation directly to improved financial performance. Moreover, though their risk management skills are conventional and sound, the banks' legacy technology inhibits both rapid product innovation and more efficient processes overall.[56]

Although the Task Force has no hard data comparable to the NIX measure for other sectors of the Canadian financial services industry, on the basis of other available measures of financial performance such as profitability, we have no reason to believe that they are more efficient than their counterparts abroad or than the banks.

Taken as a whole, it is clear to us that 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 pressures on deposit-taking institutions. It is clear that growing numbers of Canadians want the latest electronic channels and that the banks, credit unions and other financial institutions must provide them. This seems particularly so for the younger generation. On the other hand, it is equally clear that large numbers of Canadians are not yet willing to abandon their traditional channels, such as the bank branch. 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. In U.S. banks, transaction costs per customer have actually increased, as the lower cost per transaction in the new channels has been offset by the need to maintain multiple channels and an increased number of transactions per customer, apparently because of greater convenience.[57] Increasingly, and not surprisingly, banks are looking to sustain profitability through sources of revenue such as service charges and fees (including fees for managing assets), through profit from trading activities on their own account and from the investment banking business, and through making their traditional manufacturing and distribution systems more efficient by reducing costs.
- All of the institutions in the sector face increasingly heavy spending requirements, particularly for new technologies, retraining staff and brand recognition purposes. In these areas they are competing with large global institutions that allocate massive budgets for the same purposes. To put the technology

[56] McKinsey, *The Changing Landscape*, p. 44 and Exhibit 5-5.

[57] Ibid., Exhibit 4-12. From 1985 to 1995, transaction costs per customer in a sample of U.S. banks rose by 4.7 percent per year on average. We were not able to find comparable data for Canada.

issue in perspective, the three largest banks in the United States have an aggregate technology budget of US $5 billion, compared to technology budgets of US $1.6 billion for the three largest banks in Canada.[58] This spending gives rise to two issues, both potentially serious for Canadian institutions. Relative to their size, the expenditures of Canadian deposit-takers are already large and represent a huge continuing cost of doing business. But of even more significance, the inability to increase spending for these purposes is likely to result in competitive disadvantages in the near future, at least in some product lines. Life insurers face similar challenges.

In short, 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. We believe that it is of national importance that they succeed. As has been demonstrated time and again in other countries, weak financial institutions do not serve their customers well and do not play the role they should in fostering economic growth and employment.

Consolidation

In Canada, as elsewhere, consolidation in the financial services industry continues at an escalating pace. Dozens of mergers have been announced since the Task Force began its work, many of them of mind-boggling size. Thousands have been announced in the world around us.[59]

Consolidation in many markets, not just financial services, is a worldwide phenomenon aimed at achieving efficiencies by eliminating excess capacity in some markets and capturing potential 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. Taking into account recent mergers, the five largest life insurance companies now have about 60 percent of the Canadian market for life products, up from about 40 percent in 1991.[60] Consolidation also continues in the deposit-taking sector, as evidenced by continuing consolidation in the trust and loan sector and among credit unions, as well as the proposed Schedule I bank mergers.

[58] McKinsey, *The Changing Landscape*, Exhibit 5-13. Data are for 1996.

[59] Ibid., Exhibit 4-4.

[60] On the basis of 1997 premium data, the five largest had 59 percent of the market, adjusted for the following mergers and acquisitions: Great-West Life-London Life; Mutual Life-Metropolitan Life; and Canada Life-Crown Life. Source: *Canadian Insurance, Annual Statistical Edition*, June 1998.

Second-Tier Institutions

The Task Force has heard much about second-tier financial institutions, that is, those institutions that are smaller in size and which compete with the large banks in regional or local markets.

Some have contended that Canada does not have a well-developed second tier. There is considerable truth to this assertion. During the 1990s, only three new domestic banks were incorporated in Canada (compared to 207 new banks in the United States in 1997 alone). There are only six Canadian-controlled banks with shareholders' equity of less than $5 billion, and five of these have shareholders' equity of less than $1 billion. The foreign banks are engaged primarily in wholesale banking businesses and have eschewed the retail market. With the exception of Canada Trust, the trust companies mainly serve special purposes and very local areas.

On the other hand, as has been noted, there are more than 2,200 individual credit unions in communities spread across Canada. In some provinces, they have the largest share of the market for some important retail products. In other regions, their significance is less pronounced and their competitive thrust less strong. With only a few exceptions, the credit union system continues to be fragmented, without an efficient or effective means to coordinate the use of the capital available in the system. 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.

Notwithstanding these circumstances, the Task Force believes that, in most parts of Canada, the credit union movement presents a framework for the effective delivery of community-based financial services to individuals and small businesses. The movement has played this role in many other countries, such as the Netherlands, France and Germany. With supportive public policies and committed and effective leadership within the movement, there is no reason why it cannot do so in Canada. We have been encouraged throughout this exercise by the far-sighted vision that many in the Canadian credit union movement are displaying as they face change, challenge and opportunity within their sector.

However, the Task Force also believes that 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 our recommendations are directed at making it easier for new financial institutions to start up, and to enter the country from abroad. We also believe that all existing non-bank institutions need to become more competitive and provide greater competition to the banks.

Life Insurance Companies

The life insurance sector, rapidly consolidating as noted above, stands at the edge of further challenges and potential growth. The Task Force believes that life insurance companies can become very significant forces in the Canadian financial services sector, operating in more product lines and offering much greater competition to deposit-takers, including banks, than they have in the past. Over time, some insurers are likely to become leaders of major financial services conglomerates, as has been the experience in other countries.

Public policy should ensure that there are no unnecessary barriers blocking life insurance companies from full participation in a broad range of financial services. In this report we recognize three areas where policy change will be helpful in assisting greater competition by life insurance companies.

First, we believe that it will be beneficial to consumers if life insurance companies have full access to the payments system, and that such access should not cause any prudential or efficiency concerns.

Second, we suggest that the current status of the Canadian Life and Health Insurance Compensation Corporation (CompCorp, the consumer compensation plan run by the industry) and the Canada Deposit Insurance Corporation (CDIC, the government-backed deposit insurance plan) places certain important products offered by life insurers at a competitive disadvantage in the marketplace. We recommend in this report that CompCorp and CDIC be integrated and we present two options for accomplishing this.

Third, we support strongly the intention of the four major mutual companies to demutualize. We believe that this will be in the best interests of the companies, their policy holders and the future evolution of the financial services sector.

The demutualization process will entail the distribution of billions of dollars worth of shares to policy holders. Demutualization will also provide the companies with needed access to capital markets and will facilitate their ability to adjust in a way that allows them to seize more readily the opportunities that come with change. Vast new sources of equity capital will be needed by these mutuals if they are to enter the large new markets we see before them.

At the same time, their task will not be easy. Demutualization 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. As never before, these companies will need outstanding leadership, with many new skill sets. They will also require aggressive and innovative strategies, well executed, to be successful as the process of financial industry consolidation continues.

Despite these challenges, the Task Force believes that insurance companies, with their strong domestic base and long-standing international focus, will become even more important and visible members of the Canadian financial services sector in the years ahead. It is very important for Canada, and its evolving economy and needs, that they succeed in this regard.

Are Canadians Well Served by Their Financial Institutions?

As we look ahead to the sector in the 21st century, we should assess how well Canada's financial institutions serve Canadians now.

We have examined this subject in some depth and our findings are described in detail in Chapter 4 of Background Paper #1, *Competition, Competitiveness and the Public Interest.*[61] An overview follows.

Individual Consumers

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

- Interest rate spreads for consumer loans and mortgages are the second-lowest of those for a group of industrial countries examined by McKinsey & Co. Only the Netherlands had lower spreads on personal loans and only the United States had lower spreads on mortgage loans. However, credit card interest spreads and fees are significantly higher in Canada than in the United States.[62]
- Canadian deposit-taking institutions, measured by what they charge for a basket of personal banking services packages, are near the average for 10 countries examined. The variation in experience is wide, with consumers in the United Kingdom not paying any service fees, and consumers in the United States paying on average about C$15.50 per month. The average fee in Canada was $10.00 per month.[63]
- The availability of payment services in Canada is excellent compared to other countries. The number of ATMs per person is second-highest among a group of ten countries surveyed, and the number of point-of-sale terminals per person is third-highest.[64]
- The Canadian payments system is very efficient and clears cheques faster than most clearing systems in the world. Our same-day funds availability and one-day clearing of cheques on a national basis is a leader compared to

[61] See also the work of McKinsey on this topic, in *The Changing Landscape*, Ch. 6.

[62] Spreads in Canada have been higher by an average of about two percentage points over the past 10 years. See Ibid., Exhibits 6-20, 6-21 and 6-22.

[63] Ibid., Exhibit 6-25.

[64] Ibid., Exhibit 6-41.

experience in other countries. For example, both Switzerland and Australia are reported by the Bank for International Settlements to have required five days to clear cheques in 1996.[65]

- Canada's financial institutions price their services, including credit services, at the same price across Canada and do not discriminate by region.
- Representative life insurance premiums paid by Canadians are the second-lowest among those for a group of eight industrial countries surveyed.[66]
- Although Canadians have a choice among a wide range of mutual fund products, with more than 1,000 different funds available, fund administration fees are higher in Canada than in the United States.[67]

Overall, Canadian financial institutions stack up well by most quantitative measures in the delivery of financial services to individual Canadians.

Market research conducted for the Task Force found that Canadian financial institutions get high satisfaction grades from the public on many counts. For example, 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."[68]

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. There are complaints of poor or complicated disclosure in documentation, particularly in relation to the life insurance industry. And there is a continuing concern that many low-income Canadians are not obtaining reasonable access to basic banking services. Moreover, there is a striking antipathy toward financial institutions, in particular toward the banks and their leaders. These concerns are manifested in consistently low rankings for banks in quality satisfaction surveys.

The Small Business Community

The evidence in respect of small business services is mixed. Most of the positive factors noted above apply equally to small business customers. For example, the efficiency of the Canadian payments system, the benefits of national branch banking and the accessibility of technology benefit small businesses as well as individual users.

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

[66] Ibid., Exhibit 6-30.

[67] Ibid., Exhibit 6-31.

[68] Ekos Research Associates, *Public Opinion Research Relating to the Financial Services Sector*, Research Paper Prepared for the Task Force and the Future of the Canadian Financial Services Sector (Ottawa, September 1998), pp. 37, 44.

In addition, interest rate spreads on small business loans are significantly lower in Canada than in the United States.[69]

McKinsey & Co. conducted a survey for the Task Force on banking fees for small business. On the basis of a "representative" small business, they found Canadian charges to be in the middle of a range among a group of eight countries. Merchant rates, the percentage of transaction value paid to credit card companies, averaged 1.9 percent in Canada compared with an average of 1.6 percent for the United States, the United Kingdom and Argentina and an average of 2.6 percent for five European countries. The average monthly fee for a Canadian SME was $18 compared to an average of $8 in four European countries and an average of $27 for the United States and Australia.[70]

However, it is clear, from surveys conducted both by the Canadian Bankers Association (CBA) and the Canadian Federation of Independent Business (CFIB), that there is significant dissatisfaction with banks in the small business community. For some, access to credit remains an issue.[71]

There is also a widespread perception that Canadian deposit-taking institutions may be more risk-averse than institutions in other countries and that they are not prepared, or perhaps encouraged, to price appropriately for higher levels of credit risk or to develop creative high-risk debt financing packages, preferring instead to refuse the credit entirely. Service charges remain a source of substantial dissatisfaction, even though the quantitative results from the survey data suggest that Canadian charges are not out of line when compared with charges elsewhere. There is continuing frustration about access to branches, and particularly the difficulties encountered in establishing long-term relationships with account managers because of high turnover rates.

McKinsey & Co. concluded, "In terms of pricing, quality, choice and accessibility, Canadian small businesses receive only fair to slightly below fair service."[72] We agree with that assessment.

Larger Enterprises

Our work indicates that large Canadian businesses have a variety of sources of finance and are well served by financial institutions, including those based in Canada. However, our survey also indicates that large Canadian businesses see Canadian banks as being slow to introduce new technology and innovative

[69] McKinsey, *The Changing Landscape*, Exhibit 6-11.

[70] Ibid. Exhibit 6-12.

[71] This is explored in some depth in Background Paper #4 and Chapter 8 of this report.

[72] McKinsey, *The Changing Landscape*, p. 19.

products.[73] As a result of this and other factors, there is a clear trend for large businesses to look for their needs to many banking suppliers, and increasingly to foreign financial services providers, who are seen as more innovative and more capable internationally. The traditional relationships of large Canadian businesses with domestic banks have clearly been replaced with more discriminating and more critical ones.

Summary

On balance, we conclude that the Canadian financial services sector does serve the Canadian public reasonably well compared with that of other countries. But this does not mean that all is fine and that there is no room for improvement.

Many of the recommendations that we make to enhance competition and strengthen consumer protection are recommendations that are, in our judgment, independent of the trends to greater consolidation and concentration worldwide. The fact that these trends are taking place, and causing their own sets of challenges, makes it even more imperative to proceed with these recommendations if service to Canadians is to improve as we move forward.

An effective public policy framework can help create a climate for better customer service, but ultimately good service has to come from the institutions and it will be a reflection of culture and attitudes that are instilled by committed leadership. Our institutions talk about being customer-focussed; our sense is that they can and should do a better job of focussing on customers than they are now doing. In a period of change and challenge, this will be no mean feat. We realize that it is not easy to change traditional, embedded cultures. But those that do it well will win in an increasingly customer-driven marketplace.

Positioning for Challenges and Opportunities

In Chapter 3 we examined how technology, globalization and demographics were affecting consumers, institutions, policymakers and regulators. We turn now to a more focussed discussion of the challenges and opportunities for our financial institutions.

Financial institutions worldwide are pursuing many different strategies to position themselves to succeed in a more complex and turbulent environment.

Positioning Strategies

On the one hand there is a wave of consolidation around the world. Mergers have tended to fall into three categories. The first is mergers among firms in the

[73] Hugh Williams, The Conference Board of Canada, *Corporate Banking Relationships in Canada: The CFO View*, Report prepared for the Task Force on the Future of the Canadian Financial Services Sector (Ottawa, September 1998).

same business lines, sometimes in the same geographic market and sometimes in different markets. These mergers have been characterized as "in-pillar" mergers and have been pursued primarily to achieve economies and efficiencies on the cost side. Examples include the mergers between many of the U.S. banks as the United States moves toward a national banking system. In Canada, examples would include the recent mergers between Bank of Nova Scotia and National Trust, and between Great-West Life and London Life. The proposed Schedule I bank mergers also fall into this category.

The second category of merger – "cross-pillar" mergers – is among firms in complementary product lines. These have been more common in Europe, with the emergence over the past decade of very large financial services conglomerates formed by merging insurance companies and banks. Examples include the formation of ING in the Netherlands and, more recently, the mergers completed between Crédit Suisse and Wintherthur in Switzerland and announced between Rabobank and Achmea Holding NV in the Netherlands.[74] In the United States, the recently proposed merger between Citibank and the Travelers Group, to form the largest financial services conglomerate in the world, is another example of this type of merger. In Canada, the proposed Royal Bank-London Life merger would have fallen into this category, had it proceeded.

The third category of merger is the "cross-border" merger, and many observers suggest that this will be the next major stream of development in financial services. There are many examples of cross-border mergers in other industries, such as pharmaceuticals and telecommunications. There are some examples of financial sector cross-border mergers in Europe, including the recent acquisitions of Bank Bruxelles Lambert and Barings Bank by ING, and of Générale de Banque by Fortis. But there have not yet been many large cross-border mergers in the financial services sector.

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. Examples include Lloyds-TSB, which is one of the most profitable banks in the world and focusses only on retail banking services in the United Kingdom, and Bankers Trust, which decided in the mid-1980s to sell its retail operations and now focusses on wholesale and investment banking worldwide. We have seen a similar development in Canada with respect to the international operations of our major Canadian banks. None of the Canadian banks has shed major business lines in domestic operations, but within the last decade each has tried

[74] Rabobank is a cooperative bank and Achmea is a cooperative insurance company. Completion of the merger would result in the largest financial conglomerate in the Netherlands, with assets of US$236 billion at the end of 1997. For more information on Rabobank, see Background Paper #2, p. 121.

to specialize and focus in its international operations. As a result our major banks have very different international strategies, even though they are fairly similar at home.

Finally, new players are appearing and some are growing with surprising speed using the latest of modern finance techniques and new technologies. Over the past decade, GE Capital – a subsidiary of General Electric – has become one of the largest, best-capitalized and most profitable financial services institutions in the world. In Canada, Newcourt Credit Group, which was formed in the early 1980s, has grown to become the second-largest asset-based lender in North America, with operations in 24 countries and more than 60 percent of its total revenues coming from outside Canada. The increasing attraction of mutual funds has enabled firms such as Fidelity to become major international players and household names. New distribution channels are emerging. Charles Schwab, founded in 1971, has grown rapidly in recent years to become the largest discount broker in the world by a substantial margin.

As we look ahead, it is clear that new players will continue to emerge. In the United Kingdom and Australia, for example, large retailers are beginning to provide financial services and we are seeing the beginning of that trend in Canada through alliances between Loblaw Company and CIBC, and between Wal-Mart and TD Bank. Information technology companies such as Microsoft and Intuit are increasingly active in the financial services area, with a view to positioning themselves as intermediaries between the customer and a range of financial services providers. There are some observers who suggest that current financial providers may ultimately become wholesale providers of financial commodity-type products, and that brand loyalty may migrate from the financial institution to new integrators such as Microsoft.

Implications for Canadian Institutions

What does all this mean for Canada's financial institutions? All of the strategies suggested above – and others – are available to them, but there is no guarantee of success. They may select the wrong strategy option, or they may fail in implementing the right strategy. Like their international competitors, they must critically assess their strengths and weaknesses, determine their comparative advantage, and act to secure it. If they do, they should be able to hold their own in a much more competitive market and match their international competitors abroad in vigour and strength.

McKinsey & Co. concluded that the major Canadian banks and life insurance companies have strong domestic franchises.[75] For the banks, the bulwarks of the franchises are their large national branch networks and positive brand

[75] See McKinsey, *The Changing Landscape*, Ch. 5.

recognition, based upon an enviable level of trust and confidence in their safety and soundness. Among themselves, 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.

On the other hand, one has only to look at recent history to see how vulnerable the traditional product lines of financial institutions can be when they come under aggressive attack from new suppliers offering differentiated products. Consider the case of large corporate loans. In the last decade, this traditional business of the banks declined substantially as a result of the globalization of financial markets, securitization, and the emergence of new non-traditional and often unregulated suppliers of funds. As noted earlier, the banks' share of lending to Canadian business declined from 44 percent in 1986 to 34 percent in 1996. What business remains is at sharply reduced margins. McKinsey estimates that the return on equity to banks in dealing with large corporate customers ranges from 0 to 10 percent.[76] The speed at which this change has occurred seems remarkable.

Similarly deposits, which have been the traditional low-cost source of financing for the banks' lending activities, are not growing nearly as quickly because of sharply increased competition from mutual funds. To the extent that competition for deposits increases (and access to the payments system for money market mutual funds is likely to make them even more attractive), traditional deposit-takers will have to compete more aggressively to retain deposits. The ability to fund activities with core deposits paying little or no interest is unlikely to be as readily available in the future as it has been in the past.

Banks are responding to these challenges. As demand for traditional corporate loans declines, banks are increasingly becoming active players in capital markets where funding is being sourced, directly and through investment banking subsidiaries. As interest spreads erode, banks are shifting their operations to rely more on fee-based income than on spreads. As they do so, the traditional notion of what is a bank is changing. The days are long gone when Canada's large banks were institutions that mainly accepted deposits and made loans to businesses. 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.

Where these trends will go in the future is unclear. In the world we are moving into, the traditional strength of the banks, insurers and other financial institutions – reinforced by their brands and dependent on their significant long-term relationships with customers through branches and brokers – may be necessary

[76] McKinsey, *The Changing Landscape*, Exhibit 2-23.

for business success but it is unlikely to be sufficient. Continuous innovation in products and service will be essential. And a continuing imperative facing all institutions will be to become more efficient by continuing to cut costs.

The McKinsey & Co. research study conducted for the Task Force assessed the ingredients that are likely to be necessary for future business success, and examined the strengths and weaknesses of the Canadian institutions in that context.

It characterized Canada's retail banks as "vulnerable to attack", and "yet to fully realize the true operational excellence needed to meet and beat world-class competitors – either at home or abroad."[77] In international markets, Canadian banks appear to have few comparative advantages.

Concerning the life insurance industry, the study noted that the industry is facing a period of unprecedented change, characterized by the threat of greater competition and a shift toward lower-margin products. It reported a clear need for Canada's insurers to develop much more innovative products and channels and "demonstrate an unprecedented degree of rigor in managing their businesses for performance." On a more positive note, it pointed to the international success of Canadian insurers in the past and observed that the industry has "a basis for being competitive both at home and abroad."[78]

Criteria for Success

No study by a consultant, or review by a Task Force such as ours, can prove whether Canadian institutions have the "right stuff" to be successful in the years ahead and to adapt to what McKinsey calls the moving "tectonic plates" of change.

What we can say with certainty is that it will be an increasingly difficult challenge to succeed in the world we are quickly moving into. It will not be easy for Canadian institutions to adapt. They 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, while still protecting essential public policy goals. This will be as big a challenge for government and regulators as achieving success in business will be for the institutions and their employees.

Finally, 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 rely on to support them. This too will be a major

[77] McKinsey, *The Changing Landscape*, p. 48.

[78] Ibid., p. 50.

challenge for our banks and life insurance companies, neither of which is held in particularly high regard by Canadians.

At the end of the day a successful, profitable Canadian-controlled financial services sector, operating at world-class standards and serving Canadians better than any other financial sector in the world serves its customers, is something that will benefit all of us today and foster the economic growth and job creation that will help all of our children tomorrow.

Getting from here to there requires that there be a vision for our financial services sector that will allow it to position itself to be a source of strength for Canada in the 21st century. It also requires that we work together to achieve that vision. 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.

We are confident that there can be such a vision and that it can be one that is shared and pursued by the financial institutions, by the governments of Canada by regulators, and by the Canadian public.

Chapter 5

Our Vision for the Sector

This chapter sets out our vision for the financial services sector.

Early in our work we concluded that we could provide sensible and coherent recommendations for the sector only if we established firmly what our goals should be.

That process was not easy, particularly given the incredible pace of change which has already been experienced and which continued unabated as we worked. However, the very intensity of the forces that created the change process made it even more important for us to establish some guideposts.

To do so we brainstormed together for a considerable time, weighing the evidence and assessing the change factors, and elaborating a vision of the financial sector that we believe will best serve Canadians into the next century.

We present an integrated vision. It describes the characteristics of a desirable sector viewed from three perspectives:

- What should consumers expect from their financial system?
- What kind of institutional structures can best meet those expectations?
- What type of regulatory framework is most likely to achieve the structures?

We emphasize that it is an integrated vision. Achieving the objectives from any of the three perspectives alone will not be sufficient to achieve the public interest. Just as the vision is integrated, so our recommendations are interdependent and it will be important for progress to be made on all fronts. It will not be sufficient if Canada's financial services companies enjoy business success at the expense of consumer values. It will not be sufficient if there is total prudential safety and soundness but there is no market innovation and dynamism. It will not be sufficient if there are perfect consumer protection and redress systems but there is not a competitive marketplace.

We set out our vision in this chapter. It is the basis for our work. We are certainly not so naive as to imply that it cannot be refined or to suggest that every Canadian would embrace it. On the other hand we believe that, in the debate which will take place in the wake of our report, it is important for those who participate to address issues of specific interest to them in the context of their

own integrated vision of the sector, with a clear recognition of the forces of change. All concerned Canadians should be thinking carefully about this, and should develop their own views.

We believe that the Government should embrace goals such as those we articulate in our vision, and should vigorously pursue them. Our vision is designed to define the public interest as we see it.

Our Vision for the Canadian Financial Services Sector

Characteristics Valued by Consumers

We believe that all consumers of financial services products – individuals, small businesses, large private and public users – value, and should expect, the following characteristics from the financial system that serves them:

- It should be competitive, with markets being served by domestic and foreign institutions offering a broad range of choice in products, levels of service and price.
- Sales practices should be non-coercive and perceived to be so.
- Transactions should be transparent, with clear, easily understood and timely disclosure of product terms and conditions, risks, and conditions of sale.
- There should be accessible and effective redress mechanisms.
- Customers should be able to deal easily with institutions through many channels, including state-of-the art technology.
- All major participants should enjoy the confidence and support of Canadians.

In addition to these six basic characteristics, we believe that the following additional characteristics will be particularly valued by individual consumers:

- All Canadians should have access to basic financial services, regardless of income or place of residence.
- Individuals should have access to and control over their personal information.
- Consumers should be well enough informed to take greater responsibility for their own decisions.

From the particular perspective of small and medium-sized business customers, a desirable financial system should be made up of institutions that:

- promote the development of total financial relationships, including the provision of informed advice to small businesses;
- are characterized by an effective, responsive and transparent credit-granting process;

- are creative in designing innovative financing packages that permit higher-risk credits to be extended, appropriately priced for risk; and
- are willing to partner with customers, through provision of equity or participating debt.

Structural Features of a Desirable System

The following features should characterize a financial services sector that would provide all consumers with the characteristics outlined above:

- There should be a fully open, competitive trading and investment environment, including no interprovincial trade or investment barriers.
- There should be ease of entry for financial institutions, both from abroad and for new start-ups.
- There should be an open and accessible payments system that continues to be efficient and prudentially sound.
- There should be several large and many smaller, national and regional, successful Canadian-controlled financial institutions, with strong competitive positions in the domestic markets they serve.
- Some Canadian institutions should be competitive with foreign institutions (possibly across the board, but certainly in many product lines) in international and global markets.
- There should be some successful niche players and new entrants.
- Financial institutions in Canada should be sensitive and responsive to regional and other special community problems and priorities.
- There should be a creative and innovative climate that fosters the adoption of state-of-the art technology and product development.
- Institutions should be well managed, with effective governance structures.
- There should be a culture of excellence within institutions, one that rewards innovation and quality service and recognizes that talented and committed people are at the heart of a successful organization.

A Facilitative Regulatory Framework

From a public policy and regulatory perspective, the following attributes are important to foster the development of a sector that has the features set out above and can provide the kind of customer focus described:

- There should be no more regulation than necessary to achieve public policy objectives of safety and soundness, competition, and the protection of consumer interests. Other goals should be pursued not by regulation but addressed with other national policy tools.

- There should be an appropriate balance between pursuing safety and soundness, and allowing entrepreneurs and institutions to take risks that will encourage competition – accepting that taking some risks may lead to the failure of some financial institutions.
- Regulators should stay focussed on the dynamic, relevant challenges that technology and globalization are forcing, and should be aware of and sensitive to the increasing difficulties of supervision. Resources must be highly skilled, allocated to areas of risk that are important to the health of institutions, and increasingly focussed on management and governance oversight.
- To the extent that institutions perform similar functions, they should be regulated in similar ways, regardless of what they are called or what statute they fall under.
- The regulatory environment should allow room for niche players, many of which will require different degrees and types of regulation, if they need to be regulated at all.
- Regulatory duplication should be eliminated, whether it is duplication between federal and provincial governments, duplication at the federal level, or duplication between Canadian and international regulators. To the extent that federal-provincial or provincial-provincial duplication cannot be eliminated, regimes should be harmonized across Canada on the basis of best practices.
- Canada should lead in initiating and supporting international regulatory change, and should ensure that Canadian interests are adequately reflected within an effective international regulatory system.

Achieving the Vision

While our current financial system works well and has many desirable features, it falls short of our vision in a number of significant dimensions. Even in an environment that was more stable than the current one, we would wish to see many features of our system change in a way that facilitates the development of the characteristics we have set out above. In a time of turbulence like the present, our recommendations on how best to manage change in a way that moves us toward achieving the vision become even more important.

Achieving the vision will require leadership in government, in our institutions and among our citizens. It will also require flexibility and adaptability on the part of all concerned. We will have to get a number of things right. A few of the key elements are outlined below.

The Public Policy Framework

The public policy framework will have to recognize that change is inevitable and allow change to occur in the interests of Canada and Canadians. Legislators, regulators and supervisors must achieve a reasonable balance between the goals of safety and soundness, and competition and entrepreneurial innovation. Both goals serve consumers, and too much or too little of either can diminish consumer welfare.

The framework must allow for change to be shaped where appropriate to protect the public interest. In particular, attention should be paid to transition effects and ways in which adjustment to new situations can be eased for individuals. But the public policy framework must not stifle change, nor should it attempt to achieve bureaucratic or legislative views of appropriate outcomes. It must be a truly dynamic framework, not a straitjacket, and it must allow for and even encourage the dynamism of the marketplace, the leadership and creativity of entrepreneurs and managers, and the actions of empowered consumers to express their needs and shape the financial services sector.

Public policy has a particular role to play in protecting the integrity of the marketplace. What this means in practice is that consumer rights need to be assured. Consumers must have the ability to access meaningful information in a timely and understandable way; the assurance that they can contract freely with providers of their choice without being pressured or coerced into buying products or services they do not want; the right to control access to their personal information; and the right to redress when they are wronged. The market, unfettered, will not produce these outcomes, and the public policy framework must provide a balance within which an empowered and enlightened consumer provides an effective competitive check in the marketplace.

Leadership in Institutions

Within a flexible and responsive public policy framework, it is the responsibility of institutional leaders to respond to consumer concerns and needs in the most imaginative and effective way. Those who do will create shareholder value for their institutions, along with consumer and community satisfaction. Institutions led by those who do not meet this test may not survive and will certainly not prosper.

The vision set out above has room for many different strategies. Size may be important for some; focus on selected product lines or selected markets may be important for others. Just as no reasonable strategy should be automatically precluded, there is no single strategy that is going to be right for all consumers or providers. There are, however, some common principles that should apply and should be recognized and supported by leadership throughout the institutions, not only at the top.

- Industry leaders must always remember that they are dealing with other people's money. The culture and values they must instil throughout their organizations must be ones of stewardship, respect and trust. Emphasis must be placed on managing risk and sustaining the vitality and health of their institution so as to honour the promises to pay that are made to Canadians.
- Leaders must be sensitive to the power and influence that financial institutions have in the life and success of the country. Access to financial services is critical for all Canadians. The assurance of variety of choice, quality of service and competitive prices, to Canadians living in rural Canada and in remote areas as well as in urban centres, is an important public policy objective to which institutional leadership must respond.
- Institutions must recognize that they operate in communities of people and that they have many stakeholders other than their shareholders. The creation of shareholder value is an important obligation but it will best be created and sustained by institutions that command the respect and support of consumers and the many communities they serve.
- Leaders within our institutions must recruit, develop and retain effective people with world-class skills, able to meet customer needs in satisfying and innovative ways, and capable of growing their business competitively and profitably.
- Leaders must recognize their responsibility to sponsor and support effective governance for their institutions.

The Responsibility of Consumers

Consumers have a critical role to play in achieving the vision. Within a flexible and responsive public policy framework, it is consumer preferences that should determine the shape of change. This requires greater consumer literacy and advocacy. The public policy framework must create conditions conducive to consumer empowerment by addressing disclosure practices, abusive sales practices, privacy and redress. But it is up to individual consumers to be vigilant, to avail themselves of information and to exercise their rights. It is also up to individuals to acquire the basic education and skills demanded by the world around us.

Consumer organizations have a powerful and legitimate role to play in assisting consumers through education and advocacy. Industry and government should support them.

The Contribution of the Task Force

Our contribution is to help articulate a national vision and to recommend actions to governments and other players that will help create a framework within which the vision can be achieved.

The Importance of Competition

Strengthening competition is a critical centrepiece of achieving the vision. In the chapters that follow, we present a focussed, four-point strategy to enhance competition.

We make recommendations to *strengthen the position of existing participants* in order to provide a more dynamic, competitive market. These include:

- allowing life insurance companies, money market mutual funds and investment dealers to have access to the payments system directly, in order to provide transaction services to Canadians;
- increasing functionality of networks, including allowing deposits to be made to any deposit-taking institution through an ATM, in the same way cash can now be withdrawn;
- new powers for credit unions to make them more effective, including the power to become or to form banks;
- support for the rapid demutualization of major insurance companies, which will enhance their ability to compete with large banks;
- changes to deposit insurance for banks, and to compensation plans for life insurance companies, that will reduce the competitive advantage that banks now enjoy without compromising the quality of depositor protection;
- the creation of optional, regulated holding companies that will offer greater organizational flexibility to financial institutions;
- a new, more flexible definition of wide ownership that allows more scope for strategic alliances, including acquisitions; and
- the ability for banks to offer insurance and auto leasing products to consumers through their branches, as some provincially-regulated deposit-taking institutions now do.

We make recommendations to *encourage new domestic participants*. These include:

- a new consistent set of ownership rules for all financial institutions, including banks, that will make it easier and more attractive for new banks to start up;
- a 10-year federal and provincial capital tax holiday for new financial institutions;

- greater discretion to allow new institutions to be formed with less capital than is currently required; and
- accelerated approval processes by OSFI.

We make recommendations to make it easier for *foreign financial institutions* to serve Canadians. These include the following:

- Encouraging the rapid adoption of legislation to allow foreign banks to operate in Canada through branches of their foreign parent (as well as or instead of subsidiaries, which are now allowed).
- Extending the current exemption from withholding tax for debt incurred with a term of greater than five years to all arm's-length debt, regardless of term. This will remove what is effectively a trade barrier that makes it very expensive for foreign lenders to lend to Canadian businesses.
- Establishing a framework that will provide clear rules and new opportunities for lenders who wish to make loans to Canadians without establishing a physical presence in Canada.

Finally, we make recommendations to *empower consumers* to act as a discipline in the marketplace and thus make competition more effective. These include:

- proposals to increase transparency of documents;
- a stronger and broader ban on coercive tied selling than now exists; and
- a Financial Sector Ombudsman to provide more comprehensive coverage and easy accessibility for consumers.

Other Supporting Policies

This four-part strategy to enhance competition is necessary to realize a financial services sector consistent with our vision. Healthy and vigorous competition is the best guarantee that Canadians will be well served by their financial institutions well into the future.

While vibrant competition is necessary, however, we do not believe it is sufficient to achieve the vision we set out. Other supporting policies will be necessary.

Empowering consumers is important not only to make competition more effective but also to protect individuals. The measures we are proposing on transparency, tied selling and redress will do that, as will a strong and comprehensive privacy regime that we are recommending be implemented.

Corporate conduct matters. The extent to which institutions succeed in meeting Canadians' legitimately high expectations of their social and business responsibilities will be critical in building solid relationships between institutions and the communities they serve. Good relationships are a necessary foundation to building a financial services sector that will serve Canada well.

We make recommendations about many issues relating to corporate conduct, including financing small businesses and the new, knowledge-based economy, access to basic banking services, partnerships with the voluntary sector, and community accountability.

It is also necessary to improve our regulatory structures, to enhance their governance, to streamline them, and to make them more responsive to the need to play their part in facilitating competition and innovation. We make recommendations that will do this.

Finally, as change continues and as we put in place a framework to manage change, we must recognize that our institutions will need to adjust to new competition to remain strong and vibrant. It is important that public policy assist this process where possible and not put unnecessary constraints in the way of business strategies. We make recommendations with respect to taxation policy and accounting policies that are aimed at strengthening the competitive position of Canadian institutions. And we recommend a merger review process that provides an opportunity to assess whether or not mergers of large financial institutions are in the public interest. This process will allow public participation in the review of such mergers, in an open and transparent manner, and will permit the Government to extract legally binding undertakings from merger proponents, if necessary to ensure that merger proposals that do go ahead are in the best interests of Canadians.

The balance of this report sets out our conclusions and recommendations, grouped according to the four themes discussed in Chapter 1:

- competition and competitiveness;
- empowering consumers;
- Canadians' expectations and corporate conduct; and
- improving the regulatory framework.

Chapter 6

Competition and Competitiveness

This chapter reviews certain structural issues that affect the vitality of competition in our domestic markets and the ability of our financial institutions to pursue responses to change that will enable them to become and remain strong, healthy and competitive institutions. Specifically, the chapter reviews:

- ownership policy for federally incorporated financial institutions;
- organizational flexibility and, in particular, the proposal to introduce a regulated financial holding company; and
- business powers of institutions, including increased flexibility for credit unions, access to the payments system and other networks, and the ability of deposit-taking institutions to retail insurance and lease automobiles.

In each of these areas, recommendations are made that will improve competition and, at the same time, strengthen the competitiveness of our institutions.

The chapter also sets out recommendations to make it easier for foreign banks to operate in Canada, thus enhancing competition in our domestic markets.

With respect to areas of public policy where action should be taken to enhance the competitiveness of our financial institutions, the chapter presents recommendations on taxation issues and accounting policies.

Finally, the chapter proposes a process to address mergers among financial institutions, including Schedule I banks.

Ownership Policy

The Current Policy Regime

Current ownership policy is different for banks and other federally regulated financial institutions.

In general, Canadian banks must be widely held, which under the current rules means that no individual can own more than 10 percent of any class of shares. Schedule II banks are exceptions to this rule and there are three categories of

exception. The first is for foreign banks that are widely held,[79] which can own 100 percent of a Canadian bank subsidiary. The second exception is that a bank may have a controlling shareholder for up to 10 years after it is chartered, as a transition measure to becoming a Schedule I bank. The third exception, which was introduced in 1992, is that any widely held and regulated Canadian financial institution can own 100 percent of a bank. Schedule I and Schedule II banks have virtually identical powers; the only difference between them is in the ownership structure permitted.

There is no widely-held rule for federally regulated trust companies or insurance companies owned by shareholders. For these companies, as is the case for Schedule II banks, the Minister of Finance must approve any shareholding in excess of 10 percent, but there are no legislative restrictions or directions on the exercise of this authority. Since 1992, there has been a legislated requirement that when trust companies, insurance companies or Schedule II banks reach a size where they have more than $750 million in shareholders' equity, they must have a public float of at least 35 percent of voting shares.[80] Insurance companies can also be mutual companies, owned by policy holders rather than shareholders. Mutual companies are widely held by definition. Four of the five largest life insurance companies in Canada are mutual companies, but each has announced its intention to demutualize and become shareholder-owned.

There are two main reasons why policy has required the banks to be widely held.

The first is that the absence of a controlling shareholder facilitates continued Canadian control of banks, regardless of ownership. It used to be the case that foreigners could hold no more than 25 percent of the shares of federally regulated financial institutions, but successive international trade agreements have resulted in the elimination of this restriction. As capital markets become more global and economies become more integrated, all major Canadian banks have sought to raise capital in foreign markets and most have listed their shares on U.S. stock exchanges. Foreign ownership of Schedule I banks has increased in recent years.[81] However, 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.[82]

[79] The requirement that the foreign bank parent be widely held is in guidelines issued by OSFI rather than legislation.

[80] The Minister of Finance has the discretion to exempt Schedule II banks from this requirement.

[81] The approximate aggregate foreign ownership of Schedule I banks, as of July 1998, was as follows: Royal Bank – 24 percent; CIBC – 15 percent; Bank of Montreal – 13 percent; Bank of Nova Scotia – 10 percent; TD Bank – 14 percent; and National Bank – 35 percent. See Hugh Brown, "Bank Mergers: We Canadians Are a Peculiar Lot," Nesbitt-Burns Research, July 23, 1998, p. 6.

[82] The Bank Act requirements that constitute what we call the "Canadian control toolkit" are set out in Background Paper #1, pp. 177, 178.

For insurance companies, the mutual form of ownership has ensured Canadian control of companies accounting for a major share of industry activity.

There are a number of reasons why Canadian control of our major financial institutions is important. Strong domestic financial institutions provide benefits to communities through philanthropic contributions and community leadership. They also provide the basis for domestic financial centres that can offer higher-quality, skilled jobs to Canadians, and can result in greater taxation revenue for Canadian governments. Canadian institutions are also felt to be more sensitive to domestic market situations – particularly in an economic downturn – than foreign-controlled institutions might be.[83]

The second reason for requiring wide ownership is that the absence of a controlling shareholder facilitates the separation of financial and commercial activity. Those responsible for the safety and soundness of banks have long been concerned that dominant shareholders with commercial interests could influence a bank to make lending decisions that were not in the best interests of depositors or other shareholders. The failure of many trust companies owned by dominant shareholders in the 1980s and early 1990s lent credence to this view. This concern led to the introduction of much more restrictive related-party transaction rules in the 1992 legislation; it was also a factor in requiring the 35 percent public float for larger trust companies and shareholder-owned insurance companies, introduced at the same time.

In most countries there are no formal requirements that banks be widely held. But in virtually all countries government exercises control over ownership, and in all industrialized countries, major banks are either state-owned, cooperatives or widely held.[84] 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. Their role in the payments system, in particular, led to concerns that the failure of any one bank could have repercussions on other banks and lead to systemic failure of the financial system.

In the 1992 legislation, the Government proposed a framework that would allow mutual insurance companies to demutualize. This is important if they are to be able to access capital markets and grow to become significant competitors to the major banks. The framework requires large mutual insurance companies to be widely held after demutualization, but there is no definition of what widely held means in this context.

[83] A more detailed description of the benefits of Canadian control of our financial institutions and the policy tools used to maintain Canadian control is set out in Ch. 8 of Background Paper #1.

[84] See Background Paper #2 for more detail, particularly Exhibit 2.4, pp. 19, 20

As a result, we now have an ownership structure that requires Schedule I banks of any size to be widely held; that requires some but not all large insurance companies to be widely held; and that allows for dominant shareholder control of trust companies, even though they have business powers that are virtually identical to those of banks.

Reconsidering Ownership Policy

We stated in the Discussion Paper of June 1997 that "ownership of a regulated financial institution is a privilege, not a right."[85] That view continues to inform our consideration of ownership policy. However, we became convinced in our discussions that existing ownership policy can be improved in two major respects.

First, as the functions of institutions continue to converge, we believe that distinct ownership regimes for banks, trust companies and insurance companies will become increasingly anachronistic. This is particularly the case as life insurance companies demutualize and, through access to capital markets and the payments system, grow to become stronger competitors to the major banks.

Second, we believe that the current ownership restrictions are unnecessarily inflexible, particularly with respect to the ownership of banks. The current 10 percent restriction can preclude the use of stock as acquisition currency for potential transactions that might require the granting of a position in excess of 10 percent to a major shareholder in the target company. In a world where consolidations are increasingly commonplace, and where many transactions are consummated through share exchanges, this inflexibility can seriously constrain the range of potential strategies that our domestic banks can consider. Indeed, it is one factor that may force them to look at domestic consolidation rather than international acquisitions.

A further consequence of the wide-ownership provision is that it seriously constrains 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. There are many regulatory barriers facing new entrants. These include federal and provincial capital taxes and the requirement for a minimum of $10 million in capital, both of which requirements we recommend be relaxed. But, in our view, 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 risks should be permitted to reap the rewards when they are successful.

[85] Task Force Discussion Paper, p. 1.

We see no compelling public policy reason, for example, why a major retailer who wishes to offer banking services should not have the option of establishing and owning a small bank.

We recognize that allowing commercial interests to own banks is a major departure from current policy. We believe that the separation of commercial and financial interests does provide additional assurance that institutions will be managed and governed in the best interests of depositors and policy holders and, in our recommendations, we insist on such separation for the largest of our institutions. But 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 may well be the case that as new entrants emerge and competition intensifies some of the smaller institutions will fail, despite the best efforts of OSFI to supervise them. 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

In designing a new ownership policy, our starting principle is that there should be a common ownership regime for all federally regulated financial institutions. It should balance prudential concerns with the desirability of enhancing competition through encouraging alliances and new entrants. In practical terms, this means that it 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

We considered the issue of wide ownership and we concluded that the objectives served by wide ownership – Canadian control and the separation of finance and commerce – continue to be valid objectives. Further, from our consultations with Canadians and through the submissions we received, it became apparent that there was a strong desire to see Canadian control of our financial sector continue.[86] We believe that our financial services sector should remain Canadian-controlled, although it does not follow that every major institution must be Canadian-controlled.

[86] Our public opinion research confirmed these sentiments. See Ekos, *Public Opinion Research*, pp. 51, 52.

We also conclude that the separation of financial and commercial activity is to be encouraged. We recognize that, in 1992, stringent related-party transaction rules were added to the legislation and that these may help to prevent, in future, some of the worst excesses that were experienced through the early 1980s and the early 1990s. But these rules have not yet been tested in tough times and we are not prepared to say, for our largest financial institutions, that dominant commercial owners are acceptable.

From a prudential point of view, the greatest concern must be with the largest institutions, because their failure could create serious systemic risk issues. However, ownership rules should not be designed with the objective that no institution of any size could ever fail. Scope must be left for entrepreneurship and risk-taking, recognizing that the failure of some institutions may be a reasonable cost to accept in return for innovation and competition.

We therefore recommend the continuation of a wide-ownership policy, but only for the largest financial institutions. Specifically, we recommend that all federally regulated financial institutions with shareholders' equity[87] 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

We recommend a more flexible ownership regime for smaller institutions. Institutions with less than $1 billion in shareholders' equity should be allowed to be owned by anyone who is approved as "fit and proper" by the Minister of Finance. There would be no requirement to divest so long as shareholders' equity remained at less than $1 billion.

Institutions with shareholders' equity of greater than $1 billion and less than $5 billion would be required to have a minimum of 35 percent of their voting, participating shares widely held and publicly traded. The Minister of Finance would retain his current authority to exempt the subsidiary of a foreign financial institution from the need to issue a 35 percent public float.

The Definition of Wide Ownership

The current definition of wide ownership is too restrictive. We believe that the benefits of wide ownership can be obtained, and desirable flexibility added to the system, by allowing the Minister of Finance in certain circumstances to authorize individual shareholdings of up to 20 percent of any class of shares. Details of this proposal are set out in Background Paper #2.[88] In brief:

[87] Shareholders' equity as used in this discussion of ownership policy includes loans granted to the company by the principal shareholder or related parties.

[88] See pp. 27-31.

- The Minister of Finance would have discretion to permit ownership positions of up to 20 percent, so long as all shareholders so authorized do not collectively own or control more than 45 percent of any class of shares. There could, for example, be two shareholders with 20 percent each or three shareholders with 15 percent each.
- The Minister could permit an authorized shareholder to temporarily exceed the 20 percent limit, subject to an acceptable divestiture plan to be executed within a fixed time period and an undertaking not to exercise the voting rights of more than 20 percent of the shares.

The increased shareholding limit should not generally be available for passive investments. 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, but which are presently constrained by the 10 percent rule. Such transactions could take many forms, from acquisitions by Canadian financial institutions to strategic partnerships. In an era of globalization, cross-border investments between financial institutions are becoming increasingly common. Acquisitions of, or alliances with, financial institutions based outside Canada can lead to innovative products and delivery channels for the Canadian market as well as a platform from which to offer service to Canadian customers doing business abroad or to expand into foreign markets. To take another example, companies historically not active in financial institutions are showing increasing interest in the area. Supermarkets, other retailers or information technology companies may well be interested in strategic alliances with financial institutions that would involve a shareholding in the financial institution.

There is no absolute rationale for the 20 percent limit. It is a balance, but it is a balance that reflects, on the one hand, the continuing desire to ensure that large financial institutions operate free from the control of a dominant shareholder and, on the other hand, the practicality of choosing a threshold that would encourage desirable alliances. To the extent that prospective partners require the ability to "equity-account"[89] their investment, 20 percent seems to be a necessary, though not always sufficient, level of ownership.

The purpose of the 20 percent threshold is to facilitate strategic transactions that benefit Canada. For that reason we recommend the flexibility for a temporary excess, with clear, enforceable undertakings to divest and not to exercise the voting rights of excess shares. For the same reason we recommend that the Minister not grant authority to exceed 10 percent to passive investors.

[89] Equity-accounting allows the alliance partner to include the annual earnings of an investee financial institution in its own financial statements.

We recommend that the Minister of Finance issue guidelines to identify the circumstances in which he would be prepared to consider an application for authorization to exceed 10 percent. The guidelines should also outline the process by which an investor wishing such authorization would seek and obtain approval.

Finally, we recommend that any widely held regulated financial institution that is incorporated in Canada should be able to own up to 100 percent of any other regulated financial institution, regardless of its size.

Ownership of Multiple Institutions

Where a single owner, or a group of related owners, has effective control of more than one regulated financial institution, the applicable ownership rule should be determined on the basis of the combined shareholders' equity of the controlled financial institutions.

Cooperative Ownership

Canada is almost alone among developed countries in the absence of strong second-tier institutions that can compete with the major banks. The credit unions and caisses populaires are effective competitors in some provinces, but not all. We believe it is vitally important to encourage strong second-tier institutions. To ensure that the cooperative sector has every opportunity to grow, we recommend that provision be made for cooperative ownership for deposit-taking institutions, similar to the mutual form of organization now used for insurance companies. The cooperative form of ownership would allow the formation of new member-owned banks or trust companies. But we also see this provision as enabling existing credit unions or credit union centrals, with permission from their incorporating province, to be continued as banks or trust companies.

Special Circumstances

There are three sets of special circumstances, flowing from the introduction of a common, size-based ownership regime: smaller Schedule I banks, demutualized insurance companies, and non-conforming institutions.

Smaller Schedule I Banks

At the moment, all Schedule I banks must be widely held. In the new regime, those with shareholders' equity of less than $5 billion would not be required to be widely held. Should their existing widely-held ownership be grandfathered, or should they be subject to the ownership regime otherwise applicable to their size? Our view is that these banks should have the greatest possible flexibility to restructure themselves but that they should control their own destiny. We therefore recommend that they be grandfathered but that they be able

to choose to relinquish the grandfathering if they wish. To do so would require the approval of the board of directors confirmed by special resolution of the shareholders, and subsequent approval of the Minister of Finance.

Demutualized Insurance Companies

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

- the ability, through shareholdings, of policy holders to obtain liquidity for their share of the value of the company;
- greater flexibility in the type and acquisition cost of capital;
- the potential to use equity as currency in future acquisitions and alliances;
- the ability to provide equity-based compensation that can assist in attracting and keeping highly skilled employees; and
- the market discipline of being a publicly traded company, which can lead to greater innovation and competition in the market.

In line with our recommendation of a common ownership policy for all federally regulated financial institutions, the ownership regime for demutualized insurance companies should be determined by their size, based on shareholders' equity after demutualization.

The four companies considering demutualization have argued that there should be a transition period subsequent to demutualization, during which wide ownership should be required. We agree that after demutualization it may take some time for a newly demutualized company and its management team to adjust to the reality of life as a listed public corporation. It may also take some time for the company's shares to attain full market recognition of value. Many insurance companies that have demutualized in other countries have been granted a transition period during which they have been immune from takeover.[90]

We believe that the four demutualizing companies provide an important platform to enhance competition in the Canadian marketplace for financial services, particularly with an expanded power to offer payments services. Accordingly, we do not wish to totally constrain business alliances and restructurings during any transition period. We would not, however, like to see any of these 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.

[90] For example, according to information provided to the Task Force by Morgan Stanley & Company, after demutualization, shareholdings in the Equitable Life Insurance Company (United States) were restricted by law to no more than 5 percent for a period of five years; and shareholdings in AMP (Australia) were restricted by law to no more than 5 percent for one year after listing.

We therefore propose that there should be transition guidelines to be applicable for a three-year period following the demutualization of a life insurance company. The basic principle behind the guidelines would be that a newly demutualized company should not be subjected to a hostile takeover bid or amalgamation proposal in a period while it is still adjusting to the reality of the public market environment. While hostile transactions should be precluded, we do not wish the guidelines to be so inflexible that newly demutualized companies are denied the opportunities to enter into strategic alliances that may bring more effective competition to the Canadian financial services sector.

Large demutualizing companies (that is, those with shareholders' equity in excess of $5 billion) will have to remain widely held during the transition period and beyond, by virtue of their size.

Smaller demutualizing companies would not, under the general ownership rules, have to be widely held. The transition guidelines should provide:

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

Newly demutualized companies may, however, find it desirable to form strategic alliances with other providers earlier, rather than later. We therefore 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.

Non-Conforming Institutions

Some institutions will not conform to the ownership rules of the new regime at the time it is introduced. We propose that such companies be allowed to continue business without altering their ownership structure, subject to the Minister being satisfied on an ongoing basis with the quality and substance of the undertakings provided by the controlling shareholder with respect to prudential issues.

Transition rules would provide maximum flexibility for existing owners to continue to hold their investment and to dispose of it without constraint. The business would be able to be conducted with no special restrictions and existing owners would have an unfettered ability to dispose of their ownership position, so long as the buyer is judged to be "fit and proper" by the Minister. If the ownership position following disposition does not conform to the policy, that owner could also operate the institution without special constraint, but would be required to ensure compliance on disposition of his interest. A sale of the non-conforming interest would be allowed to a widely-held regulated financial

institution from abroad and such a sale would be deemed to bring the institution into compliance with the ownership policy.[91]

Flexibility for the Future

This is a time of rapid change in the financial services business and it is simply not possible to foresee all scenarios. It is possible to imagine circumstances in which additional flexibility in the ownership policy might be desirable to achieve important national policy interests.

One example might be where a major Canadian financial institution faces financial difficulty that gives rise to serious concerns about its continuing viability. One option would be the combination, by merger or takeover, of that institution with another large Canadian financial institution. That, however, would increase still further the concentration in Canada's financial sector. In such a circumstance, the Minister of Finance should have the statutory authority to look beyond Canadian financial institutions to find a "white knight", weighing the various objectives of the ownership policy and the need for a competitive marketplace.

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

In either of these cases, the Minister would want to know if a transaction can be crafted that maintains the benefits of a Canadian controlled financial sector, while furthering objectives of safety and soundness or enhanced competition. We believe the ownership policy should allow such flexibility.

We therefore recommend that the Government should have the power, to be used only in exceptional cases, to approve the acquisition of a large Canadian institution by a widely held, regulated foreign financial institution, free from the impact of the widely held rules. Any such transaction should be subject to approval by the Governor-in-Council on the basis that the acquisition would significantly enhance competition in the domestic market or increase safety and soundness, and there should be provision for enforceable undertakings to ensure that the transaction provides its anticipated benefits to Canada.

Because this flexibility is intended to be the exception, not the rule, we recommend that approval be required by the Governor-in-Council, rather than the Minister of Finance.

[91] Further detail on how these transition rules might work is found in Background Paper #2, p. 34.

Summary

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

- It will preserve Canadian control of our largest institutions, and ensure that they are free from commercial linkages that could prejudice their safety and soundness.
- It will facilitate alliances that can bring benefit to Canada by promoting innovative practices and competition in the Canadian market, and benefit to Canadian institutions by assisting them to develop platforms to become more successful international and global players.
- It will encourage new entry to banking, by allowing entrepreneurs and commercial entities to own smaller banks and by allowing cooperative banks.
- It will provide a breathing space for demutualized insurance companies to adjust to market discipline so that they can become more significant competitors to the banks.
- It will provide flexibility for smaller Schedule I banks to seek new alliances that can help them grow and become more significant competitors in the Canadian marketplace.
- It will respect non-conforming ownership positions, while ultimately bringing all financial institutions into compliance.
- It will provide desirable flexibility by allowing the Governor-in-Council to consider foreign acquisitions of large Canadian institutions on an exceptional basis, where this is clearly in the Canadian interest.

Organizational Flexibility

In our Discussion Paper we raised the question of whether a holding company structure could provide welcome organizational flexibility to financial institutions. We raised this in a context of functional analysis, which suggests that it would be desirable for similar functions to be regulated similarly, even when carried out by different institutions. An example that was often cited was the lack of prudential regulation of wholesale lending activity when carried on by institutions that do not take deposits, compared with regulation of the same activity when carried out by a deposit-taking institution. While we are sympathetic to the concept of functional regulation, it is difficult to attain in practice. At the end of the day it is institutions, not functions, that fail.

To the extent that more flexible organizational structures can allow a separation of function into legal entities that are grouped in a holding company, it may be possible to move closer to the ideal of being able to regulate by function. It was this consideration that lay behind our desire to examine holding companies.

We received a number of submissions from institutions outlining the business reasons why they felt holding companies were desirable. We also received continuing assistance from OSFI in understanding the regulatory concerns that holding companies raise, and ways in which these concerns can be addressed in order to capture as many of the business-case benefits as possible. OSFI also undertook a research project to assess the use of holding companies in other countries, and made that information available to us and to the public.

The issue of organizational flexibility is a highly technical one.[92] In brief, we recommend that a regulated holding company structure be permitted. We propose that a Financial Holding Company Act set out the requirements for the holding company and the relationship between the holding company and the regulator. Highlights of this relationship would include the following:

- Ownership requirements for the holding company would be consistent with those for federally regulated financial institutions.
- A financial holding company would be allowed to hold only entities that could be held by an operating regulated financial institution. We recommend the list of eligible subsidiaries and minority investments be reviewed to create additional flexibility.
- Capital requirements for the holding company would allow it to serve as a source of strength for the group.
- A related-party transaction regime would recognize the holding company as a related party.
- The regulator would have access to information on the holding company and all of its subsidiaries, regulated and unregulated, together with a right to examine any of the affiliated companies, including the unregulated companies in exceptional circumstances.

We believe that a holding company, established along these lines, will offer important flexibility to financial institutions wishing to meet the challenges of a more competitive, global environment. Some examples of the benefits this structure can offer are the following:

- It can provide a vehicle for medium-sized companies in different financial services businesses to come together, under common ownership, without losing their individual identities.
- It offers the possibility of greater flexibility for regulated financial institutions to raise external capital and develop alliances with strategic business partners.
- It can result in more nuanced regulation of regulated institutions. This could occur if functions that require less oversight (because, for example,

[92] Our conclusions and proposals are set out in some detail in Ch. 3 of Background Paper #2.

they do not involve taking deposits or premiums) become established as affiliates of the regulated financial institution within a holding company structure. Over time, this may provide an effective way of moving closer to a system of functional regulation.

Achieving these benefits will in large measure depend upon OSFI's confidence that it can adequately ring-fence the institutions held by the holding company, in order to prevent the failure of an affiliate from affecting the safety and soundness of the regulated financial institutions in the family. An important aspect of this ability will be public perception. It will therefore be important for the market to recognize that not all entities in a holding company structure are supervised to the same standard; that, from time to time, some may fail; and that failure of an unregulated or lightly regulated affiliate should not compromise the position of the regulated deposit-taking institution or insurance company. To the extent that such recognition can be achieved, OSFI will be able to lighten the regulatory burden with greater confidence that contagion can be prevented.

To assist in this process, appropriate disclosure rules will be important. Any consumer dealing with unregulated entities in a holding company group must be informed that such entities are not regulated financial institutions or subsidiaries of regulated financial institutions; that liabilities issued by these entities are not deposits and are not insured or guaranteed by government-sponsored protection programs; and that the entities or their liabilities are not guaranteed by the regulated financial institution in the group. There should also be restrictions on the use of the name "bank" within the group.

Business Powers

An important aspect of our vision for the financial services sector is that there should be a fully open and competitive trading and investment environment. We have considered the issue of business powers in this environment from the perspective of the consumer and with the consumer's best interests in mind. Our bias was to increase consumer choice and benefit unless there appeared to be compelling reasons not to do so.

There are five major areas that we considered:

- greater flexibility for credit unions;
- whether institutions other than deposit-takers should have access to the payments system;
- access of institutions to other networks;
- whether deposit-taking institutions should be allowed to retail insurance products through their branches; and
- whether deposit-taking institutions should be allowed to offer automobile leases to retail customers.

Greater Flexibility for Credit Unions

Credit unions and caisses populaires today play an important role in meeting Canadians' financial services needs. Indeed, in some provinces, they are dominant market forces in many product lines. Their role can and should be strengthened. It is important that there not be public policy constraints on the ability of credit unions and caisses populaires to make their greatest possible contribution to a competitive financial services environment.

The existing federal and provincial legislation was designed to nurture and regulate a very loose confederation of relatively small self-governing financial institutions. We have concluded that the present public policy framework is unduly rigid in constraining credit unions, through their provincial centrals and national bodies, from creating a more integrated and effective credit union system. The changes we propose will remedy those defects at the federal level.

In particular, we are proposing several measures to increase the flexibility of the centrals to engage in joint ventures and to provide services that can assist the locals in offering a more complete menu of financial services products to their customers. We are also recommending the establishment of a cooperative bank charter, which would allow credit unions and provincial centrals the flexibility to operate nationally. These two initiatives should significantly enhance the opportunity for the credit union movement to grow into a major second-tier competitive force in the Canadian financial services marketplace, across Canada.

It will, of course, be for the members and leaders of the credit union movement to determine the direction they should take. In the rapidly changing and increasingly competitive environment that faces them, credit unions will be more and more challenged to meet the demands of their customers. Credit unions will have to find ways to deploy their capital more efficiently, to access capital markets, to build necessary technology platforms, and to provide the more sophisticated advice and products which customers expect. These are major issues.

On the other hand, the credit unions should be well positioned to address them. They have much inherent strength, rooted in their local relationships and community responsiveness.

The challenge for the leadership and members of the movement is to build on that foundation. We believe that the new tools we are providing should materially assist them.

A more extensive discussion of the role of credit unions, their challenges and opportunities, and our recommendations in this regard can be found in Chapter 5 of Background Paper #2.

Access to the Payments System

The Canadian payments system[93] consists of a set of separate networks that include the cheque payments system, the credit card systems of Visa and Mastercard, the ATM and debit card networks of Interac, and the separate clearing systems for debt and equities, and for mutual funds. At the centre of the system is the Canadian Payments Association (CPA), which has the mandate under the Canadian Payments Association Act to operate a national clearing and settlement system. Members use this system to settle claims arising from their customers' cheque payments and receipts, and to discharge their net claims from transactions in the other networks.

The payments system is an invisible but critically important part of our financial services sector. It is like the electrical wiring of a house – taken for granted when it works well, a major nuisance and inconvenience when it does not, and the source of a possible catastrophe if things go really wrong. The Canadian payments system works well.

Until 1983, the Canadian payments system was operated by the Canadian Bankers Association, as it had been since the turn of the century. In 1980, the Government established the CPA and extended membership eligibility to trust companies, credit unions and caisses populaires. 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.

In recent years, institutions competing with payments system participants have become more eager to join the payments system, in order to provide transaction services to their customers and to participate in the governance of the Association. When the dominant mode of payment was cash or cheque, this was relatively less important. With the increasing acceptance of electronic payment and the development of easily accessible electronic networks, access to the payments system is becoming a more important way of providing customer value, and a way for institutions to build long-term relationships with their customers.

In particular, life insurance companies, mutual funds and investment dealers are all eager to become members of the system directly. Life insurance companies pay out about $30 billion a year in claims under life and health policies and annuity contracts. Companies would like to be able to keep claimants as customers in a broader relationship by offering to retain their claims in deposit-like accounts and providing payments services on those accounts. Similarly, mutual fund companies would like to be able to allow their customers to access

[93] We are also recommending changes to the governance of the payments system. See Ch. 9.

their investments in the funds to make payments, and investment dealers wish to allow clients to access their cash balances directly rather than through transferring funds to a deposit-taking institution.

The issue of access to the payments system is complex. As the system is structured today, 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. This same-day availability of funds is rare and to be valued. 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 to 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.

The Government established a Payments System Advisory Committee in 1996, to examine issues of access to the system and governance. The Committee was co-chaired by the Department of Finance and the Bank of Canada, and it considered four papers prepared by the Department and the Bank.[94]

Following the deliberations of the Committee, the Department of Finance released a Discussion Paper in July 1998.[95] The paper pointed to the need for a framework and criteria to assess how new entrants would affect the balance between customer choice and inconvenience. Specifically, it identified the desirability of ensuring, for new entrants:

- appropriate regulatory oversight;
- appropriate solvency and liquidity standards and practices;
- access to liquidity support;
- a satisfactory legal framework; and
- adequate operational and technical capacity.

The paper also identified life insurance companies, mutual funds, and investment dealers as candidates worthy of a more detailed examination against these criteria.

[94] The four papers dealt respectively with the scope and elements of the payments system, public policy objectives, access to the system, and governance issues. The four papers, together with comments of the Advisory Committee, are available at <www.fin.gc.ca> or from the Department of Finance.

[95] Department of Finance, *Payments System Review: Discussion Paper*, July 1998.

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. We support the need for a careful review of potential participants, their business and their regulatory framework to determine any conditions that may be required of them. We expect that life insurers, money market mutual funds, and investment dealers will be capable of meeting the criteria with few, if any, restrictions. The Department of Finance should give high priority to this review so that these institutions can participate in the payments system as soon as possible.

Access to Other Networks

Maximizing the competitive potential of existing players will require that there be open access on reasonable terms to other networks as well, such as Interac. The development of networks 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 in other countries. In such a situation, government will have to monitor carefully whether existing and prospective networks facilitate competition to the extent that they can and should.

One particular issue we have considered is the suggestion that functionality in the Interac 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.[96] This suggestion has considerable merit, and we recommend that the members of Interac act to implement it.

The Retailing of Insurance

Federally regulated deposit-taking institutions are currently allowed to sell certain types of insurance through their branches. In addition, they may have subsidiaries that underwrite and sell insurance of any kind, using any distribution channel except branches. They may not share customer information with an insurance company, regardless of whether the company is a subsidiary, and they cannot target-market insurance to their customers.[97] These restrictions were introduced in 1992, at the time deposit-taking institutions acquired powers to own insurance subsidiaries. Provincial regulations governing credit unions generally follow the federal restrictions, although some credit unions and caisses populaires have broader powers.[98]

[96] This suggestion was made in a letter to the Task Force by Hongkong Bank of Canada, May 21, 1998.

[97] They may market insurance directly to their total customer base or their credit card customers, but they are prohibited from segmenting their customer base. For example, a bank can promote auto insurance to all its customers, but not to only those customers that have auto loans.

[98] Broader powers exist in Quebec, British Columbia, Manitoba and New Brunswick. See Background Paper #2, Exhibit 4.2.

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 – creating unemployment and disadvantaging consumers in the long run. They also argue that the banks are too powerful. They claim that banks are likely to engage in coercive sales practices, such as tying insurance purchases to loan requests. They also express concern that banks may abuse the substantial amount of personal information at their disposal if they have the right to share information in customer files between their insurance and other operations, or otherwise use such information to secure an unfair competitive advantage over insurance agents and brokers.

Consumers have not matched the high level of industry concern. Research conducted for the Task Force indicates that less than 30 percent of Canadians are personally concerned about this issue. Most Canadians want to be able to choose where they buy insurance, but there is also some concern that banks selling insurance would have too much consumer information and that competition would increase only in the short run.[99]

Linkages between banks and insurance companies, known as bancassurance, have been common in Europe for many years. We reviewed some of the international experience and our findings are presented in Chapter 4 of Background Paper #2. In general, banks are allowed to underwrite and distribute insurance products with little or no limitation in most European countries, and they can distribute but not underwrite insurance in most of the United States. We have seen no evidence that markets have been seriously disrupted in these countries by bank distribution of insurance. In most European countries the share of the market taken by banks has been about 20 percent or less.[100] There is some evidence – although it is not strong – that the lower costs and higher productivity that banks achieve in distribution has led to an overall expansion of the market.

On balance, we believe that consumers will benefit from more choice and that to deny choice would be contrary to the public interest.[101] However, we recommend a number of conditions that should be fulfilled before deposit-takers are allowed to retail insurance.

[99] Ekos, *Public Opinion Research*, pp. 55, 56.

[100] In France and Spain the share is higher, exceeding 50 percent for life insurance.

[101] A more complete explanation of the reasoning that supports our recommendations is set out in Chapter 4 of Background Paper #2, particularly pp. 88-99.

First, we recognize that the potential exists for coercive tied selling when insurance products can be linked to applications for credit. We were surprised at the number of Canadians (16 percent) who reported, in our public opinion survey, that they felt that a loan or a mortgage might not have been approved unless another product was purchased from the same institution.[102] We believe, however, that problems with coercive tied selling should be dealt with directly and not indirectly. Accordingly, we make recommendations that we believe will address the problem of coercive tied selling. These recommendations should be adopted whether or not deposit-takers are allowed to sell insurance. Their adoption will provide greater assurance that consumers will be free to choose the insurance product that is best for their needs, regardless of supplier.

Second, we share the concerns of those who are worried about privacy and the extraordinary amount of personal and sensitive information in the hands of deposit-takers. We do not believe that current privacy codes are adequate – regardless of whether the right of deposit-takers to retail insurance is expanded – and we are proposing a strong set of recommendations to increase individuals' control over the release and use of their personal information. Among these recommendations are very strict controls on the collection and use of medical information, modelled after those in Quebec's Bill 188. We believe that the adoption of the privacy regime we recommend will ease concerns about the potential negative impacts of allowing deposit-takers to retail insurance.

Finally, we recognize that there will be some disruption in the marketplace as new suppliers and new distribution methods come into effect. If new competitors are in fact more efficient and offer consumers better value, they will win market share. Some existing jobs may well be lost. But new jobs are likely to be created as the share of new competitors grows. The bottom line is that consumers will have more options available at better prices.

In view of the disruption that new competition may cause, however, we believe that there should be a reasonable transition period to allow those in the industry to prepare for the more intensive competition that we expect will come. We therefore recommend that the existing restrictions on distribution of insurance remain in force for all deposit-takers until such time as the amendments to the tied selling and privacy provisions are proclaimed, and remain in force for large deposit-takers (that is, with shareholders' equity in excess of $5 billion) until January 1, 2002. We further recommend that the tied selling and privacy provisions be enacted and proclaimed quickly, thus giving smaller deposit-takers an earlier start on retailing insurance products.

[102] Ekos Research, *Public Opinion Research*, p. 54.

We have considered what licensing and other regulatory regime should apply to employees of deposit-taking institutions who sell insurance. Many submissions expressed concern about the need to ensure that only appropriately educated and licensed salespersons serve consumers. We note that educational requirements vary among the provinces, and that some provinces have provisions in their regulations that do not allow employees of deposit-taking institutions to qualify for an insurance licence. In our view, there is a need to upgrade educational requirements for the licensing of market intermediaries, and we make recommendations on this in Chapter 7.[103]

We believe, however, that provincial regulation of market intermediaries is appropriate and we therefore recommend that employees of deposit-taking institutions engaged in the sale of insurance should comply with applicable provincial requirements with respect to education and licensing, so long as those requirements are not discriminatory. We urge provinces to consider adopting a model code in this area, as was done in the United States. We have reviewed the Illinois model code and the proposals in Quebec's Bill 188, which is similar in many respects to the Illinois model code. These approaches appear to provide a good base for developing a harmonized system across Canada.[104]

Leasing Automobiles to Retail Customers

Deposit-taking institutions were given the power to enter into leases in 1980 but, as a result of concerns expressed by auto dealers, the 1980 Bank Act revisions restricted them from leasing vehicles weighing less than 21 tonnes. The 1992 legislation extended this restriction to trust companies and life insurance companies. Credit unions and caisses populaires are able to lease vehicles in all provinces except New Brunswick and Newfoundland. Provincial trust companies have leasing powers in most provinces.

The automobile leasing market in Canada has grown rapidly in importance. In 1997, about 47 percent of new retail vehicles were leased, compared with only 4 percent in 1989. The financing arms of the auto manufacturers, which have an estimated 70 to 80 percent of the market, dominate the light vehicle leasing market in Canada. About one third of all auto dealers own a lease portfolio, although only about 45 dealers (less than 1 percent of the dealers in Canada) lease as many as 200 units per year for their own portfolio.[105] The average

[103] See also Background Paper #3, *Empowering Consumers*, Ch. 7.

[104] For more background information on the Illinois code and Bill 188, see Background Paper #2, p. 87.

[105] Background information is drawn from a DesRosiers Automotive Consultants, *Background Report on Extending Bank Powers to Include Light Vehicle Leasing*, research paper prepared for the Task Force. For precise references, see the discussion on Light Vehicle Leasing in Ch. 4 of Background Paper #2.

dealer-owned leasing operation, excluding the top 45, is estimated to lease about 25 vehicles annually. All dealers combined account for about 10 to 15 percent of the light vehicle leasing market.

Deposit-taking institutions argue that consumers should have the choice of leasing vehicles from a bank or trust company, suggesting that this would lead to more competition and lower lease rates. They argue that leasing is a substitute for lending, and therefore leasing of vehicles should be an allowable business power, as is leasing of other equipment. They note that the leasing market is dominated by foreign-controlled finance companies such as Ford Credit, which successfully face bank competition in retail leasing in the U.S. market.

Auto dealers and manufacturers are united in their opposition to expanded leasing powers for deposit-taking institutions. They argue that allowing banks to lease will reduce auto dealer profitability and lead to job losses in many communities. They maintain that this increased competition will be unfair, based on coercive tied selling and advantageous use of customer information bases.

Consumer groups did not generally express an opinion on this issue to the Task Force.

Our review of international experience showed that banks in most developed countries are not restricted from automobile leasing, and that the financing arms of the major manufacturers are active internationally in competition with banks. Canada appears to be the only developed country where bank leasing powers have been a major policy issue. Indeed, General Motors notes that the major competitors of General Motors Acceptance Corporation (GMAC) are "banks and credit unions and other financial services companies," and it also reports that its Canadian lease volumes increased by 46 percent in 1997, while "decline in the U.S. and international retail and lease financing revenues from 1996 to 1997 was attributable to continued competitive pressures in these markets."[106]

In accordance with the vision of the financial sector that we believe will best serve Canadians, we recommend that the restrictions on light vehicle leasing for deposit-taking institutions and life insurance companies be removed. We believe that the additional competition will be beneficial to consumers, and that concerns expressed with regard to coercive tied selling and privacy can be adequately addressed by the recommendations we are making in these areas.[107]

As with the distribution of insurance, we recognize that there will be some disruption and adjustment in the marketplace as competition intensifies.

[106] General Motors Annual Report, 1997, pp. 44, 46.

[107] A more complete explanation of the reasoning that supports our recommendation is set out in Ch. 4 of Background Paper #2, particularly pp. 99-109.

We therefore recommend the same transition arrangements for automobile leasing as we have done for insurance distribution.

Summary

The business power revisions proposed above will provide consumers with a wider choice of financial service providers. Opening the payments system will allow insurance companies, money market mutual funds and investment dealers to provide more direct and effective competition to deposit-takers. Allowing deposit-takers to retail insurance and lease automobiles is consistent with the principle that consumers, not regulators, should choose who gets to provide these services. The privacy and tied selling provisions, discussed in the next chapter, will protect consumers against abusive practices, and the new ombudsman regime that we are recommending will also ensure that they have an effective, accessible and independent adjudicator of complaints if they feel badly dealt with.

We recognize that change will bring some disruption to established players. That is a consequence of change wherever it occurs. We have recommended a reasonable transition period to allow those who will be most affected to prepare. We believe strongly, however, that providing wider choice to consumers and encouraging new competition should have a higher policy priority than attempting to preserve the current situation.

The Entry of Foreign Banks

The entry of foreign banks into Canada was prohibited from 1967 to 1980. Since 1980, it has been regulated. The World Competitiveness Survey ranked Canada 41st out of 53 countries surveyed with respect to the degree of competition from foreign banks.[108]

Foreign banks have been allowed to operate bank subsidiaries in Canada since 1980. The number of foreign bank subsidiaries reached a high of 59 in 1987 and has since declined to 44 at the beginning of 1998. Foreign banks in Canada account for about 10 percent of total assets held by the banking sector, 7.3 percent of business credit, and only 2.8 percent of credit extended to small and medium-sized businesses. 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.

The federal government undertook to relax restrictions on foreign bank entry in the trade negotiations on financial services that were concluded, under the auspices of the World Trade Organization, in December 1997. In September 1997,

[108] Institute for International Management Development, *The World Competitiveness Yearbook 1997*, June 1997.

the Department of Finance published a consultation paper outlining options for easing restrictions on foreign bank entry.[109] The paper discussed the conditions under which foreign banks would be allowed to operate in Canada through a branch, as opposed to or in addition to a subsidiary. It also discussed entry options for regulated foreign banks that wanted to undertake a more limited form of financial activity in Canada.

With respect to the ability to operate in Canada through a branch, the consultation paper set out a number of requirements for the parent bank. The branch itself would have to hold capital in Canada, would be barred from accepting retail deposits (defined as deposits under $150,000), would be supervised by OSFI, and would be subject to a taxation regime that would put the branch on a reasonably level playing field with respect to Canadian banks. A foreign bank would be allowed to operate through both a branch and a subsidiary.

For foreign banks that wished to undertake a more limited form of financial activity in Canada, the Department proposed two options.

The first option would force a foreign bank to choose between a “regulated stream” and an “unregulated stream.” If regulated, it could operate a subsidiary or a branch, or both; if unregulated, it could engage in a limited range of financial services, such as consumer or small business lending with no prudential regulation, although it would still be subject to market conduct regulation. The two streams could not be mixed. If a foreign bank had a regulated operation, all of the activities it engaged in would have to be regulated. If it had unregulated activities and wished to open a branch or a subsidiary, it would have to cease the unregulated activities or transfer them to the regulated entity.

A second option would permit a foreign bank to create a “limited purpose” entity that would be subject to lighter regulation than a subsidiary or branch but would have restricted powers (for example, credit card or leasing powers). This option would be available only if the foreign bank had no deposit-taking entity in Canada.

We have considered the Department of Finance consultation paper and 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. We further believe that the rules intended to regulate foreign branch operations should not serve as an artificial barrier to entry. Specifically, we are concerned that the $25 billion worldwide asset requirement for the parent bank proposed in the consultation paper is too onerous. If an asset test is required at all, it should be substantially reduced. Well-capitalized smaller institutions should be encouraged to do business in Canada.

[109] Department of Finance, *Foreign Bank Entry Policy – Consultation Paper*, September 1997.

Where a subsidiary or branch of a foreign bank does not engage in activities that give rise to prudential concerns (that is, the taking of retail deposits), we believe that the lightest possible regulation should apply. Indeed, if the operation does not wish to operate as a bank in Canada, we do not see that there is a need for any prudential regulation at all, although such an entity should be subject to market conduct regulation.

We understand that there has been reluctance in the past to allow foreign banks to undertake unregulated activities (such as asset-based lending or wholesale finance) that compete with Canadian banks because Canadian banks could not conduct similar activities on an unregulated basis. We believe that the holding company regime we are recommending can potentially overcome this perceived disadvantage. In any event, we do not believe 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 foreign bank operating in Canada can now accept retail deposits through a subsidiary and branches of that subsidiary. Hongkong Bank of Canada, for example, is a major retail deposit-taker. Even though this was not raised as a pressing issue by foreign banks, we considered whether competition could be further enhanced by allowing foreign banks to engage in direct retail branching, that is, to accept retail deposits through direct branches of their parent rather than through branches of a Canadian subsidiary. We recognize that direct retail branching might offer additional sources of competition to Canadians. However, it would entail some serious prudential risks. In particular, if deposit insurance were provided to entities where the primary regulator was in a foreign jurisdiction, where there was no legal entity in Canada and where capital was not required to be vested in this country, there would be prudential risks that appeared to us to outweigh potential benefits.

Indeed, since the collapse and liquidation of the Bank of Credit and Commerce International (BCCI), there appears to have been a greater reluctance in other countries to allow branches of foreign banks to accept retail deposits, and the United States has now moved to bar such activity. We considered whether ways might be found to allow direct retail branching with greater prudential confidence, such as through requiring the vesting of capital in Canada. We concluded that the existing alternative by which foreign banks may accept retail deposits through a subsidiary does not seem to us to be so onerous as to warrant the difficult legal steps that might need to be taken to create an acceptable direct retail branching alternative. Accordingly, we are not prepared to recommend direct retail branching.

Taxation Issues

The taxation of financial institutions is a major factor in their competitiveness. Taxation can also directly affect domestic competition.

In our Discussion Paper we indicated that we did not intend to focus on taxation, in view of the technical complexity of the issues and the parallel review of business taxation being conducted by the Technical Committee on Business Taxation.[110] Instead, we commissioned – jointly with the Technical Committee – a research study to identify aspects of the tax regime affecting financial institutions that might give rise to policy concerns. This joint research study is being released with this Report.[111]

The Technical Committee concluded, "As long as the financial services sector is under broad review by the Task Force and the government, we should make no recommendations nor suggest any policies that would significantly alter the level of tax revenues currently derived from the financial sector under the existing regime."[112]

The Task Force has now concluded its review and, on the basis of the research we have examined, we feel it is imperative to raise the issue of the level and structure of capital taxes.

Regulated financial institutions are subject to special taxes on their capital that are not faced by other industries or by unregulated financial institutions. At the federal level, these taxes have existed since 1986 for deposit-takers, and since 1990 for insurers. The rates have been increased over time and, since 1995, there has been a "temporary" surtax on the capital tax, which has been extended annually and is now scheduled to expire in 1999. The special capital tax can be reduced by income tax paid, so that it functions as a corporate minimum tax on regulated financial institutions.

All provinces have levied capital taxes on regulated financial institutions since 1990. Definitions of capital for tax purposes vary, as do the rates. Some provinces have introduced surtaxes as well. In 1996, regulated financial institutions paid $350 million in federal capital taxes[113] and $522 million in provincial capital taxes.

[110] The Technical Committee concluded its work at the end of 1997. See *Report of the Technical Committee on Business Taxation*, submitted to the Minister of Finance in December 1997 and released in early April 1998.

[111] See Kevin Dancey, *Impact of Taxation on the Financial Services Sector* (Ottawa, September 1998). See also the discussion of taxation issues in Background Paper #1, pp. 132-139.

[112] *Report of the Technical Committee on Business Taxation*, p. 5.36.

[113] Federal capital taxes have decreased as profits and income taxes have increased. For example, they were $601 million in 1991. From 1995 to 1996 they grew from $153 million to $350 million because of the introduction of the capital tax surtax, which is not reduced by income taxes paid.

Capital taxes on financial institutions raise particular policy issues:

- Capital is important to the safety and soundness of the institution, and taxing it makes it more expensive and encourages the institution to have less of it. This runs counter to prudential concerns and is particularly troublesome when the tax is levied on all capital, including every additional dollar of capital raised. Dancey estimates that the cost of the capital tax in raising new capital is in the range of 1.5 percent of every dollar of capital raised.[114] Furthermore, capital held offshore is not taxed, and this creates incentives for institutions to hold capital abroad, which can make it more difficult to access in times of financial stress.
- Capital taxes increase the cost of doing business. Dancey estimates that the impact of capital tax on a loan could be as high as 12 to 13 basis points,[115] a considerable proportion of the spread and a substantial cost to the customer.
- Capital taxes are payable even if institutions lose money. This compounds the impact of losses on capital, which can be a particularly important problem during the early years of an institution. It can thus be a serious entry barrier to new competitors.

We believe that capital taxes make our regulated financial institutions less competitive and create incentives that are inconsistent with sound prudential management. We therefore recommend that special capital taxes on regulated financial institutions be eliminated.

If revenue considerations make it impossible for governments to eliminate these taxes, at least in the short term, we recommend that steps be taken to make the taxes more acceptable. First, the tax burden should be shifted to the greatest extent possible away from capital and toward profits. Second, the federal government and provinces should agree on a common definition of the capital tax base. Third, the capital tax should be reconfigured so that it does not apply to additions to capital over some targeted amount. This could be accomplished, for example, by a schedule of capital tax rates that declined to zero at some level of capital (perhaps required capital for regulatory purposes) that was appropriately related to the assets of the institution.

A particular aspect of the taxation of capital that deserves special comment relates to the differential between the taxation of capital of credit unions and banks. In general, this does not appear to us to be a problem. In the province of Quebec, however, because of the economic importance of the caisses populaires, the difference in capital tax treatment creates substantial competitive

[114] Dancey, *Impact of Taxation*, p. 32.

[115] Ibid.

problems for National Bank and Laurentian Bank.[116] In its last budget, the Government of Quebec took a modest step that addressed this issue by reducing provincial capital tax on banks. Our recommendation to eliminate special capital taxes will help mitigate this situation. But we also urge the Government of Quebec to keep the situation under review and take further action if necessary to ensure that there is reasonable competitive balance within the province.

Business Combinations and Accounting Policy

Business combinations are an increasing phenomenon, not only in the financial services sector but also more generally. We believe that public policy should not unnecessarily constrain business combinations.

The changes we have recommended with respect to a more flexible definition of the widely-held rule, and the implementation of a regulated financial holding company, will increase the options available to institutions as they determine how to position themselves in order to realize the opportunities that the changing environment presents.

An additional serious constraint on business combinations results from current Canadian accounting policies with respect to how such combinations must be treated, and in particular the treatment of goodwill arising from such combinations. There are two issues involved. One is the circumstances under which a business combination can be treated as a "pooling of interest" where no goodwill is generated, rather than as a purchase where goodwill must be recognized on the balance sheet of the acquiring or resulting entity. The second issue is the appropriate treatment of goodwill when it is recognized.

Many industries and groups raised these issues with us. They described them as seriously constraining strategic choices and requiring urgent and thoughtful attention.

The problem is that Canadian accounting principles are considerably less generous than the U.S. regime in allowing business combinations to be structured as pooling-of-interest transactions. Canadian accounting principles are also less generous than some other systems in allowing goodwill to be recognized without affecting the future earnings of the entity.[117]

[116] National Bank estimates, in its submission to the Task Force, that the differential in federal and provincial income and capital taxes confers an advantage on the caisses populaires estimated to be on the order of $100 million, of which $42 million comes from the differential operation of provincial capital taxes.

[117] In Canada, goodwill (the difference between the purchase price and the fair value of the assets) must be recognized on the balance sheet and amortized over a reasonable time period, thus affecting future reported earnings. In some other systems (for example, in Germany and the Netherlands) goodwill is expensed immediately with balance-sheet impacts only and no impact on

These Canadian accounting policies have several negative impacts on the competitiveness of our industry. The share values of Canadian public companies depend in significant part on market perceptions of their earnings and the trendlines of those earnings. If earnings are reduced because of acquisition goodwill, share values will be depressed and that in turn may stifle the growth of Canadian-based financial institutions by increasing their cost of capital. Canadian institutions which attempt to use their shares as acquisition currency to acquire foreign-based institutions to expand internationally will be disadvantaged relative to foreign-based competitors who have more generous accounting treatment of goodwill and whose shares will not therefore be affected in the same way. In addition, decreased market values of Canadian companies will make it easier for others to successfully acquire Canadian companies in takeover bids. Even within Canada the policies may have impacts. In a period of industry consolidation, the accounting rules may inhibit business combinations of smaller Canadian financial institutions which might well produce vibrant competitors in the marketplace.

As a result, some transactions which would benefit Canadians may not take place at all. Some institutions will see their options constrained and their strategic choices reduced. The ability to pursue necessary business agendas may be materially, and negatively, affected to the great disadvantage of Canadian companies and their employees.

The Task Force and its staff have met with representatives of the Canadian Institute of Chartered Accountants (CICA) to discuss this issue on several occasions. While we respect the technical and professional expertise of the CICA, it seems to us that the current policies place Canadian firms at a significant competitive disadvantage in the North American marketplace. The CICA advises us that the United States is likely to revise its generous pooling rules but it is not clear when this will happen, nor is it clear what regime they will adopt. Change may take some years. The Accounting Standards Board of the CICA has informed us that they are unlikely to provide any interim relief.

We strongly recommend that the CICA reconsider its position and develop a regime that puts Canadian firms on an equal footing with those in other countries, and particularly the United States. If the accounting profession cannot satisfactorily respond or is delayed in finding an acceptable solution, we recommend that OSFI use its authority to specify accounting principles so as to remove this competitive anomaly. Although we are encouraged that OSFI has reopened the file and appears to be moving in the direction of addressing the

future reported revenues. We understand that the United States is considering moving to a system where goodwill might be recognized on the balance sheet, but not written off unless and to the extent it becomes impaired.

issue, this is clearly a second-best solution because it would not assist provincially regulated financial institutions or firms in other industries that are facing the same problem. However, if the CICA cannot act, action by OSFI is better than continuing with no solution at all.

A Framework for Merger Review

This section assesses the rationale for mergers, reviews some evidence on the effectiveness of mergers, discusses the Canadian context, and recommends a framework that should be used to review mergers of financial institutions, including Schedule I banks.

Experience and Rationale for Mergers

The number of mergers in the financial services sector worldwide has continued to grow and more than 4,000 transactions annually have been reported for each of the past few years.[118] The market valuation of transactions is growing even faster than the number, as mergers are getting larger. In 1994, reported mergers in the financial sector were valued at about US$200 billion; last year they were valued in excess of US$500 billion and the 1998 value is likely to be higher, on the basis of mergers already announced.[119]

There are a number of factors behind the recent increase in merger activity. In the United States, the elimination of regulatory restrictions on interstate branching is resulting in the construction of a national banking system for the first time in that country's history. In Europe, the introduction of the euro marks a new stage in European integration. This is leading to increases in consolidation in order to exploit the capacity to deliver cross-border financial services in a single currency regime. But beyond these special situations, merger activity is a response to the broad forces of change discussed earlier in Chapter 3, and it is by no means limited to the financial services sector. 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. In Canada, there were 185 mergers and acquisitions in the financial sector from 1993 to 1996, up from 125 in the previous four years.[120] Total merger activity in all sectors in Canada in the first half of 1998 set a record high, without counting the two proposed Schedule I bank mergers.[121]

[118] McKinsey, *The Changing Landscape*, Exhibit 4-4.

[119] For example, the market valuation of bank mergers alone totalled US$318 billion in the first half of 1998. See Securities Data Company, "Good Deal Hunting! Record Volume of M&A Dominated by Banks and Telecommunications," news release, July 2, 1998.

[120] Chris Roth and Hugh Williams, *The Canadian Financial Services Industry, The Year in Review, 1997 Edition* (The Conference Board of Canada, December 1997), p. 10.

[121] See "M&A activity on record pace in 1998," *Globe and Mail*, July 7, 1998, p. B1. The article reports that there were 605 transactions in the first half of 1998, valued at $105.9 billion. These

In order to understand these trends better, we examined aspects of recent merger activity in Australia, the Netherlands, Switzerland and the United States. As well, the research conducted for the Task Force by McKinsey & Company focussed on the strengths, weaknesses and opportunities of our domestic institutions and on the importance of size.[122]

Mergers are driven by individuals. Industry leaders will assess their own situation, the external environment, their strengths and weaknesses, and the options open to them to take their companies to new, strategically stronger positions. The expected benefits that such individuals and their boards of directors seek to derive from mergers are varied. Merger proponents point to the following:

Economies of scale: Increasing volumes of business allow a firm to spread costs over a larger base and lower average costs. Economies of scale are typically associated with an identifiable function – for example, issuing and servicing credit cards. Research has typically found strong evidence of economies of scale, but only up to relatively small asset sizes.

Economies of scope: Such economies relate to cost reductions that come through sharing overhead and technology in the production of different but related groups of services.

Operating synergies: Efficiencies of scale and scope are static concepts that relate cost to size, and to variety of product offerings, at any point in time. Merger proponents also point out that mergers are dynamic undertakings where success depends on entrepreneurial innovation, leadership, cultural fit and change management skills, among other things. Mergers offer opportunities to achieve either cost savings through the elimination of duplicative functions, or revenue gains through the ability to broaden the product range or customer base in a way that allows effective cross-selling. They also provide opportunities to spread marketing and advertising costs over larger volumes.

Technology spending: This is a particular example of operating synergies that is often referred to by merger proponents. The argument is that duplicative systems can be eliminated with significant savings in information technology expenditures, which can then be redirected to research and to new technology and systems development to ensure that institutions remain at the leading edge.

Access to a larger capital base: There are several advantages of a larger capital base. It allows for greater diversification of a total portfolio. An increase in portfolio diversification allows an institution to make trade-offs between

compare with 630 transactions valued at $101.6 billion for all of 1997. The transactions reported in the first half of 1998 do not include the two proposed Schedule I bank mergers.

[122] A brief review of international experience is presented in Background Paper #1, pp. 144-149. The McKinsey analysis is presented in *The Changing Landscape*, particularly Ch. 5.

higher returns and lower risks. Large amounts of capital are also necessary to participate in large bought deals and global public offerings where underwriters assume the risk related to the issue. In loan syndication, where many institutions share the risk of a loan, size of capital is an important (though not the only) consideration in choosing the lead manager, who is rewarded with the greatest share of the transaction fees.

Defence against acquisition: Some mergers are undertaken to achieve a size that acts as a defensive measure against takeovers, or to provide opportunities to refocus business strategy as a survival technique.

Platforms for growth: Some mergers create platforms for growth through the acquisition of strategic assets. Such assets can take many forms, including the physical assets of the acquired company, brand or franchise value, or human resources. Very often, an acquisition can lead to an increase in size that creates a platform for further acquisitions.

National platforms: Governments in some countries are encouraging some of their larger institutions in particular industries to consolidate as "national flagships," operating worldwide from a strong domestic base.

These rationales for merger will be more or less relevant depending on specific circumstances. Notwithstanding their relevance, however, 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. Most jurisdictions appear to be willing to allow significant mergers, sometimes with conditions attached to meet competition or other public policy goals.

Review of Evidence

The Importance of Size: Economies of Scale and Scope

Most research has concluded that economies of scale and scope are limited for large financial institutions. A recent survey of the literature covering 23 different studies found that economies of scale do exist for small institutions with up to about $5 billion in assets, but that beyond this size it was difficult to find significant economies of scale or scope.[123]

Conclusions based on historical research need to be interpreted with some caution, however, particularly in light of the pace of change in market conditions and regulation. For example, a recent study by Berger and Mester, cited in the research that Donald McFetridge conducted for the Task Force, found evidence

[123] Ingo Walter, "Universal Banking: A Shareholder Value Perspective," *Financial Markets, Institutions, and Instruments* (New York: Salomon Centre, New York University, 1997). Most of the studies reviewed focussed on the United States, but four were international.

of economies of scale for U.S. banks with asset size ranges of up to $25 billion. They reached this conclusion by examining the ratio of cost per dollar of gross total assets, which consistently declined with size through asset size ranges of up to $25 billion. This finding confirmed their econometric research. They also calculated the same ratio for banks in the 1980s and that ratio did not exhibit the same properties. It declined only through asset size classes of up to $1 billion, confirming the weight of evidence that showed economies of scale were difficult to find for larger banks.[124]

The work of Berger and Mester does not give any greater confidence that significant additional economies of scale exist for institutions the size of Canada's major banks. Its importance is in demonstrating that potential economies of scale and scope can change over time and in response to external factors. The reasons why potential economies have increased so dramatically are unknown. Berger and Mester put forward three possible explanations. The first is that interest rates are lower in the 1990s than they were in the 1980s. This would lead to relatively larger declines in cost ratios for larger banks than smaller banks because a greater share of the liabilities of larger banks would be interest-rate-sensitive. This explanation would suggest that the potential economies of scale might be transitory and not a permanent part of the structure of financial markets. The second reason is that regulatory change in the United States, particularly the elimination of interstate branching restrictions, tended to favour relatively larger banks. Finally, they suggest that improvements in technology and new applied finance developments have assisted large banks relatively more than smaller banks. These include, for example, efficiencies in information processing, credit scoring, ATM machines, and financial engineering tools such as derivative contracts.[125]

McFetridge comments:

> These last two possible explanations are very important. The widely held and well-documented view that there are no significant scale economies in banking is of U.S. origin and is drawn from a period in which banking technology (both product and process) was changing less rapidly, U.S. banks were limited in the ways they could expand and in the additional financial services or products they could offer.[126]

[124] See Allen N. Berger, and Loretta J. Mester, *Inside the Black Box: What Explains Differences in the Efficiencies of Financial Institutions?* Board of Governors of the Federal Reserve System, Working Paper 1997-10. The paper is cited in Donald G. McFetridge, *Competition Policy Issues*, (Ottawa, September 1998).

[125] Berger and Mester, *Inside the Black Box*, pp. 31-34.

[126] McFetridge, *Competition*, p. 89.

The Importance of Size: Assessment of Relative Performance

Studies of economies of scale deal only with efficiencies realized through size. An alternative way of assessing the importance of size is to examine the relationship between size and some key drivers of financial performance: revenues, cost, capital and risk. McKinsey & Co. analysed this relationship, reaching conclusions summarized below.

With respect to revenues, the U.S. experience suggests that size is not correlated with revenue growth. An analysis of the 125 largest banks in the United States (by size of assets) showed that the top 25 had revenue growth over the 1992 to 1996 period that was only slightly higher than the total and lower than the second quintile.[127]

With respect to cost, there is no doubt that size can help in spreading fixed costs. McKinsey suggested that this is particularly important in technology and branding, where major U.S. institutions spend substantially more than their Canadian counterparts.[128] However, there is no firm evidence that larger institutions are any better at reducing their costs than smaller institutions.

With respect to capital efficiency there is evidence, based on the same sample of the 125 largest U.S. banks, that larger banks use capital more efficiently, operating with greater leverage than smaller banks. As McKinsey pointed out, however, "Being able to leverage your balance sheet more efficiently does not always mean you will do so with attractive assets or with good returns to shareholders."[129] Indeed, an examination of the average annual growth in total shareholder return from 1992 to 1997 for the largest 25 banks in the world measured by market capitalization shows that returns are not directly correlated with size. For example, the three Japanese banks in the sample showed negative returns and the 25th-largest bank, the Bank of New York, had an average annual growth in total shareholder return that exceeded that of all other banks except Citibank and Lloyds-TSB.[130]

Finally, with regard to the ability to absorb risk, McKinsey concluded that larger institutions "have a greater ability to absorb the credit risks of a single counterparty or country and the market risks of their entire portfolio. Larger

[127] McKinsey, *The Changing Landscape*, Exhibit 5-11.

[128] For example, McKinsey reported that in 1996 the three largest U.S. banks spent US$5 billion on information technology, compared with US$3 billion spent by the entire Canadian banking sector (Ibid., Exhibit 5-13) and that in 1996 the top nine U.S. financial services advertisers spent an average of C$175 million per brand in advertising, compared with an aggregate C$187 million spent in advertising by 50 Canadian financial institutions in 1994 (Exhibit 5-14).

[129] Ibid., p. 47.

[130] Ibid., Exhibit 5-19. There are no Canadian banks among the largest 25 in the world by this measure.

institutions can also absorb their own operational setbacks to a greater degree – but they likely remain as exposed to environmental and behavioural risks as smaller institutions."[131]

The Benefits of Mergers

A merger is a dynamic phenomenon, which may yield efficiencies from many factors in addition to size. Another strand of research has attempted to examine whether mergers have resulted in efficiency gains for whatever reason. Again, the results are mixed. Earlier studies show limited evidence of efficiency gains through merger. More recent studies suggest that efficiency can be enhanced but this typically occurs not through cost reductions but changes in the mix of output toward a riskier and higher-return portfolio that is justified by the additional capital in the merged entity.[132]

Most recent large mergers in the United States have not been "in-market" mergers. Because institutions are taking advantage of the removal of restrictions on interstate branching, there has not been a lot of overlap in the operations of the merging firms. One recent major "in-market" merger occurred between the Chase and Chemical banks in New York in 1996. According to the Chase Bank's 1997 Annual Report, the post-merger efficiency gains were significant. The efficiency ratio, defined as operating non-interest expense per dollar of operating revenue, fell from 0.63 in 1995 to 0.55 in 1997, and it also declined in all functional business lines reported.[133]

Whether mergers work well or not ultimately depends on people. Even when market opportunities appear obvious, there are tremendous challenges in putting two organizations together. Different cultures have to be blended, and individuals throughout the new organization will ultimately determine whether a merger succeeds or fails. 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 inward.

Concerns about Mergers

Concerns about mergers generally fall into three categories. The first relates to employment impacts, with many observers being concerned about large direct job losses that often accompany mergers. The second has to do with decreasing competition as competitors are removed from the marketplace.

[131] McKinsey, *The Changing Landscape,* p. 47.

[132] See J. Akhavein, A. Berger and D. Humphrey, *The Effects of Megamergers on Efficiency and Prices: Evidence from a Bank Profit Function*, Board of Governors of the Federal Reserve System, Working Paper 1997-07.

[133] Chase 1997 Annual Report. See "Financial Highlights" at <www.chase.com>.

This can show up in the form of poor service, more limited choice and higher prices. These concerns will be more or less intense depending on the nature of specific mergers.

There is a third concern that relates to mergers between very large institutions, and this is that economic power is becoming concentrated in the hands of relatively few powerful institutions and individuals. This concern goes beyond the hard numerical calculations of market share of individual products. It reflects a general unease when a small number of large institutions become significant players in virtually all markets, even though they may be dominant in only a few.

Conclusions on the Evidence

The evidence we have reviewed does not sustain a case that, for most purposes, size is a strategically important variable or that all, or even most, mergers tend to bring about gains in efficiency. 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. However, research has not addressed the size ranges of the major Canadian life insurance companies or banks. In our view, McKinsey & Company summed up the evidence well, concluding:

> While it is true that larger institutions have more opportunities for improved performance, it does *not* hold that larger institutions always capture these opportunities or realize the advantages of increased size.[134]

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 no diminution in safety.

In addition, we believe it to be intuitively plausible, and confirmed by business experience in both the financial sector and other industries, that substantial savings can be obtained in "in-market" mergers where there is considerable overlap in functions and operations. An example is the recent merger between the Chase and Chemical banks.

Every merger is unique, with its own set of opportunities and challenges, its own personalities and culture, and its own costs and benefits to shareholders and other stakeholders as well. It is also important to look beyond efficiencies and synergies to the strategic platforms that mergers may create for their proponents and the country.

[134] McKinsey, *The Changing Landscape*, p. 45.

For all of these reasons, we believe that it would be wrong to reject merger proposals out of hand on the grounds of evidence drawn from historical, statistical analyses indicating that size is not always a benefit. Mergers need to be assessed on their own merits, taking into account the overall context in which they are put forward.

That assessment should be made very carefully, particularly for large institutions which are important market and community participants. This will be especially true where, as in the Canadian context, there is already substantial concentration in the financial services sector. We believe, however, that it will be important to approach merger review from the perspective that mergers often can present valid institutional decisions and may offer important national opportunities. 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

Canada is a large country with a small, geographically dispersed population. We have only 35 metropolitan areas with a population greater than 100,000. Historically, we have had large national players in many areas of our economy, ranging from newspapers to telecommunications to airlines and railways. Many of these large national players were originally conceived as government-owned enterprises and have only recently been privatized. Others, like Canada's major banks, were private-sector enterprises that benefited from favourable government policies as they grew.

Despite the geographic and population challenges of the country, Canadians have benefited 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.

One overall measure of concentration is the percentage of domestic banking assets controlled by the top three and top five banks, respectively. Exhibit 6.1 shows this measure for Canada and six other countries. On this measure, Canada has the most highly concentrated banking sector using the five-bank ratio, and the fourth most concentrated using the three-bank ratio.

Exhibit 6.1:
Bank Concentration Ratios, End 1996

Country	Five-bank ratio (%)[1]	Three-bank ratio (%)[1]
Canada	81	53[2]
Netherlands	75	57
Switzerland	71	66
Australia	69	59[2]
United Kingdom	40	27[2]
United States	19	13
Germany	15	10

[1] Percentage of domestic banking assets controlled by top 5 and top 3 banks, respectively.

[2] 1997 data.

Sources: Reserve Bank of Australia Bulletin; Deutshe Bundesbank Monthly Report; annual reports; ONS financial statistics; Bank of Canada; McKinsey & Company analysis.

Over the past 10 years, consolidation among traditional players has been increasing in our financial services sector. Exhibit 6.2 shows how the relative positions of the five largest banks and insurance companies have evolved over the past 10 years.

Exhibit 6.2:
Some Measures of Industry Domestic Concentration – 10-year View

	Share (%) held by five largest banks of:			Share (%) held by five largest life insurance companies of:		
Year	Personal deposits in banks	Personal deposits in all deposit-taking institutions	Total household financial assets[1]	Life insurance premiums	Total insurance premiums[2]	Total household financial assets[3]
1987	87.8	46.1	13.8	40.4	38.2	4.1
1992	86.1	47.4	15.9	38.7	33.3	4.0
1997	85.9	58.1	17.5	59.3	58.7	6.9

[1] The share of bank personal deposits plus bank-owned mutual funds in total household financial assets.

[2] The total of life, health and annuities premium income.

[3] The share of life insurance assets, segregated funds and life insurance company-owned mutual funds in total household financial assets.

Sources: Bank of Canada, Statistics Canada National Balance Sheet Accounts, Investment Funds Institute, *Canadian Insurance*, Annual Reports, OSFI, Canada Deposit Insurance Corporation.

Consolidation has increased rapidly in the life insurance sector, with the top five firms increasing their share of total life insurance premiums by more than 50 percent in the past five years. Over the same period their share of household

financial assets increased by almost 75 percent, although it is still less than half the share of the five largest banks.

Consolidation is also increasing in the banking sector, but from a much higher base. The major factor in the increase in bank consolidation was the absorption by the banks of most of the previously independent trust companies in the early 1990s. Many of these companies were in financial difficulty at the time and absorption by banks was assisted by CDIC support to protect depositors.

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. Similarly, personal deposits and bank mutual funds in the five largest banks together account for only 17.5 percent of total household financial assets. The exhibits point to the need to look beyond aggregate measures and to understand what the state of concentration or competition is on a product line and geographic market basis.

The Director of the Competition Bureau, in a submission filed with the Task Force in November 1997, issued a discussion paper outlining how the Bureau would apply its merger enforcement guidelines to assessing a possible merger of two Schedule I banks. That paper emphasized the need to look at specific markets and product lines. Subsequent to the announcement of two proposed mergers between Schedule I banks, the Director requested comments on certain specific aspects of his discussion paper and, in July 1998, issued a revised paper reflecting these consultations.

We commend the Competition Bureau for the open, consultative process it has followed in order to develop its guidelines. We support the overall direction of the amended guidelines. We believe that they provide the most effective way to reach an appropriate appreciation of the extent and nature of concentration in the Canadian context, when assessing the potential impact on competition of a merger of two Schedule I banks.

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. Mergers are one, though not the only, response to those questions. At the end of the day it is the leadership, the boards of directors, and the shareholders of the institutions involved who have the responsibility for determining what strategy is best for each institution. 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

In June 1997, we were asked by the Government to submit an interim report outlining the framework and criteria that should be used to assess mergers[135] of large financial institutions, with the exception of mergers of Schedule I banks. In our Interim Report, submitted in July 1997 and reproduced as Appendix 4, we recommended the following:

- Mergers should not be automatically prohibited but should be assessed on their merits.
- The Competition Bureau should assess the impacts on competition on the basis of the Competition Act; OSFI should assess whether a proposed merger raises concerns about safety and soundness of the institution or the financial system; and the Minister of Finance should assess whether a proposal is consistent with the public interest. These assessments could take place concurrently and should involve as much sharing of information as is necessary.
- If there are no competition and safety concerns, mergers should ordinarily be approved unless there are public interest issues that suggest otherwise.
- In the Minister's assessment of the public interest, he should consider the benefits to consumers, international competitiveness, employment, the adoption of innovative technologies, and the impact of precedent.

Our Interim Report considered the question of whether big financial institutions should be barred from buying other big financial institutions as a matter of policy. We concluded:

> A "big shall not buy big" policy, as it affects transactions between entities other than two Schedule I banks, should not have general application and that any such proposed transactions be reviewed on their merits.

We have reviewed the recommendations of our Interim Report in the context of mergers among Schedule I banks, and we conclude that the basic framework and process set out in July 1997 is still appropriate. No transaction should automatically be rejected. Each should be reviewed on its merits.

We recommend that the framework proposed in our Interim Report apply to all financial sector mergers involving federally incorporated institutions, with a number of modifications. These include the elaboration of additional public interest criteria, the introduction of a Public Interest Review Process and a Public Interest Impact Assessment for mergers involving large institutions,

[135] By merger we mean any business combination among financial institutions that would require review by the Competition Bureau under the terms of the Competition Act, or by the Minister of Finance under the terms of relevant financial institutions statutes.

measures to ensure that undertakings can be accepted and enforced, and certain proposals to streamline the process in particular cases. The modifications are described below.

Public Interest Criteria

We recommend a further elaboration of the criteria that the Minister of Finance should address in considering the public interest. In particular, the Minister should take into account the costs to consumers as well as the benefits, and regional considerations. The list of criteria that we recommend thus includes:

- costs and benefits to individual consumers and to small and medium-sized businesses;
- regional impacts;
- international competitiveness;
- employment;
- the adoption of innovative technologies;
- whether the transaction creates a precedent; and
- any other public interest considerations that the Minister or the merger proponents feel should be taken into account.

Each of these criteria is discussed in more detail in Chapter 7 of Background Paper #1.[136]

Public Interest Review Process

We recommend that the Government introduce a Public Interest Review Process for mergers among larger firms in the financial services sector. We believe that public participation in the review of proposed mergers involving very large institutions is essential in light of their public importance. Such participation can lead to a greater awareness of the public interest costs and benefits of specific transactions, and can assist in pointing to possible remedial measures that may help tailor the transactions to enhance benefits and mitigate costs.

The process we are recommending is intended to be transparent, efficient and cooperative. It should permit the public to intelligently assess the costs and benefits of merger proposals, and to provide comment as input to the Minister. It should not unduly delay the decision-making process. Merger proponents and government should share the obligation of identifying the public interest concerns and should work together to see whether solutions can be found that are in the best interest of the institutions, Canadians and the country.

[136] See Background Paper #1, pp. 161-166.

The basic elements of the Public Interest Review Process would be as follows:

- Whenever two institutions propose to merge to form a new institution that has at least $5 billion of shareholders' equity, and each of the merging institutions has at least $1 billion of shareholders' equity, public participation in the merger process would be required by law. The Minister of Finance could also require it in other cases where it would be helpful to decision making.
- Merger proponents would be required to submit a written, detailed Public Interest Impact Assessment. This Assessment would outline their business plan and objectives, identify the public costs and benefits of the proposed transaction, and set out what steps they propose to take to mitigate any undesirable impacts. The Assessment should be based on factual information and should address the public interest criteria set out above. The Assessment would be made available for public review in an open and transparent manner, including being available in branches of the financial institution and electronically on World Wide Web sites.
- There would be a reasonable time period for written public comment on the Assessment to be made to the Minister of Finance. Such comment should also be made available for public review in an open and transparent manner.
- The Minister should decide on the proposal as quickly as possible, following the period for public comment.

This process is not intended to be a formal adjudicative process, but rather informal and cooperative.

The Public Interest Review Process will provide an opportunity for Canadians to explore whether a proposed merger is consistent with the public interest and, if it is not, whether it can be reconfigured to provide benefits for both the merger proponents and Canada. This will require that the proponents provide responsible assessments of the challenges they are facing, the options open to them, and the costs and benefits of the proposed merger to Canadians. It will also require all other participants to deal with the mergers with an open mind and in the same spirit. It may in some circumstances also require cooperative efforts to determine whether or not ameliorative measures can be found.

If the Public Interest Review Process reveals that the public interest requires such measures and if merger proponents wish to proceed with a transaction, they should be prepared to present approaches to its structuring that would allow the transaction to proceed in a manner consistent with public interest goals. We would encourage institutions to be forthright, bold and creative as they approach that issue. To be tentative would be short-sighted because it would risk a process of micro-negotiation which we doubt would be in the public interest, even if it were to be possible. The merger proponents know

their businesses very well. They will understand, better than anyone, the steps that should be taken which would allow the mergers to make sense while at the same time satisfying legitimate public interest concerns.

For this to be done, of course, the institutions will need to have some sense of the public interest objectives. In practical terms this may well require some forthright dialogue to move toward a solution, if one exists, based upon a growing understanding by all participants of the needs of both the merger proponents and others in the Canadian community.

We think it important to urge that the process be approached without regard solely to special interest views. That will, of course, not be easy and it will be the task of the Minister to ultimately assess the public interest in light of what is revealed in the Public Interest Review Process. However, we caution that the Public Interest Review Process should not be used as a vehicle solely to advance special interests, including those of the merger proponents. The long-term success of a Canadian-controlled financial services sector is vital for all Canadians, for reasons we have described elsewhere in this report. We believe that the Public Interest Review Process provides an opportunity to achieve it.

Enforceable Undertakings

We believe it is important that undertakings that may be required to assure that mergers meet the public interest should be public undertakings and strictly enforceable in law. We therefore recommend that the Minister have the power to accept and enforce undertakings from merger proponents. If this power is not sufficiently clear in existing legislation, amendments should be introduced that make it explicit and unambiguous. This power would apply not just to the larger mergers that are subject to a Public Interest Review Process but to all mergers that the Minister is required to approve. The legislation should provide authority for the Governor-in-Council, on the recommendation of the Minister, to issue directives to the merged entity, requiring it to cease or to perform any such acts as are necessary to give effect to the undertakings where they are not being met. The legislation should also provide sanctions for non-compliance, including substantial fines for non-compliance with undertakings, and criminal sanctions for failing to comply with a directive of the Governor-in-Council.

Streamlined Merger Process

The above elements will provide a merger process for large institutions that is transparent, efficient and, with good will on all sides, one that can be cooperative as well. The process will provide assurance that large mergers that do proceed are structured in a way that will protect essential public interests.

It is important, however, that the extensive process set out above not become a procedural block to the many relatively small mergers that take place in the financial sector every year. We recommend two additional measures that will help streamline the process.

First, mergers that do not meet the size criteria that make a public interest review necessary can proceed without the formal tabling of public documents. The Minister would still have to approve such mergers, however, and he would still take into account the criteria that we have set out as relevant to determination of the public interest.

Second, we recommend that for any transactions so small that they do not require pre-notification under the Competition Act, the Superintendent of Financial Institutions be able to approve or reject the transaction on the Minister's behalf, so long as the acquiring entity is a federally regulated financial institution.

Finally, we recommend that for any merger the Minister be empowered to exempt the transaction from the review process set out above when, on the recommendation of the Superintendent, he is of the view that expeditious completion of the transaction is in the best interests of the financial system. It is intended that this exemption be used to deal with a failing firm or other identified threat to the safety and soundness of the financial system.

Chapter 7

Empowering Consumers

Introduction

Consumer protection issues received considerable emphasis in our work. A principal test of how well our financial services sector functions is how well it serves consumer needs. It is important to understand how well consumers are served by the financial sector that exists today and how consumer needs can be better met.

To this end we commissioned research by McKinsey & Co. that examined, among other issues, the question of how well Canadians are served by their financial institutions compared to citizens of other countries. We also commissioned a major research project, coordinated by Professor Robert Kerton, that examined practices related to transparency and redress in the United States, Australia, the European Union and five European countries. Professor Kerton's own contribution drew on these studies and complementary work for Canada to assess best practices in these areas, and set out ways to move the Canadian system toward better performance. We commissioned a major research report on privacy by Richard Owens. Finally, we contacted consumers directly through the public opinion research conducted on our behalf by Ekos Research Associates.[137]

Our approach to consumer issues is driven by our vision for the sector. In our judgment, a desirable financial services sector should provide the following characteristics:

- choice, with the absence of both coercion and the perception of coercion;
- transparency, with clear, easily understood and timely disclosure of product terms and conditions, risks, and conditions of sale;
- easily accessible and effective redress mechanisms; and
- access to and control by consumers over personal information.

[137] See the following research studies conducted for the Task Force: McKinsey, *The Changing Landscape*, Ch. 6; Robert Kerton, (ed.), *Consumers in the Financial Services Sector*, (Ottawa, September 1998); Richard Owens, *Privacy and Financial Services in Canada* (Ottawa, September 1998); Ekos, *Public Opinion Research*. This research is reflected in Background Paper #1, *Competition, Competitiveness and the Public Interest*, and Background Paper #3, *Empowering Consumers*. Background Paper #1 reports on how well consumers are being served by the current system. Background Paper #3 reports in some depth on the evidence, arguments, conclusions and proposals with respect to transparency, privacy, tied selling, and redress. Paper #3 also discusses education and certification requirements for intermediaries, and some licensing obstacles to open and competitive markets.

Two sets of benefits flow from these characteristics. The first is assurance that in a marketplace where there are imbalances of information, resources and power in commercial relationships, basic consumer rights are protected. The second is actual improvement in the functioning of the marketplace through protection of consumer rights. Consumers who are more informed, more vigilant, and able to exercise their rights more easily will provide an important discipline that enhances competition by ensuring that providers offering better products and services win out over providers offering inferior value to customers.

The first set of benefits flows to individuals in particular circumstances. The second set flows to everyone – consumers and good providers – by enhancing the quality of competition. Too often, the second set of benefits is ignored, and consumer protection measures are assessed only in terms of the costs they impose on providers. In fact, customer-focussed providers as well as consumers benefit from a better-functioning marketplace.

Consumer Protection Responsibilities

Consumer protection responsibilities are shared between the federal and provincial governments. The federal government has exclusive jurisdiction over banks and regulates some consumer protection aspects of banking. The federal government also regulates some consumer protection aspects of federally incorporated trust and insurance companies through its power to incorporate these institutions. For example, all federally incorporated financial institutions are subject to federal requirements with respect to privacy and some limited aspects of disclosure. OSFI administers federal consumer protection provisions.

Provincial governments regulate the standards of competence and behaviour of financial intermediaries, all aspects of provincially incorporated financial institutions, and market conduct and consumer protection in respect of financial institutions. Their constitutional authority to regulate consumer protection for banks is not fully defined, but many banks comply with provincial regulations.

Our recommendations are intended to fit within the current framework of responsibilities. For example, in Chapter 6, where we discussed banks retailing insurance, we recommended that their employees comply with provincial education and certification requirements so long as these were non-discriminatory. With regard to consumer protection issues, we have focussed our concern on what works best for consumers regardless of jurisdictional responsibilities. Our emphasis on best practice derives from our view that the fundamental interests and needs of consumers do not vary across jurisdictional boundaries.

We therefore recommend that the federal government implement our proposals to the full extent of its jurisdiction, and that provincial governments move their legislation toward best practices where these are not already reflected.

The Changing Environment

As technology and globalization lead to convergence of functions and more intense competition among institutions, the nature of the relationship between institutions and consumers is changing. Traditional relationships are becoming less important to many customers, who are increasingly willing to shop around for the best deals and are less loyal to institutions.

It is a long-standing truism in the insurance industry that insurance is sold, not bought. This is becoming true of other financial service products and, increasingly, every institution and intermediary is now in the sales business. Although there may have been a time when financial institutions simply undertook account transactions or underwrote insurance policies that others sold, those days are gone. Emphasis is now placed on the "total customer relationship," which from a provider's perspective entails cross-selling products to maximize the "share-of-wallet." Incentives and compensation arrangements support this emphasis.

In a recent interview, the CEO of Norwest Corporation, a major U.S. bank that owns Trans-Canada Credit, commented:

> I would argue that financial services are a bunch of commodity products, all pretty much the same no matter what company sells them.... And even if you can differentiate your product, it takes about a week for someone else to copy you, just as it does with clothes, toothpaste or food.... Fifty years ago there may have been good reason to keep (deposit-taking, insurance sales and stock brokerages) separate. But the customer wouldn't have driven you to design this thing this way. And the customer and technology are driving you not to do this anymore. They want you to give them better service at lower cost, just like the Home Depots, the Wal-Marts and others do.[138]

Although financial products are increasingly being marketed like other retail products, there are many points of difference from a consumer perspective. Many financial services are complex and are usually purchased on an infrequent or even once-only basis by the average consumer. Because they tend to be abstract, often qualified by assumptions about the future, and because they contain many non-price characteristics, they are not easily compared. This makes shopping around difficult. In addition, many consumers 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 channel. And, as noted in Chapter 3, new intermediaries are emerging who do not themselves sell products but undertake to work on behalf of the consumer to identify products that have the most

[138] Richard Kovacevich, cited in Toronto *Star*, "Banking Just Retail, U.S. Dynamo Says," Saturday, May 2, 1998.

desirable characteristics[139] for a particular set of circumstances. While these trends are positive, change brings some cause for concern. Specifically:

- Complexity of products is increasing as technology and new ideas lead to the development of more innovative and customized products. It is not always easy to understand how new products work and how they compare with older, more familiar products.
- The growing desire to cross-sell products can result in situations where consumers feel coerced, and indeed may actually be coerced, into purchasing one product from a provider in order to secure another.
- As more products are mingled together in a single institution or group of institutions, the ability of individuals to protect the privacy of their personal information becomes a greater concern.

The challenge for public policy is to build a framework that can ease these concerns without stifling the innovation that will lead to consumer benefits.

Disclosure and Transparency

Disclosure and transparency are related, but the difference between them is important. Disclosure governs what information is provided. Transparency is concerned with the clarity of that information: how understandable is it to the consumer?

Our research suggests that there is considerable room for improvement, particularly with respect to transparency.

A 1997 survey[140] of 10,333 respondents by the National Quality Institute ranked 21 sectors on the clarity and completeness of information available to customers. Insurance and banking ranked 16th and 17th, respectively. Credit unions ranked 3rd and trust companies 7th.

As part of Professor Kerton's research project, we commissioned a review of 49 English-language agreements collected from four areas of Canada's financial services sector: auto leasing, banking services, auto and life insurance, and mutual fund prospectuses.[141] With respect to readability, which is measured quantitatively, the authors noted, "Almost without exception, the documents are difficult and complex and require a college/university level of comprehension."[142] With respect to comprehensibility, which is measured qualitatively, they found "a great gap between the characteristics of the documents and the

[139] Such intermediaries are called integrators. See note 23.

[140] Cited in Kerton, *Consumers in the Financial Services Sector*, vol. 1, p. 214.

[141] See Judith Colbert, et al., "Practice: Assessing Financial Documents for Readability," in *Consumers in the Financial Sector*, vol. 1. A more extensive summary is found in Ch. 3 of Background Paper #3.

[142] Colbert, "Practice," p. 58.

capacity of their audience to understand them. This review suggests that the purpose of such documents is disclosure in response to regulatory requirements, rather than genuine communication with consumers."[143] The researchers also examined 21 French-language documents and found similar deficiencies in readability and comprehensibility.

The study identified some issues other than language and format that affected consumers' ability to understand the nature of the contract they were entering into:

- In many cases, the actual contract was not available for examination in advance of completing the transaction. Notable examples were credit card agreements and life insurance contracts.
- The increasing use of agreements generated on-line makes it more difficult to comparison-shop, as generic agreements become less common.
- Legal requirements influence the clarity of contracts. Regulations can make documents more transparent by stipulating how information is to be presented. They can also make documents less transparent by prescribing legal concepts and language.

From our review of other countries, we have noted that other governments are involved in the promotion of market transparency through leadership, through joint efforts with industry and consumers, or through setting standards in legislation or regulations. A review of experience in the United States, the European Union, the United Kingdom, Netherlands, Denmark, Sweden and Australia is presented in Chapter 3 of Background Paper #3. The United States relies primarily on a system of legislation, whereas the European countries rely more heavily on consultative processes and industry codes.

In Australia, the Wallis Inquiry placed great emphasis on disclosure and transparency, commenting, "Financial markets cannot function effectively unless participants act with integrity and there is adequate disclosure to facilitate informed judgements."[144] The Inquiry recommended:

> The law ... [should] require the issue of succinct profile statements about offers of retail financial products, including initial public offerings. These statements must contain:
>
> - a brief description of the characteristics of the product;
> - a clear and unambiguous statement of the risks involved;

[143] Colbert, "Practice," p. 58.

[144] The Wallis Inquiry was established by the Government of Australia in June 1996 to review the legislative and regulatory framework for the Australian financial system. It reported in March 1997. See *Financial System Inquiry, Final Report*, p. 16.

- a clear and unambiguous statement of applicable fees, commissions and charges in a form which enables comparison with similar products; and
- such other disclosures for specific products as the regulator considers appropriate.[145]

The Inquiry also recommended that 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. One of the more innovative outcomes of the Wallis Inquiry is recognition of the value of user testing and a commitment to integrate it into measuring effectiveness of material. The emphasis in the tests will be on whether users understand a product's key elements, not whether they like and would buy the product.[146]

In Canada, there are examples of statutory requirements for disclosure at both the federal and provincial levels, but statutory requirements for transparency are rare. Although transparency still leaves much to be desired, it appears to be improving.[147] There is also considerable variation in corporate performance. For example, Colbert's and Beam's study compared two mutual fund documents. One of them had difficult and formal language, with an average sentence length of 63 words with multiple ideas and cross-references. It was highly technical. The second document used simple language that spoke directly to the consumer in an informal way. It was fairly easy to read with an average sentence length of less than 20 words.[148] The message is clear: transparency can be achieved with leadership and commitment.

Some submissions to the Task Force identified serious inadequacies with respect to disclosure practices followed in life insurance contracts.[149] In addition, there are two aspects of disclosure in Canada that warrant particular comment.

First, many financial services contracts in Canada allow the financial institution, unilaterally to amend the contract by changing, adding or deleting any terms and conditions.[150] This is an unacceptable practice that should be changed.

[145] *Financial System Inquiry, Final Report*, p. 35.

[146] See Peter Kell, "Reform of Consumer Protection in the Australian Financial Sector," *Consumers in the Financial Services Sector*, vol. 1, p. 216.

[147] Colbert comments, "Most of the documents assessed in the study were surprisingly free of old fashioned 'legalese'." See "Practice," p. 63.

[148] Ibid., Appendix IV, pp. 197-199.

[149] See the submissions of the London Life Policyholders' Association and the Independent Life Insurance Brokers of Canada.

[150] For example, the Balance Transfer Terms section of a credit card agreement from a major bank states, "I understand that you will only make this payment on the terms set out below; and I agree to be bound by those terms." The fifth of the six terms set out states: "You may change the terms under which you will process a balance transfer amount request at any time, without notice to me or any other person."

Second, there is no consistent regime in Canada governing the disclosure of fees and commissions on transactions. In order to weigh advice given by intermediaries and to compare products, it is essential that consumers understand the fee and commission structures underlying alternative products. This is becoming increasingly important as products become more complex and as the culture continues to shift from a transactions culture to a sales culture, with emphasis on cross-selling. The key issue is to distinguish the consumers' interest from the sellers' interest. Making the sellers' interest more transparent can help. It is unlikely that a consistent disclosure regime can be achieved in this area without strong government leadership.

On balance, we conclude that Canada is far from where it should be, or can realistically be, in terms of disclosure and transparency. Our performance falls short of what consumers have a right to expect and industry is capable of delivering. There are a number of areas for improvement.

We recommend, first, that governments undertake, as a priority, to lead a multipartite exercise with industry, consumer groups, and legal and other experts to improve the transparency of financial services documents. The mandate of this exercise should be to develop processes, based on best practice, which can be used by industry in drafting documents. The terms of reference for these processes 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. These processes could, for example, determine acceptable readability standards or determine the appropriate use of testing in production of documents. They might also include the development of Model Codes or Model Forms, as are used in the United States.

Second, we recommend that industry leaders commit to increasing transparency and allocate adequate resources to this task. This would involve participating in the multipartite exercise described above, setting milestones for the review and redrafting of key documents, employing user testing for readability and comprehensibility as an integral part of document preparation, and reporting progress annually as part of the new Community Accountability Statements recommended in Chapter 8.

Third, we recognize that legal requirements can impose restraints on the ability to use clear language. We recommend that governments, as they review financial institutions legislation on an ongoing basis, give weight to the desirability of transparency. This would involve acting wherever possible to remove or reduce regulatory requirements that prevent the use of clear language, as well as considering ways to give positive reinforcement in law to the efforts that might come from the multipartite exercise described above.

Finally, we recommend that governments require the disclosure of all transactions-related commissions and fees of financial intermediaries, and that it be made illegal to have contractual terms that permit institutions to unilaterally amend consumer contracts.

The Protection of Personal Privacy

In our society, privacy approaches the status of a basic human right. 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.[151]

Although individuals may have different attitudes about the use to which they are prepared to see their personal information put, the overwhelming majority (73 percent) opted for stricter privacy rules and less convenience when presented with a trade-off between the two.[152]

Privacy protection regimes in most industrialized countries are based on a set of principles adopted in 1980 by the Organization for Economic Cooperation and Development. Canada committed to these guidelines in 1984 and most financial industry associations developed codes of conduct based on them. In 1996, the Canadian Standards Association (CSA), as a result of a multipartite process involving business, government and consumer groups, developed the CSA Model Code setting out 10 privacy principles. The principles deal with issues such as the purpose of information, consent, limitations on collection and use, safeguards, access, and accountability. The Canadian Bankers Association amended its privacy code to conform to these principles in 1996 and the Insurance Bureau of Canada did so in 1997. Credit Union Central of Canada has developed a model code that will come into force in 1998. The privacy code of the Canadian Life and Health Insurance Association and the Trust Companies Association of Canada (both adopted in 1993) predate the CSA Model Code.

The protection of privacy under these codes is voluntary and based on industry self-regulation.

By contrast, law protects privacy rights in the public sector (that is, the privacy rights of individuals in relation to governments). Most governments in Canada now have privacy laws and privacy commissioners. In Quebec, legislation also extends the protection of privacy rights to individuals dealing with private-sector firms, making Quebec the only jurisdiction in Canada to legislate substantive privacy rights for the private sector. The federal government has

[151] This definition is drawn from the work of A.F. Westin (cited in Owens) and Richard Owens. See Owens, *Privacy and Financial Services in Canada* (Ottawa, September 1998), p. 9.

[152] Ekos, *Public Opinion Research*, p. 58.

enacted a limited privacy framework for banks and federally regulated insurance and trust companies. This legislation does not impose any standards on the institutions. Rather, it requires them to take reasonable precautions to ensure that their records are accurate and protected, and to establish procedures restricting the use of confidential information.

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."[153] This would be consistent with recent trends internationally, as the European Union, the United Kingdom and New Zealand have legislative provisions governing the private sector as a whole, and the United States has sectoral provisions.[154] The European Union Directive, adopted in October 1995, contains provisions stipulating that data may be transferred to a non-member state only if there is an adequate level of protection in the third country. This has led to considerable debate about what constitutes "adequate" protection.[155]

Our assessment of the current privacy regimes in the financial services sector is that there is considerable scope for interpretation of the principles of the codes in developing operational standards and, as a result, there is considerable variation in the actual operation of privacy regimes among institutions. An illustration of the scope for interpretation is given in Chapter 4 of Background Paper #3 with respect to the principle governing consent in the privacy code of the Canadian Bankers Association. In brief, the principle provides that consent can be expressed orally, in writing or electronically, or can be implied through action or inaction. The principle states clearly that "express consent will be the preferred form."[156] Significantly, the Code indicates that customers must consent specifically to the financial institution's using "personal information (except for health records) to market products and services to its customers, either directly through the bank or through its existing subsidiaries or affiliates. The bank will get the consent of the customer before using personal information for this purpose."[157]

This implies that consumers must opt in to direct or targeted marketing. However, because the principle allows for consumers to imply consent by using a bank product or service, or not responding to a bank's offer to have their personal information removed from a direct marketing list, the system,

[153] Industry Canada and Justice Canada, *The Protection of Personal Information: Building Canada's Information Economy and Society* (January 1998), p. 2.

[154] See Owens, *Privacy and Financial Services in Canada*, Part IV: The European Union.

[155] Ibid., pp. 95-106.

[156] Canadian Bankers Association, *Model Privacy Code*, Principle 3.3, p. 11.

[157] Ibid., Principle 5.3, p. 15.

in at least some institutions, functions more like an opt-out than an opt-in system. That is, the onus can be on the consumer to take explicit action if he or she does not want personal information used for marketing purposes. Different institutions can obtain consent from customers in different ways, some asking for express consent and others relying on implied consent.

Personal privacy should be a matter of personal preference. But 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.

There is not a lot of evidence that the current privacy regime in the financial services sector is working badly, although some examples of practices that appeared questionable, at best, were brought to our attention. 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. As insurance activities become increasingly integrated with other financial transactions, there are particular concerns with respect to the use of medical information – not only by deposit-taking institutions but by insurance companies as well.

With an increase in both the opportunity and incentive to abuse personal information by using it in ways the donor did not intend, it will be important to have high standards of behaviour to preserve the integrity of the relationship between customer and institution. In a situation where there is inadequate disclosure and transparency, and where consumers must expend considerable time and effort to comparison-shop, institutions will be tempted to implement lower rather than higher standards to gain a competitive advantage through the more intensive use of customer information. In such cases there is a clear public interest case for regulation.

We therefore strongly support the intention of the federal government to legislate standards for the collection, use and protection of personal information, and urge it to proceed expeditiously. On the basis of our consideration of privacy in the financial services sector, and our specific recommendations set out below for that sector, we conclude that there are certain principles that should be reflected in such general legislation. In particular, we suggest that the legislation set out basic minimum standards of behaviour, building upon the CSA Model Code. 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. An appropriate authority should certify these codes as complying with the legislation, and should have the responsibility to audit conduct. We also suggest that there should be a redress mechanism for consumer complaints and a right of civil remedy.

With respect to the financial sector in particular, we recommend that the principles we have enunciated be elaborated as set out below.

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. If the customer is entering into what he or she perceives to be an ongoing financial relationship, then the purpose of the information that is being sought could be expressed in terms of furthering that relationship. This is now the case under the CBA Model Code. If the transaction is specific, however (for example, a one-time purchase of term insurance or a mortgage), the purposes for which information is collected should be expressed only in terms of the need to assess and complete the transaction. The consumer should be asked clearly and explicitly what relationship is being sought with the institution.

Consistent with the specification of the purpose of information collection, the financial institution or intermediary should specify what information might be sought about the individual from third parties.

Consent to the collection, use or disclosure of personal information should be express, not implied.

In the specific case of information used to market other products or services to the customer, the customer must agree in writing to such use. For existing customers, this requirement should apply whenever a "new" consent is required. If the customer does not give such consent in writing at that time, he or she should be deemed to have refused consent and any information should be removed from the appropriate data base. 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 (which should include any information received about the customer from a third party), and to have factual corrections made. If access to any information in the file is denied, the customer should be informed in writing of the specific grounds for denial of access.

Medical Information

The purposes for which medical information is collected from customers vary depending on the product lines of any given financial institution. The end result, however, is that financial institutions collect and hold medical information on their customers. This is a matter of particular sensitivity and concern, already recognized, for instance, in the CBA Model Privacy Code. It provides, in Principle 5, that health records may be collected only for specific purposes and that they cannot be disclosed within the corporate group (parent to subsidiary

or affiliate, or the reverse). Health records cannot be used in marketing. Personal information, presumably including health records, can be shared with third parties with the consumer's consent (Principle 7.6). The minimum standards contained in privacy legislation should contain provisions ensuring at least the same level of consumer protection.

A specific area of concern is the mingling of medical information with information related to credit decisions. The greatest potential for this exists in deposit-taking institutions that also distribute insurance. The privacy standards suggested above do not fully address this concern as the financial institution is collecting information wearing two hats, its own and that of the other entity for which it is acting in collecting the information as part of the distribution of that entity's products. Although it cannot share its own information within the corporate group or with third parties without consent, as the collector it will have access to other medical information collected in its role as distributor.

The Task Force recommends a strict regime to limit such mingling. The same employee should not be engaged in credit decisions and insurance sales. Medical and non-medical information collected in making an application for insurance should be collected on separate forms, and the medical or lifestyle information must be forwarded only to the insurer concerned with no copy being retained by the deposit-taking institution. Medical information collected for insurance should not be disclosed to any person other than the insurer concerned. An insurance company should not be allowed to share medical information with a deposit-taking institution, regardless of whether they are in the same corporate group and even if the consumer consents.

The whole area of the sharing of medical information with third parties, including medical bureaus which function in a similar fashion to credit bureaus, is of particular concern to consumers given the breadth of the information often collected and the wide-open nature of the consent for sharing such information usually presented to, and signed, by customers. This is a subject that would benefit from a fresh public policy review

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, where they have not yet done so, should legislate a similar regime that is harmonized with the federal regime to the greatest extent

possible. This would cover provincially chartered financial institutions, financial intermediaries, and unregulated financial institutions that deal with individuals and/or small businesses.

Sectoral Binding Codes

Industry associations should work with government and consumer groups to develop binding codes under the legislation that are consistent with the CSA Model Code and contain the minimum basic standards set out above.

Certification and Audit

OSFI should have the responsibility for certifying the codes of industry associations and individual institutions, for prescribing the consultative process to be followed in elaborating such codes and for ensuring that compliance is audited.

Redress

Privacy complaints should be dealt with through the comprehensive redress system that the Task Force is recommending.

The Government should consider allowing civil remedies, including punitive damages, for breach of the certified privacy codes.

Coercive Tied Selling

There has been considerable debate over the practice of coercive tied selling. In 1997 the Bank Act was amended to make it an offence to "impose undue pressure, or coerce, a person to obtain a product or service from ... the bank and any of its affiliates, as a condition for obtaining a loan from the bank."[158] The relevant section is not yet proclaimed, but a recent report from the House of Commons Finance Committee, in June 1998, recommended that the Government proclaim the section.[159]

The recent history leading up to the enactment of that provision is reviewed in Chapter 5 of Background Paper #3.

Tied selling is widespread in our economy, and is generally considered a good thing. Combining products with certain attributes to form a new product can offer consumers more choice and convenience. For example, the purchase of a "combo" meal at McDonald's is a tied sale. In the financial services sector, bundling investment options with term insurance to create a life insurance product that allows consumers to earn a return on their premiums is a tied sale.

[158] Bank Act, section 459.1(1).

[159] House of Commons, Standing Committee on Finance, *Report on Tied Selling: Section 459.1 of the Bank Act* (7th Report, June 1998).

So is offering a deposit account for a single price that includes access to other services such as travellers' cheques without additional charge. Tied selling itself is a neutral concept.

What is abusive is coercive tied selling. If a consumer is told that he or she cannot qualify for a loan unless an outstanding mortgage is also renewed with the same provider, choice is being constrained instead of augmented. Similarly, if a loan is made conditional upon transferring mutual funds from a third-party manager to the credit-granting institution, there is clearly coercive behaviour involved. Unfortunately, there is no simple black-and-white definition of when coercion occurs that will serve for all purposes. The examples above are clear. But a loan might justifiably be conditional on securing life insurance, and the consumer may still feel he or she is being coerced into buying life insurance from the loan provider if it is not clearly indicated at the time of sale that any provider could supply the insurance. Presented with identical circumstances, individual consumers may react in different ways. In many cases, the determining factor will be whether the consumer perceives coercion.

Institutions do not condone coercive tied selling and there is broad agreement that it is an unacceptable business practice. Yet it does occur. In public opinion research undertaken for the Task Force, 16 percent of respondents answered "yes" when asked, "Have you personally ever felt that one of your loans or mortgage may not be approved unless you also purchased another product like insurance from your institution?"[160] We were both surprised and concerned that the perceived incidence of coercive tied selling attempts was so high.

In our view, concern about and consideration of coercive tied selling is justified in light of conditions in today's marketplace. 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. This does not necessarily imply an increase in coercive tied selling but the potential for abusive practices will grow.

Chapter 5 of Background Paper #3 reviews tied selling in detail, including measures in place to deal with it at the provincial level, in the United States and in the United Kingdom. It also discusses remedies under the Competition Act. The conclusion is that these remedies are not adequate to deal with the practice because they focus primarily on the restraint of trade or lessening of competition among firms in the market, rather than on abusive treatment of consumers.

Our recommendations start from a basic premise: all consumers are entitled to expect freedom from coercion by the businesses with which they deal, including financial institutions. This value should be basic to the operation of the

[160] Ekos, *Public Opinion Research*, pp. 54, 55.

marketplace. Building on this premise and recognizing the history of the current, unproclaimed section of the Bank Act, we have four recommendations to strengthen the legal regime that applies to coercive tied selling.

First, we believe it would be desirable for all jurisdictions to enshrine in legislation a general proscription against coercion in commercial relationships. Breach should constitute an offence (by an institution) or professional misconduct (by a licensed intermediary), and remedies should be available through the redress provisions recommended below. Although necessarily general, such a proscription would be comparable to many provisions that exist in law where society has deemed it appropriate to set a standard of behaviour.[161] It would confirm the high standards that apply to those who either give advice about, or deal with, other people's money; and it would assist consumers who seek redress by giving some guidance to courts or ombudsmen about expected standards of behaviour.

Second, we recommend that section 459.1 of the Bank Act be proclaimed after amendment in two respects. The offence of coercive tied selling, which now applies only to ties to a "loan" should be extended to apply to ties to all credit products and to insurance products. Further, in view of the pace of change in the marketplace and the desire for flexibility in regulation, regulators should be given legislative authority to designate other specific products or services to which the coercive tied selling prohibition would apply. This would ensure that flexibility exists in the regulatory framework to respond to unacceptable marketplace practices. We also recommend that the section in the Bank Act, amended as recommended, be applied to other federally regulated financial institutions.

Third, we recommend that as a matter of good business practice, where suppliers offer tied products as well as the components, they should itemize and price the different components in the package so that consumers can make comparisons to stand-alone products and other combinations.

We recognize the critical importance of disclosure in this area. We recommend that the law require institutions and intermediaries to notify every prospective customer in writing, prior to entering into any contract that includes the sale of insurance or credit products, of what constitutes coercive tied selling and the fact that coercive tied selling is illegal. Government should work with industry and consumer groups to develop an acceptable, easily understood statement that can be generally used by all institutions and intermediaries.

[161] For example, the Financial Institutions Act in British Columbia provides that agents must not coerce a prospective buyer of life insurance through the influence of a business or professional relationship (S.B.C., c. 47, s. 176) and the Insurance Act of Alberta (R.S.A. 1980, c. I-5) contains a virtually identical provision. The Insurance Act (Ontario), (R.S.O. 1990 c. I.8, s. 439) contains a general prohibition against unfair or deceptive acts or practices.

Finally, we recommend that the Government consider legislating remedies for coercive tied selling, including the right of contract rescission and the possibility of private actions that would include punitive damages.

Consumer Redress: Financial Sector Ombudsman

Given the great number of financial transactions that take place every day across the country, it is inevitable that mistakes will be made. At times, consumers may make ill-informed decisions and feel, after the fact, that they were misled. At times, they may indeed be misled – deliberately or by inadvertence. In addition, there may be situations where policies or procedures are simply improperly administered. No system in the world will be free from mistakes. The hallmark of a well-functioning system is the way in which it deals with mistakes.

By way of illustration, 9 percent of the people surveyed in our public opinion research indicated that in the previous year they had had a serious problem with the deposit-taking institution with which they deal. The comparable response in respect of insurance companies was 7 percent. Of the total number of complaints with respect to deposit-taking institutions, 54 percent were not fully resolved and in 21 percent of cases the people with a problem switched institutions. With respect to insurance companies, 66 percent were not fully resolved and in 31 percent of cases people switched institutions.[162]

Chapter 6 of Background Paper #3 discusses the nature of redress mechanisms that now exist in the Canadian financial services sector. These include:

- statute-based remedies, which provide for charges to be laid by the appropriate Crown authority on the basis of consumer complaints;
- disciplinary proceedings, which are similar to statute-based remedies but apply particularly to licensed intermediaries, such as insurance agents or brokers;
- regulatory assistance, whereby provincial and federal regulators offer assistance to consumers who have complaints, generally on an informal and non-statutory basis; and
- industry initiatives, which include toll-free lines, designated officials to deal with complaints, and full-scale ombudsman systems.

Consumers may require different redress options depending upon the nature of their concern. The mix should include access to the courts as well as ready access to a general forum for redress in situations where the consumer has not been treated fairly or in accordance with good business practice, and where satisfaction has not been obtained from the institution. Such a general forum

[162] Ekos, *Public Opinion Research*, pp. 30-36.

should satisfy four principles: it should be accessible, independent, transparent and efficient. In this regard, a system that provides a good model to build on is the office of the Canadian Banking Ombudsman (CBO), established in July 1996 by Canada's chartered banks.

The origin of the CBO was an effort by the banks to improve relations with small business customers, but the mandate of the office was broadened to include personal banking customers in March 1997. The CBO describes itself as "an independent organization" whose "goal is to provide fair, impartial and prompt resolution of complaints, according to good business and banking practices."[163] The Ombudsman is directed by the CBO's terms of reference to seek a resolution that is satisfactory to the complainant. Where there has been some loss, damage or inconvenience suffered, the Ombudsman may recommend appropriate compensation.

A board of directors composed of five senior bank executives and six independent directors governs the CBO. Changes have been made to the board to increase its independence. The Chair is chosen from among the independent directors, who have special responsibilities, including recommending the budget for the office and recommending candidates for Ombudsman. Moreover, an Ombudsman may not be dismissed without the unanimous approval of the independent directors. The board does not play any role in individual complaints.

Participation by the banks in the CBO is voluntary and at present 12 banks are members. The Ombudsman's recommendations are not binding, although all have been complied with to date. The Ombudsman is required to publicly name any bank that does not comply with a recommendation.

Bank-appointed ombudsmen in each of the participating banks complement the CBO. A customer's first recourse is to the ombudsman within the institution; failing satisfaction, the customer may appeal to the CBO.

It is too early to assess how well the CBO is working. Visibility is low, with only 20 percent of consumers aware that this redress option is available.[164] The Ombudsman is working with member banks to increase awareness of the Office. Further, the CBO is inviting additional banks and other types of financial institutions to join, at which point it would become a broader financial services ombudsman with appropriate modifications to its terms of reference and structure. There is no indication of whether or not this initiative will be successful.

There has been some criticism of the CBO as being a public relations exercise, without bank commitment. That is not our view. We are impressed with the

[163] Canadian Banking Ombudsman, Annual Report, 1997, p. 2.

[164] Ekos, *Public Opinion Research*, p. 32.

spirit behind, and the structure of, the CBO, and we believe that it compares well in most respects with similar initiatives in other countries and industries.[165] However, we see two major problems with the structure: because it is industry-sponsored, it is not perceived as independent, notwithstanding the changes in governance recently made; and it is not comprehensive since participation is voluntary. Even if member institutions cover most of the marketplace, some banking customers, as well as customers of other financial institutions, are left without access.

We recommend that the federal government establish a single financial sector ombudsman office, and that membership be mandatory for all federally chartered financial institutions and their regulated subsidiaries. Having both federal and provincial institutions in a single redress system would substantially limit consumer confusion. Accordingly, the office should be structured so that provincially chartered institutions could belong as well, either voluntarily or as a requirement should provinces choose to make membership mandatory.

Mandate and Coverage

An important issue is the question of how broad the mandate and coverage of the office should be. We believe that the mandate should be based on concepts of fairness and good practice. Within this broad framework, it would normally focus on improper administration of existing policies and approved practices of institutions. We do not suggest that the ombudsman should have the authority to second-guess an institution's risk-management regime with respect to the granting of credit or the underwriting of insurance.

With respect to coverage, given the changes that are taking place in the industry and the diverse range of products in the same institution or financial group, we believe that coverage should be comprehensive. It would be a step backward to establish separate ombudsman offices for each of the former pillars in the financial services sector. A consumer who purchases creditor life insurance from the subsidiary of a bank, or who has a complaint against a trust company subsidiary of an insurance company, should not have to figure out which redress channel is the appropriate one. The United Kingdom, which has a long history of statutory and voluntary ombudsman systems, is now in the process of integrating eight different systems into a single office for consumers.

[165] Chapter 6 of Background Paper #3 reviews approaches to redress in the United States and the United Kingdom in some detail. Comparisons are also presented of banking ombudsman offices in Australia, the United Kingdom and Ireland.

Independence

It will be critical that the office be independent and perceived as such, and for this reason a number of structural features are recommended. The office should report to Parliament through the Minister of Finance, who should have authority to appoint the board of directors. There should be a majority of directors who are independent of member institutions, and a minority of directors appointed from a slate nominated by member institutions. The Minister should approve the terms of reference of the ombudsman.

The board of directors should appoint the ombudsman. The office should be funded by member institutions, and the board should approve funding arrangements and the annual budget.

Access and Cost

Each member financial institution should be required to make available an internal ombudsman as the first recourse for consumers. The mechanism should be aimed primarily at individuals and small businesses, but there should be flexibility and discretion for the ombudsman to accept other customers if the case is compelling. Some ombudsman systems levy a charge on the consumer, which is refunded if the consumer is successful. We recommend against such an approach, although the volume of complaints should be closely monitored and nuisance complaints that slow down response times should be discouraged.

Decisions and Procedures

The issue of whether decisions should be binding is a difficult one. In the United Kingdom, the current banking ombudsman has the right to make binding decisions but the plan itself is voluntary and has no legislative basis. The new ombudsman office in the United Kingdom will be mandatory, legislatively based and empowered to make binding decisions. As a consequence, certain rights will flow to the participating parties, including the right to have the proceedings conducted in public, the right to legal representation, the right to call and cross-examine witnesses, and the right to have decisions published, with reasons.

The advantage of binding decisions is that they cannot be ignored by the institutions. The disadvantage is that they necessitate a formal, adversarial process. This process may deter consumers by making access more difficult, and it might also restore the resource imbalance between the institution and the customer, which the redress mechanism is designed to eliminate in the first place. Moreover, such a process can slow the system down considerably.

On balance, we conclude that binding decisions are not necessary and would not be desirable. We note that the public underpinning for the system should provide increased assurance of the independence of the office. Our conclusion

with respect to the need for and advisability of binding decisions is based on an assumption that the member institutions will participate within the spirit of the initiative, and will respect the importance of the ombudsman process. Should it become clear that institutions are acting in a manner to frustrate or impede the effectiveness of the ombudsman process, binding decisions would probably be the inevitable outcome.

The ombudsman should have the right to make any recommendation public, should he or she feel that doing so would be influential or constructive. Recommendations not complied with should be made public.

Visibility

Government and institutions should work together to ensure the visibility of the new office. We recommend efforts by the member institutions to ensure that the office achieves substantial visibility, for example including the use of periodic mailings to inform and remind customers that the institutional ombudsmen, as well as the office, are available to deal with complaints.

The Licensing of Intermediaries

Intermediaries are licensed by provincial governments. Regulatory regimes differ from province to province and, indeed, sometimes two or three regimes operate within a province. The multiplicity of regimes stems from the historical structure of the sector, where intermediaries were associated with traditional pillars and usually single-licensed only. Convergence is leading to multi-licensing, which is now well established in Canada. Given the explosion of products and options in each pillar, let alone across pillars, today's market intermediaries are in a far different position relative to the consumer than they were in the past.

The changes taking place are leading many provinces to actively rethink traditional approaches to the certification and regulation of intermediaries. For example, Quebec enacted a bill in June 1998 that sets out a more integrated regulatory regime for market intermediaries in financial services by creating a single financial services bureau. A recent discussion paper issued by the Government of Ontario also proposes moving toward a more coordinated, industry-based regulatory regime for insurance intermediaries. The Ontario approach is based on regulating the transaction rather than the individual.

We believe that the role of the financial intermediary will become increasingly important. Some evidence suggests that advice-based channels have been the

fastest-growing channels in recent years,[166] and there has been a proliferation of so-called financial planners – many of whom are neither certified nor regulated.

We endorse and encourage provincial initiatives to implement the concept of a single regulator for market intermediaries, and as far as possible to harmonize the proficiency standards across all jurisdictions. We believe that adequate proficiency standards for financial intermediaries should include:

- a post-secondary educational requirement of a diploma in a relevant and approved program for new applicants;
- examination standards that reflect the role of market intermediaries, and the reliance placed upon their advice; and
- enhanced continuing education standards for all licensed individuals.

Finally, we have noted that in some provinces occupational and residence restrictions limit the ability to offer certain financial services products within the province. Some of these restrictions, for example, prevent employees of deposit-taking institutions from qualifying for a licence to sell insurance. Others require individuals to be employed full-time in dealing with a particular type of product or service. Residence requirements sometimes prevent residents of a province from being served from a call centre outside the province. In a world where work patterns, attitudes and even definitions about part-time work are shifting rapidly, where technology is increasingly making borders less relevant to selling practices, and where we are recommending that deposit-taking institutions be able to retail insurance products, these restrictions are anachronistic and constitute undesirable barriers to trade. We urge provincial governments to remove them.

The traditional rationale for occupational exclusions was to avoid licensing individuals who might be capable of exerting "undue influence" on prospective buyers of insurance. To the extent that this concern remains, it should be dealt with by making it illegal to use coercion in the sale of financial services products, as recommended earlier.

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

[166] Earl Bederman, *The Outlook for Retail Financial Services in Canada: The Next Decade (Edition III)*, (Toronto: Investor Economics, December 1996), p. 77.

with complaints. These measures will go a long way toward improving the functioning of the marketplace, with benefits to both consumers and customer-focussed providers.

But we are not likely to move to this state of affairs tomorrow. And many of the recommendations in this chapter call for processes to elaborate new ways of doing things in which consumer advocacy groups should participate. We believe that such groups need to be strengthened if they are to play this role constructively and effectively.

The Task Force has considered two options that might be considered to strengthen consumer advocacy groups in the financial services area, but we are not comfortable making a recommendation to support either one.

The first option is the proposal advanced by the Canadian Community Reinvestment Coalition (CCRC),[167] that the utility-funding model used in the United States to fund ratepayers' groups be introduced in the Canadian financial services context. In this model, utilities include in their mailing to customers a notice that allows customers to make a contribution to a ratepayers' group that represents their interests at regulatory hearings.

In the Canadian context, the CCRC is suggesting that banks, as well as federally regulated trust companies and life and health insurance companies, be required to include in mailings to customers a similar notice inviting them to join a Financial Consumers Organization (FCO). The CCRC proposal suggests that the creation of the FCO should be coordinated by representatives of a broad-based coalition of existing citizens' groups which work in, or are concerned about, the area of financial services. The mandate of the FCO 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."[168] The FCO would solicit membership fees from Canadians through voluntary or mandatory periodic mailings by institutions to their customers, and would also solicit donations that could be used to fund projects undertaken by existing citizens' groups.

We believe that this proposal may contain a basis for action, but we also believe it requires further elaboration before it should be considered.

The ratepayer group model is not strictly analogous since it has been developed in a context of a regulated industry and the need to give consumers adequate voice in regulatory hearings that determine price. Our financial sector is not a

[167] Canadian Community Reinvestment Coalition, *A Financial Consumer Organization for Canada*, Position Paper #4, December 1997.

[168] Ibid., p. 13.

public utility and not regulated in the same manner. The relevant regulatory structures have different mandates and processes. It is therefore critical to ensure that the mandate of such an organization is well specified since it will lack the operational focus that defines the U.S. groups on which it is to be modelled. In our view, 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. We believe that complaints-handling processes should be restructured, as recommended earlier, with a view to making the system less formal, less adversarial and more amenable to direct access by consumers, although this might not eliminate the need for support and possibly representation in specific instances.

In our deliberations we heard from a number of consumer advocacy groups including the CCRC, but also including Options Consommateurs, the Insurance Consumers Group, the London Life Policyholders Association, the Canadian Federation of Independent Business, the Public Interest Advocacy Centre, and the Consumers' Association of Canada. We believe that all these groups have important roles to play. For a Financial Consumers Organization to succeed, it is important that groups such as these have an opportunity to contribute to it, to help shape it, to be active participants in it and to endorse it.

We urge these groups and others that might be interested to pursue the idea further and, once a broad consensus is reached on an acceptable mandate and an agreed structure, to present a refined proposal to the financial institutions and to the Government.

A second option we considered was to recommend creation of a new Office of Consumer Protection at the federal level. The federal government, through OSFI, already has substantial consumer protection responsibilities with regard to financial institutions, and the recommendations we are making in this chapter will extend them, particularly in the area of privacy protection and transparency, where OSFI would take on new responsibilities. We considered whether consumer protection functions should be split off from prudential functions, as has been done in Australia, and a separate office established. If this course were followed we would expect the office to have advocacy, as well as regulatory, responsibilities. That is, we would expect it to advocate consumer interests within the federal policy-making structure. We would have recommended an advisory board composed, at least in part, of representatives of consumer organizations, and a budget that could be used to fund projects undertaken by such organizations in support of the advocacy responsibilities of the office.

In the end we decided that, given the large and continuing role of the provincial governments in this area, a new federal office was not required and not desirable. We therefore recommend leaving the federal consumer protection

functions with OSFI but, as discussed in Chapter 9, changing its mandate to reflect this role and enhancing its governance structure by adding a board of directors. We do not think it appropriate for OSFI to have advocacy responsibilities on behalf of consumers.

We believe it is important to move forward to strengthen consumer advocacy groups and, in particular, to enable them to participate in the multipartite exercises that we have recommended be carried out with respect to improving transparency and developing stronger privacy codes.

Within the Government of Canada, Industry Canada has responsibility for consumer issues. Our experience is that consumer advocacy groups would have been able to make a stronger contribution to the work of the Task Force if they had been stronger organizations, with some assurance of reasonable core funding. This was particularly the case with respect to the Consumers' Association of Canada, which indicated it was not able to participate fully in the work of the Task Force because of resource constraints. We believe it is important that the voice of consumer groups not be lost to public debate in Canada. We urge Industry Canada to work with consumer organizations to find ways to make them sustainable and strong contributors.

Industry Canada has a general mandate for consumer issues but it does not have a particular focus on financial institutions. That is the responsibility of the Department of Finance. 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.

Finally, with regard to the ongoing processes recommended in this chapter, we expect that OSFI would lead on the multilateral exercise directed at improving transparency and on the processes to develop sectoral privacy codes. Consumer advocacy groups should be involved in both these processes. We urge the Department of Finance, in collaboration with Industry Canada, to ensure that the relevant groups are not constrained from effective participation by lack of resources.

Chapter 8

Canadians' Expectations and Corporate Conduct

Introduction

Our terms of reference asked us to examine several specific issues that relate to the conduct of financial institutions. We were asked the following questions:

- What obligations does the financial services sector have to provide financial services to all Canadians, including those with low incomes?
- In what ways can the public policy framework assist the evolution of the financial services sector so that it can best meet the needs of the rapidly evolving new economy, including a growing number of knowledge-based and high-technology firms?
- In what ways should the financial services sector evolve to ensure that the needs of small businesses are adequately met?[169]

Further, we received a number of submissions that asked us to examine particular areas of concern to interested parties. Several groups raised with us the role of financial institutions in supporting micro-credit[170] – that is, very small loans to individuals to start small businesses. The Chair of the National Aboriginal Financing Task Force met with the Chair of this Task Force to make us aware of the report that his group was submitting to the federal government,[171] and to draw to our attention certain specific issues related to the financing of aboriginal businesses. We received a submission from the Voluntary Sector Roundtable[172] outlining a number of ways in which the

[169] See Appendix 1.

[170] Groups that made presentations about micro-credit included Results Canada (Vancouver and Montréal), the Mennonite Central Committee (Calgary), and Self Employment Development Initiatives / Women & Rural Economic Development (Toronto).

[171] National Aboriginal Financing Task Force, *The Promise of the Future: Achieving Economic Self-Sufficiency through Access to Capital*, Final Report, September 1997.

[172] Voluntary Sector Roundtable, *Presentation to the Task Force on the Future of the Canadian Financial Services Sector*, April 8, 1998.

financial sector could work more closely in partnership with Canada's voluntary sector. In addition, we received representations to the effect that Canada should adopt a U.S.-style Community Reinvestment Act.[173]

As we considered the substance of these issues, we recognized that most of the concerns being raised related more specifically to banks (and, to a much lesser extent, trust companies and credit unions) than to other financial institutions. And we recognized that underlying these issues was a premise that was more often unstated than expressed: that banks should be held to a higher standard of behaviour than is expected from other financial institutions or other businesses.

This is a premise that Canadians generally endorse. In our public opinion research, 58 percent of Canadians agree that banks have greater public responsibilities than other businesses. Canadians expect to be well served by banks in the normal course of business. But they also expect banks to play leadership roles in their communities. This special position places banks under closer scrutiny than other businesses.

It is timely to re-examine the relationship between banks and the communities they serve for three reasons.

First, the nature of economic activity is shifting toward small business and knowledge-based activity. These activities are the drivers of economic growth and job creation. But they are often costly, risky and difficult to finance. Are our banks and other financial institutions doing enough to support the capital allocation necessary to new and innovative activities?

Second, the business of banks and other financial institutions is converging. As boundaries continue to blur, should banks still be special? Should the higher expectations that banks are now subject to be reduced? Or should other financial institutions – as they become more "bank-like" – be subject to the same expectations as banks?

Finally, the relationship between banks and communities is strained. The financial services sector is strategically important to Canada's economic prospects. It is also critical to the daily needs of Canadians as they make payments for goods and services, save and invest for their retirement, seek credit for major purchases, or buy insurance to protect their loved ones. Our vision of an ideal financial services sector is one in which major institutions enjoy the broad confidence and support of Canadians. This does not appear to describe the current state of affairs with respect to Canada's banks. Only 31 percent of

[173] Canadian Community Reinvestment Coalition, *An Accountability System for Financial Institutions in Canada: How to Ensure They Meet a High Standard of Performance*, Position Paper #5, December 1997.

Canadians place high trust in CEOs of large banks, 44 percent feel that banks are "heartless," and 59 percent believe that the large banks "exert too much influence and power in Canada."[174]

This chapter examines the basis for community expectations with respect to banks. It concludes that there is a legitimate basis in our history and public policy framework for higher expectations of banks, and that these expectations take two forms: expectations about social performance and expectations about business performance. The chapter then discusses the implications of these two sets of expectations in the context of the particular conduct issues that have been raised.[175]

The Basis for High Expectations

There are two principal features of banks that give rise to high community expectations.

The first is simply their economic importance. Banks have traditionally been, and still are, fundamental to the economic and social well-being of communities. Moreover, they are very important repositories of people's money. Their role in facilitating transactions is critical to businesses and individuals across the country, and they play a particularly important stewardship role with respect to the deposits and savings of virtually all Canadians. Canadians interact with their banks more often, and on a more regular and systematic basis, than with many other private businesses. And a particular characteristic of such interactions is the special role that banks play in granting credit. Unlike most other industries with which consumers deal on a regular basis, banks have tremendous influence over individuals' abilities to pursue their plans – whether starting a business, buying a car or purchasing a house. It is no wonder that the behaviour of banks attracts attention.

Second, Canadians view banks as privileged institutions, operating with the sponsorship of governments in a protected and very concentrated environment. There is sometimes a debate about whether banks are public utilities or private businesses. We do not believe that they are public utilities. They are not monopolies and are subject to competition in most if not all markets in which they operate. But they have never been, and are not, strictly private enterprises.

In all social democracies governments grant bank charters and give banks their special powers and privileges. They also take responsibility for the health of banks both domestically and in dealings with governments of other

[174] Ekos, *Public Opinion Research*, pp. 37-43.

[175] Supporting information on our conclusions and recommendations can be found in Background Paper #4.

countries in which their banks operate. Without this framework, banks would be very different from what they are today. It is questionable whether they would enjoy the same degree of public confidence, necessary to hold public deposits, as they now do.

Public Policy Perspective

In Canada, public policy has deliberately aimed at facilitating the development of strong, large banks with national reach. The tools used to build a nationwide banking system have included the following:

- A restrictive foreign bank entry policy. Foreign banks were not allowed to be established in Canada from 1967 to 1980, and there are still restrictions on the manner in which they can be established.
- Deposit insurance coverage guaranteed by the government, beginning in 1967.
- Access to liquidity support from the Bank of Canada.
- A mandate to operate the payments system, which was run by the Canadian Bankers Association until 1983. Access is still restricted to deposit-taking institutions.
- A framework of federal regulation that gives credibility to banks wishing to establish operations in other countries.
- A wide-ownership policy that has successfully maintained Canadian control.

Some observers have referred to these characteristics of our banks as privileges. Equally, they should be regarded as tools of public policy. The tools have helped build a nationwide banking system that has been important in developing a strong national economy. Nationwide banking has also provided Canadians from Prince Rupert to Corner Brook and to Chicoutimi with the same choice of bank products at national prices, and with same-day access to cash through a very efficient cheque-based payments system.

These public policy tools are what have made banks special. Nevertheless, in today's evolving financial system, they need to be re-examined. Our report recommends many changes. Some of the so-called privileges, such as restrictions on foreign entry, should be eliminated. Others, such as access to the payments system and wide-ownership policies, should be shared with other financial institutions. Still others, such as deposit insurance, should be reconfigured to ensure that deposit insurance does not confer on banks a competitive advantage over life insurance companies.

Changing the public policy framework will change our future but it cannot change our history. As we move forward, banks will become less special and we believe that community expectations about performance will, and should, apply to other financial institutions as well.

Today, however, the strong market positions that banks enjoy are a beneficial legacy of our past. And it is the broad sweep of our history that forms the basis for public expectations about the behaviour of banks.

The special position of banks in our society leads to two types of expectations, about the financing of business and about social performance:

- In their business dealings, banks are expected to support the community. No one would ask or expect banks to make decisions that do not make business sense. But there is concern that banks may choose not to make profitable loans within the community because the risk-adjusted returns are not great enough or the administrative costs are too burdensome, compared with alternatives that may benefit shareholders but not other stakeholders.
- Banks are also expected to play a leadership role in the community, beyond their business imperatives. They are counted on to contribute to enhancing the quality of life for citizens through social responsibility and good corporate citizenship, by undertaking activities that may or may not be profitable.

Expectations about the Financing of Business

In this section we address the questions of financing small and medium-sized enterprises (SMEs), firms in knowledge-based industries (KBIs), and certain specific issues with respect to financing aboriginal businesses.

Financing Small and Medium-Sized Enterprises

SMEs are powerful engines of employment and growth. In 1996, some 99 percent of all firms in Canada had less than 100 employees and these firms accounted for 38.5 percent of employment.[176] In addition, they have been the main generators of new jobs for some time.

Lending to business, especially small and medium-sized enterprises, is a core function of banks. Serving SMEs is also a profitable business. There is, nevertheless, a continuing public concern that banks may not be doing enough to finance SMEs, a concern that arises partly because of experience in the recession of the early 1990s and partly because such businesses have few alternatives and are so important to our economic health.

In order to get a better understanding of the issues arising in small business finance, we commissioned a comprehensive study by Professor Allan Riding. It reviews the many studies that have been undertaken on SME finance over the past several years, and provides an assessment of outstanding issues.[177] Our

[176] Statistics Canada, *Employment Dynamics*.

[177] Allan Riding, *Financing Entrepreneurial Firms: Legal and Regulatory Issues*, (Ottawa, September 1998).

analysis of the issues and conclusions are presented in detail in Chapter 4 of Background Paper #4.

A number of points warrant emphasis:

1) Data Limitations and the Nature of the Problem

The SME category is a large and diverse collection of businesses. Different-sized firms, operating in different areas of activity and in different regions of the country, are likely to have distinct financing issues. Despite the numerous studies undertaken and the public attention focussed on these issues since 1994 in particular,[178] there is no data base adequate to support focussed research and solid public policy conclusions about the specific categories of small businesses that may be having particular financing problems. Anecdotes abound, but the plural of anecdote is not data. We make recommendations below to improve our knowledge of the financing and other characteristics of this important sector of the economy. We believe these recommendations are very important for future analysis and action.

Notwithstanding the unsatisfactory quality of the data, there is a general consensus that a great many SMEs have difficulty securing credit. Data do show that SMEs are less likely than larger firms to apply for financing, borrow from banks or have adequate equity. And they are more likely than other firms to require guarantees for their loans, have higher rates of loan loss, pay higher interest rates on loans, and be turned down on loan applications.[179] SMEs clearly pose particular problems to traditional lenders. Often they are small, very young firms with no track record, no realistic business plan and untested management. Understanding their potential requires time, effort and specialized expertise. Financial institutions have to work hard to be successful small business lenders. Yet their relationship with SMEs is profitable, with an estimated return on equity to Canadian banks of 10 to 15 percent.[180]

2) The Changing Nature of the Marketplace

The nature of the marketplace is changing. Canadian chartered banks clearly dominate the debt financing of SMEs. In 1996 they accounted for slightly more than 50 percent of the total credit extended to SMEs and almost 60 percent of commercial loans. From 1994 to 1996, the share of the domestic banks did not

[178] In 1994, four separate Parliamentary and government-sponsored committees and Task Forces issued major statements or reports on financing SMEs. These were the Report of the Standing Committee on Industry (Berger Committee), *Taking Care of Small Business*, October 1994; Federal Ontario Liberal Caucus (Mitchell Committee), *Report of the Task Force on Access to Capital by Small Business*, August 1994; Small Business Working Committee, *Breaking through the Barriers: Forging Our Future*, 1994; and Industry Canada (Toriel Committee), *Financing the New Economy*, June 1994.

[179] See Background Paper #4, p. 52.

[180] McKinsey, *The Changing Landscape*, Exhibit 2-23.

change much. Specialized finance companies increased their share of the SME debt market from 9 percent to almost 16 percent, while all other participants lost share.[181] Comprehensive statistics on outstanding bank loans to small business are now available from data published by the CBA, but these data cover only half the credit market and do not deal at all with equity finance, which continues to be a very significant issue for SMEs.

The changing nature of providers reflects innovations in the marketplace. In particular, credit scoring, securitization and asset-based finance are playing increasingly important roles in SME finance.

Credit scoring is a technique that simplifies approval by using statistical profiles to judge credit risks electronically. It is being used increasingly by Canadian banks but its highest-profile use is by Wells Fargo – a U.S. bank that is offering credit to Canadian SMEs by mail and call centre, with no physical presence in Canada. Credit scoring offers convenience and speed of response to borrowers who qualify.

Securitization is a powerful innovation because it separates the funding of loans from their origination and management, allowing for the efficient use of capital and the development of specialized expertise in each of the three categories. For example, Newcourt Credit Group, which is now the second-largest asset-based lender in North America, specializes in loan origination and management, and funds many of its loans through securitization. The creation of a broader market for funding, separate from origination and management, has the potential to broaden the number of lenders and increase the available funds for SMEs. The securitization of small business loans has recently gained momentum in the United States but is still developing in Canada.

Asset-based finance ties loans or leases to capital equipment. Typically, the financing is arranged with the vendor rather than the purchaser. Such financing allows buyers to use equipment without tying up cash or using credit lines, and it also facilitates securitization by reducing the need to assess the creditworthiness of borrowers.

We expect the increased use of these techniques to assist small business finance, but they will play a major role in particular niches rather than being of general assistance to all.

[181] Catherine Moser and Pierre Vanasse, *What's New in Debt Financing for Small and Medium-Sized Enterprises?* The Conference Board of Canada, 208-97.

3) The Role of Banks

Banks will continue to be the main lenders to SMEs.

The relationship between banks and the SME community will always be one of tension. Riding describes the conflicting expectations on both sides of the relationship: small businesses are seeking personal relationships with their lenders but small lending balances require loan account managers to administer large volumes of borrowers to cover overhead and profit. From the banks' perspective, large caseloads result in little time to monitor existing borrowers and appraise new applications. This is exacerbated by the turnover of managers. Fewer than 40 percent of small businesses responding to a survey initiated by the Canadian Federation of Independent Businesses (CFIB) have had the same account manager for the past three years.[182]

This relationship was seriously strained in the early 1990s. From 1989 to 1991 outstanding bank loans were drastically curtailed, particularly for the smallest borrowers. Loans outstanding under authorizations of less than $200,000 fell by 25 percent in two years, while total business lending by the banks increased by 3.2 percent. The proportion of CFIB members expressing concern about credit availability rose from 15 percent in the late 1980s to an unprecedented 37 percent in 1994.

Since 1994, much has been done to repair the relationship. The Canadian Bankers Association has developed alternative dispute resolution models and a code of conduct for dealing with SMEs that have now been adopted by all major banks, and the banks have also established an ombudsman system to deal with small business complaints. The CBA also publishes extensive information about the small business lending of the banks, and undertakes a regular, annual survey focussed on SME attitudes toward financial institutions and their experiences with them.

Individual banks have introduced special credit programs and simplified procedures; most important, bank credit to small business appears to have recovered from the low points reached in the mid-1990s. It is difficult to assess the real extent of the progress made. For example, loans outstanding under authorizations for under $200,000 are only now back to their pre-recession peak, notwithstanding the growth in the economy and the growth in the capacity of banks to lend over the past few years. Larger loans, in the $200,000 to $500,000 category and in the $500,000 to $1,000,000 category are, respectively, 40 percent and 19 percent above previous peaks. The concerns of CFIB members about credit availability, last measured in 1997, have abated somewhat. But the percentage of

[182] See Riding, *Financing Entrepreneurial Firms*, p. 17-19, and CFIB, Submission to the Task Force, October 1997, Exhibit 6.

members expressing concern has declined from 37 percent to only 28 percent, well above the 15 percent levels of the late 1980s.

While we believe that progress is being made, more should be done. If the financial sector is to evolve to ensure that the needs of small businesses are adequately met, we need healthy and effective competition, additional institutional initiatives and better information than is currently available.

The Importance of Competition

A very important condition for a well-served SME community is that there be a dynamic and competitive marketplace, with many competitors. Many of our recommendations will increase competition by encouraging more foreign and domestic participants and assisting existing institutions – such as credit unions and insurance companies – to play a more active and vigorous role in meeting the full range of Canadians' financial service requirements.

With respect to SME finance in particular, we recognize the strong role that the Business Development Bank of Canada (BDC) is playing, particularly in innovative quasi-equity financing instruments. The BDC is filling an important niche and developing constructive partnerships with private-sector lenders. This activity should be encouraged.

Securitization offers potential to bring new lenders into the marketplace. We urge the Government to work with lenders to develop a healthy market for securitized SME loans in Canada. The BDC may have a role to play here in assisting pilot projects to help develop the market, possibly as an originator of securitized packages or as a partial guarantor. In addition, the ongoing review of the Small Business Loans Act (SBLA) should consider whether the SBLA guarantee could be used to facilitate securitization of SME loans.

Institutional Initiatives

We believe it is important that relationships between the banks and the SME community be enhanced. There are three particular initiatives that we believe should be pursued.

First, institutions should recognize the validity of the concerns in the SME community about the rapid turnover of account managers and the resulting inability for SMEs to build and maintain the personal credibility that underlies a sound small business-banking relationship. We urge the institutions to find new and creative ways of addressing this problem, including establishing career paths and compensation incentives that allow long-term, meaningful careers for community-based account managers. Consistent with this, we urge a continued decentralization of credit authorization limits in amounts that would allow most SME demands for credit to be dealt with at a local or regional level, with an emphasis on the local level.

Second, we believe that banks should be able to appropriately price for risk and additional cost, and should be encouraged to do so. Few if any loans today are granted to SMEs at rates above prime plus 3 percent. As a result, many SMEs finance themselves through their owners' personal credit cards at substantially higher rates. In contrast, financial institutions in the United States, where credit is perceived by the SME sector to be more readily available, offer customers a wider variety of terms and prices. Indeed, in Canada the BDC extends credit to willing borrowers at higher rates than prime plus 3 percent, and Wells Fargo is offering loans at rates that extend to prime plus 8 percent. In many cases, such loans are really of a near-equity nature, given the risks involved, and if they are to be granted higher returns are warranted. Our concern is not that the banks are charging too little, but that, because they are unwilling to charge higher rates, they are denying credit to those borrowers with risks that might be acceptable at higher pricing levels.

We would obviously not support a regime of pricing for risk if it became a veil behind which banks increased their spreads on loans that they would grant anyway at lower rates. That having been said, we believe that credit properly priced for risk would provide more financing to businesses that need it. We urge the banks to be willing to offer credit further up the risk curve, with appropriate pricing and more innovative financing packages and appropriate professional support. We also urge the community to recognize that this will result in some loans at higher rates than we are now accustomed to seeing, as credit is extended to those who were previously denied it.

Third, our assessment of SME financing needs suggests that, for many small businesses, unmet needs relate more to equity than to debt. Banks have not been traditional suppliers of equity and, with their fiduciary duties to depositors, must be cautious about large-scale equity investment. Most banks now have seed capital and venture capital initiatives. We believe this is a healthy development and urge the institutions to increase the supply of equity to smaller firms, through the specialized financing corporations and venture capital partnerships that are consistent with their prudential responsibilities.

Improved Information

Although the quality of existing data on small business finance has improved markedly in the last few years, it is still not adequate for analytical or public policy purposes. This is not a uniquely Canadian problem.[183] In our particular circumstances, however, the information available is less than adequate because the data are not comprehensive and the supplementary survey information is not perceived to be independent.

[183] See Background Paper #4, p. 82, for reference to data problems in other OECD countries and in the United States.

Consistent, comprehensive data – supported by regular survey information that is perceived to be objective – can allow high-quality, focussed analysis of SME financing issues. Such data and analysis can provide valuable information about market gaps to suppliers of finance; can help SME firms know the full range of participants in the market and the niches they are serving; can assure the community that expectations about SME financing are being met; and can help government refine the public policy framework.

We recommend a comprehensive data collection, analysis and publication program, described in detail in Chapter 4 of Background Paper #4.[184] It would have the following main characteristics:

- Statistics Canada would be given a legislated mandate to regularly collect and publish information from all substantial providers of finance to SMEs. This would include loans, leases and equity finance,[185] and would cover regulated and unregulated financial institutions as well as government funding programs. Particular attention should be paid to financing of firms in knowledge-based industries (KBIs). Appropriate definitions and coverage should be developed by Statistics Canada in consultation with data providers, potential data users, and representatives of Industry Canada. Some suggested criteria are set out in Background Paper #4.
- Financial institutions that play a major role in financing SMEs or firms in KBIs should be required to publicly release their submission to Statistics Canada, so that individual institutional performance can be easily tracked by the community on an ongoing basis.
- A dedicated SME Finance Group should be established within Industry Canada. The mandate of this group would be to assess and analyse the Statistics Canada data, to conduct other complementary surveys, and to prepare an annual report on the state of SME Finance to be tabled with the House of Commons Industry Committee. The Group should also conduct continuing research on SME finance, including KBI issues. Similar groups provide similar reports in the United States and United Kingdom.
- The SME Finance Group in Industry Canada should assume responsibility for coordinating the annual survey of SME attitudes, now conducted under the auspices of the CBA. Further, the Group should institute a new, periodic benchmark survey that would provide a comprehensive picture of financing from the perspective of users, to complement the provider information collected annually by Statistics Canada. Such a survey should be conducted once every three to five years.

[184] See Background Paper #4, pp. 82-89.

[185] Riding points out that the need to better understand the equity requirements of small firms is critical. It is clear that there is a pressing need for greater research about the demand for equity capital among owners of new businesses. See Riding, *Financing Entrepreneurial Firms*, pp. 11, 51.

Financing Firms in Knowledge-Based Industries

Knowledge-based firms are the backbone of the "new economy." They have consistently outperformed the total economy in terms of growth and job creation since the 1970s. Because of their size and the nature of their activities, they pose particular problems for traditional suppliers of finance.

In order to understand this sector better, we commissioned research studies by Groupe Secor and Macdonald & Associates. Based on these studies and other material, Chapter 4 of Background Paper #4 presents a more extensive discussion of our analysis and conclusions.[186]

There is no single, agreed definition of what constitutes the knowledge-based industry sector. Indeed, one of the benefits we expect from our recommendation that Statistics Canada collect data on KBI firms is that an agreed definition can be established that will allow for consistent analysis of the sector. Whatever definition one uses, there can be no dispute that knowledge-based firms are becoming increasingly important to growth and employment. The creation, development and application of knowledge are at the root of innovations that raise productivity and living standards, and enhance our quality of life.

In considering the financing issues raised by KBI firms, we restricted our scope to science-based and high-tech craft firms.[187] These are generally relatively small firms on the leading edge of discovery in their sectors (typically pharmaceuticals, health biotech, new materials, software, medical equipment and avionics). They have long product development cycles and their comparative advantage usually comes from highly innovative and creative people who make up the development team. These companies face particular financing challenges because of their lack of fixed assets, the difficulty that traditional lenders have in assessing their potential, and the unique operational risks they face.

As a result of these challenges, KBI firms tend to rely much more heavily than other firms on equity, although they do have requirements for working capital at an early stage and term debt as they mature. The federal government has introduced a number of policies to assist the financing of KBI firms. These include the following:

- The Scientific Research and Experimental Development (SRED) Tax Credit is refundable and provides cash flow to eligible KBI firms in early years even when there are no sales. This credit is enhanced by provincial credits in most provinces. Banks have been willing to provide bridge finance for SRED refunds.

[186] See Secor, *Financing Knowledge-Based Small Business*, Research Paper Prepared for Task Force, (Ottawa, September 1998); Macdonald & Associates Limited, *The Canadian Venture Capital Industry: Sources of Capital and Implications for Industry Structure*, (Ottawa, September 1998); and Background Paper #4, *Canadians' Expectations and Corporate Conduct*, pp. 70-82.

[187] These definitions are based on the work of Secor, *Financing Knowledge-Based Small Business*.

- The Canadian Community Investment Plan (CCIP) program, run by Industry Canada, provides funding to communities that wish to match innovative business with sources of capital in the community. Many of the networks set up under CCIP also provide management and planning support to entrepreneurs.
- The Business Development Bank provides targeted financing and has increased its emphasis on KBI firms since its mandate was revised in 1995. BDC has been an innovator in developing new risk-sharing instruments. In 1997, some 36 percent of all BDC's loans went to KBI firms.
- Federal regional development agencies have entered risk-sharing partnerships with the banks to promote KBI investment. In a typical partnership, the bank would lend with a guarantee for a portion of potential loss being undertaken by the regional development agency.[188]
- Loan guarantees and insurance are provided to eligible KBIs through the Small Business Loans Act (SBLA) program and the Export Development Corporation (EDC).
- Generous tax incentives to individual investors by federal and provincial governments have spawned the development of labour-sponsored venture capital corporations (LSVCC), which now play a major role in the industry.
- Changes to financial institution legislation in 1992 allowed regulated financial institutions to create "specialized financing corporations" (SFCs) that could be used to make equity investments in SMEs and KBI firms. Financial institutions can commit up to 5 percent of their regulatory capital to SFCs.

The balance of this section reviews recent developments with respect to venture capital and the role of the banks, and presents some approaches to improve the finance of KBI firms.

Recent Venture Capital Developments

The Canadian venture capital industry has exploded in the past five years and now plays an important role in funding "early stage" and "expansion" finance.[189] Driven in large part by generous tax credits for labour-sponsored venture capital corporations, funds under management increased from $3.3 billion in 1992 to $8.4 billion at the beginning of 1998. LSVCC funds

[188] For example, in a partnership with Western Economic Diversification (WED), the regional agency uses its local networks to identify potential clients and help develop their business plans, and contributes a loan loss reserve that covers up to 12.5 percent of losses incurred under each agreement. The take-up has been significant and a similar program has been introduced by the Federal Office of Regional Development-Quebec and FEDNOR in Northern Ontario. See Secor, *Financing Knowledge-Based Small Business*, p. 27.

[189] The data in this section are drawn from Macdonald & Associates, *The Canadian Venture Capital Industry.*

account for half of the industry's funds under management. Private independent funds, which were dominant in the 1980s, account for slightly less than 25 percent; corporate funds, including bank groups, account for about 16 percent of the pool.

The amount of committed funds that are actually invested has also grown rapidly, from only $302 million of new investments in 1992 to $1.8 billion in 1997. The amount invested in 1997 compares favourably with the $12.8 billion in investments made in the same year by the U.S. venture industry, which is acknowledged to be the world leader.[190] As a result of the high pace of investment in 1997, net liquidity of venture capital funds (the amount available for investment) declined in 1997 for the first time this decade. Net liquidity now stands at $2.4 billion, representing only 1.3 years' supply at last year's disbursement rate.

Macdonald & Associates concludes that demand is likely to continue to grow and will create some supply-side pressures on development of the industry. The key to the ability of the venture capital industry to meet demand is identified by Macdonald & Associates as:

> … the willingness of institutional investors to commit more capital to this asset class. While there are a handful of pension funds that are actively pursuing venture capital investments at present, the vast majority are still sitting on the sidelines. Whether the practical and attitudinal hurdles they face in becoming more active in the market can be overcome remains to be seen.[191]

The Role of the Banks

Banks have been active, particularly since the last legislative revisions in 1992, in supplying both equity and debt to KBI firms.

With respect to debt, Secor reports:

> Most banks are developing KBI-specific lending models and risk management approaches to assess enterprise value rather than just individual assets, and to recognize the lending value of intangible assets. Indeed not all banks require full collateralization of loans in the traditional sense. But the definition of what can be accepted as collateral for KBI clients with intangible assets needs further development and circulation into the field.[192]

In response to a recommendation from the Toriel Committee in 1994,[193] all major banks have established KBI lending units that have regional operations.

190 See Price Waterhouse, "National Venture Capital Survey," 1997, at <www2.pw.com/vc/>.

191 Macdonald & Associates, *The Canadian Venture Capital Industry*, p. 14.

192 Secor, *Financing Knowledge-Based Small Business*, p. 24.

193 Industry Canada, Financing the New Economy Committee (Paul Toriel, Chair), *Financing The New Economy: Towards a Positive Conspiracy*, Project Report, June 1994.

In addition to direct lending, the banks have been active lenders in partnership with BDC and the federal regional development agencies, as noted earlier.

As of the third quarter of 1997, the seven major banks (including Hongkong Bank of Canada, which is active in this market) had made $7.1 billion in loans to KBI firms. There were 16,071 KBI loan customers, and 15,555 of them had loans outstanding under authorizations of less than $5 million.

As indicated earlier, banks are also becoming increasingly active in the provision of equity to KBI firms, through the specialized financing corporations that were authorized in 1992. All the major banks now have venture capital funds, many of which are operated in partnership with others who have more experience in venture capital investment. Several of these funds are dedicated to specific areas. For example, Royal Bank has a fund that specializes in life sciences, information technology and advanced materials, and another fund that specializes in neuroscience. Each of these funds has a different set of partners.

Over the past four years, banks have provided $740 million in funding to corporate venture funds and a further $150 million to private independent venture funds, accounting for about 17 percent of total venture capital funds raised over that period. Bank-owned venture groups, which had been investing $10 to $20 million per year in the early 1990s, invested $129 million in 1997. While most other types of fund split their investments fairly evenly between new and follow-on transactions, almost 70 percent of the capital invested by bank groups went to first-time financings. At the beginning of 1998, bank groups had $311 million still available for investment, a 2.4-year supply at 1997 investment rates.[194]

Impediments to Raising Equity Capital

In his research for the Task Force, Allan Riding reviewed the work of earlier public policy studies that indicated areas where Canadian securities laws and practices were not as conducive as they might be to raising early-stage equity financing. He identified a number of initiatives that could be undertaken to assist the equity financing of growing small firms.[195] These include:

- broadening the exemptions from securities regulations for "love money" investments, relaxing offering memorandum requirements, and eliminating or shortening hold period requirements and other resale restrictions, all as recommended by a 1994 study by MacIntosh;

[194] Macdonald & Associates, *The Canadian Venture Capital Industry*, pp. 7-12.

[195] Riding, *Financing Entrepreneurial Firms*, pp. 63-73.

- the development of a special offering system related to small public offerings, as proposed in the report of the McCallum Task Force to the Ontario Securities Commission in 1996;
- further consideration of the Alberta Junior Capital Pool Program as a model for other exchanges; and
- examination of the Small Corporate Offering Registration (SCOR) system in the United States, which provides for small enterprises to raise up to $1 million of new capital per year from public equity markets with minimal registration and disclosure requirements, to see whether the system can provide a useful model for Canada.

These initiatives fall within provincial jurisdiction and a detailed review of them is beyond the scope of the Task Force. However, it is evident from Riding's study that access to equity is the key issue for many growing SMEs and particularly for KBI firms. It is equally clear that barriers have been identified and not yet acted on. These barriers do not relate to the role of financial institutions in providing equity capital but they appear to be significant. We therefore urge provincial authorities to review them and, where they can be implemented without giving rise to serious questions of investor protection, to act on them expeditiously.

Approaches to Improving KBI Finance

We believe that adequate finance of KBI firms is critically important to the future development of Canada's economic potential. We recognize that since the 1992 legislative changes a great deal of progress has been made in KBI financing, and we recognize as well that it takes time to achieve the training and attitudinal changes necessary to make successful venture investments and, indeed, to find suitable candidates.

However, concerns have been raised about the speed at which commitments are being translated into investments. There are cultural issues that need to be addressed and resolved within the banks. It will take consistent, determined leadership to develop a culture that can appropriately manage investing in and financing of KBIs. This is an urgent challenge, since many of these firms have potential to provide the innovation that can keep Canada competitive in a knowledge-based global economy. Further, they offer the opportunity to provide high-skilled, high-quality employment that can help reverse the current brain drain of skilled workers to the United States.[196]

[196] For a recent article on the brain drain see *Time* (Canadian Edition), "Pulling Up Stakes," May 11, 1998, pp. 44-51.

We have considered how best the Task Force can assist in providing a continuing focus of attention on the progress being made and the distance yet to go in this important area. We have elsewhere recommended a comprehensive data collection and publication program for SMEs and KBIs. As part of that program, we have suggested that Industry Canada annually table a report on the state of SME and KBI finance with the House of Commons Industry Committee. We recommend that the Committee consider holding annual hearings on the state of KBI finance, at which the CEOs of the major banks would have an opportunity to update the Committee on the progress they are making to support the industries of the new economy.

Financing Aboriginal Businesses

In recent years considerable steps have been taken to support the financing of aboriginal businesses. Special financing institutions have emerged, including first nations credit unions, Peace Hills Trust Company, and the First Nations Bank of Canada.[197] Other institutions have established special units dedicated to financing aboriginal businesses.

We met with representatives of some of the aboriginal financial institutions and we reviewed the report of the National Aboriginal Financing Task Force (NAFTF), which was tabled in 1997. We believe it is important that aboriginal communities and individuals have the necessary tools, including access to capital, to participate fully in the Canadian economy.

Certain existing barriers to the provision of collateral stem from the provisions of the Indian Act; these were addressed by the NAFTF. We believe that these are constraining financial institutions from providing credit to these important sectors of our community. We endorse the recommendation of that Task Force that aboriginal community leaders support changes to the Indian Act, the SBLA and the Farm Credit Act to allow movable personal property to be used as security. We recommend that the Government move rapidly to amend these acts, subject to reasonable consensus within the aboriginal community.

We also endorse the initiatives that financial institutions are making in this area and urge them to continue their support for aboriginal financing initiatives.

Finally, we agree with the NAFTF recommendation that better data be collected. The data collection, publication and analysis program for SMEs that we recommend should be structured so that data on aboriginal business financing could be collected and analysed.

[197] Peace Hills Trust Company is aboriginal-owned. First Nations Bank is a joint venture between Saskatchewan Indian Equity Foundation and Toronto-Dominion Bank. It will ultimately be owned entirely by first nations people.

Expectations about Social Performance

In this section we address access to basic banking services, support for micro-credit, relationships with the voluntary sector, and accountability to communities.

Access of Low-Income Canadians to Basic Banking Services

In February 1997, the major banks and the federal government agreed on a new regime to facilitate access to account and cheque cashing services for low-income individuals. This regime included a commitment by the banks to accept only two pieces of signed identification and to rely on sponsorship of potential customers by responsible customers known to the branch. It also made clear that employment would not be a condition for opening a bank account, and it committed the banks to ensuring that staff were appropriately trained and sensitive to the needs of low-income individuals. In December 1997, the agreement was augmented by an understanding that an unsatisfactory credit report in itself, so long as it did not reflect fraudulent or dishonest behaviour, would not be a reason to deny an account application, although it might lead to restrictions with respect to some activities on the account.

At the time of the agreement it was estimated that about 3 percent of Canadians over the age of 18 did not have accounts with financial institutions. For individuals with incomes of less than $25,000 the number rose to 8 percent. It did not exceed 1 percent for any other income group.[198]

We heard many representations from interested groups about the importance of making basic banking services available to all Canadians. These concerns related to both the ability to open a basic transaction account and the lengthy holds that were sometimes put on government cheques by deposit-taking institutions.

In our public opinion research we asked how Canadians felt about basic banking services and about their experience with holds on cheques. A strong majority of Canadians views it as essential for all Canadians to have access to basic banking services. Access to a basic chequing account was viewed as essential or important by 85 percent of respondents. With regard to holds on funds, close to one in five Canadians reported facing a holding period before being able to access funds placed in their account, and as many as 8 percent reported holds on cheques issued by governments. Among young people and lower-income groups, 15 percent reported experiencing holds on government cheques.[199]

198 Association coopérative d'économie familiale du Centre de Montréal, *The highs and lows of access to banking services in Canada*, Report to Industry Canada, June 26 1996, pp. 17-20.

199 A research study by Michael Grant reported that holds have been placed on government cheques even when the financial institution bears no risk because of an indemnity agreement with the government concerned. See Michael Grant, *Canada's Social Payment Disbursement System and the Financial Services Sector* (Ottawa, September 1998), pp. 29, 30.

We believe that access to basic banking services is an important policy objective, and its attainment should be a shared responsibility of government and financial institutions. We recognize the legitimate requirements to place holds on the use of funds from time to time, but we do not see any reason why holds should be placed on government cheques. This is especially the case when an indemnification program exists that protects banks against fraud when they follow appropriate identification procedures.[200] Further, we endorse the element of the 1997 agreement that commits the banks to clearly explain to customers bank policies on holding or freezing deposited funds.

There is considerable uncertainty about how well the agreement is working in practice. Follow-up "mystery shopping tours" sponsored by Options Consommateurs suggest that there has been only limited progress. The CBA and the Department of Finance have also sponsored "mystery shopping tours" but at the time of writing this report the results were not available to us. The Task Force conducted its own "mystery shopping tour": one of our research associates attempted to open an account with a government cheque at seven bank branches in Toronto one year after the agreement, using a SIN card, driver's licence and birth certificate. He was successful at three branches and unsuccessful at four. At one branch he was refused an account because he did not have a telephone.[201]

We are sceptical that the February 1997 agreement is making a substantial difference. We believe that the major problems preventing further progress are attitudinal and cultural, not problems of process. It appears that notwithstanding the stated policy of the banks, and some bright spots in actual practice, there is still a considerable problem "on the ground" in serving a class of customer that is not likely to be profitable to the branch. The increased trend in all financial institutions to focus more resources and attention on profitable customers is exacerbated in this situation by stereotypical attitudes toward individuals with low incomes. Unfortunately, this is a problem not simply of attitudes of some bank employees but of attitudes toward low-income individuals that are more general in our society.

Recommendations have been made to the Task Force that basic accounts at an affordable price should be legislated, as a right of all Canadians. Our research, reported in Background Paper #4,[202] shows that transaction accounts at affordable prices (compared to the mandated account in New York state) do exist in

[200] Indemnification agreements vary. The federal government's agreement with financial institutions does not cover customers but applies only to those wishing to cash cheques without accounts. Other agreements (for example, the Alberta and British Columbia government agreements) cover customers and non-customers.

[201] Results are reported in more detail in Background Paper #4, p. 26.

[202] See p. 23.

most of our major banks. The issue is ensuring that they are made available to low-income people who want them, and that these customers are treated with courtesy and respect. It is not clear to us that the best way to attain that result is through legislation. Because the root cause of the problem is attitudinal and cultural, our view is that the committed cooperation of the leadership of the banks, community groups and governments holds the promise of achieving a more meaningful and durable solution. But this will only happen if such cooperation is effective.

We therefore recommend a number of specific steps:

- Federal and provincial governments should make low-cost identification available to anyone requiring it, as is now done in some jurisdictions.
- All deposit institutions should work with government and community groups to develop a standard basic account, and should prominently post in their branches the terms of the standard account and the identification required to open one. Beginning immediately, banks should prominently post in their branches the terms of their most economic transaction account and the identification requirements necessary to open one.
- Governments should expand the use of direct deposit for all government programs that offer regular benefits, using individual accounts or master accounts as is now done in Metro Toronto.[203] Direct deposit provides a mechanism for providing bank accounts to all participants and eliminating holds on funds. Every effort should be made to encourage participation in such programs without forcing people to participate.
- All governments making regular payments to low-income individuals should enter into indemnity agreements with financial institutions that cover both customers and non-customers. This should effectively eliminate the need for holds on government cheques, and financial institutions should ensure that there are no holds when indemnification agreements are in place.
- Financial institutions should work with government and community groups to change the culture and attitudes within the institution, wherever necessary. This should include not only training programs but changes in incentive and compensation programs at the branch level if necessary, to ensure that the agreed policies on access are being implemented.
- The government should monitor results regularly. The government should undertake an early survey of the "unbanked" in Canada, both to benchmark the extent of the problem and to understand better the reasons why those

[203] The Metro Toronto pilot project gives a choice between having payments deposited to an individual account or to a master account at Metro Toronto's bank. The master account allows people to withdraw cash from it using a personal debit card, with three free withdrawals per month.

individuals are outside the system. Progress toward access should be monitored regularly against this benchmark survey.

We are hopeful that these actions will increase access and we would expect progress within a reasonable period of time. If progress is not being made, we recommend that the Government legislate the terms of the February and December 1997 agreements, with appropriate sanctions for non-compliance.

Access to Branch Services

Branch closures have a disproportionate impact on particular groups in society. They have been, until now, primarily a concern of those who live in smaller, rural communities and low-income neighbourhoods in urban centres. Recent merger proposals have raised the sensitivity of most Canadians to the issue.

There are increasing pressures on bank branches as we have traditionally known them. The population decline in many rural areas and the relative decline in deposits as consumers shift to mutual funds both make branches less economic to operate.[204] In addition, electronic alternatives are reducing branch use. McKinsey & Co. reports that branches accounted for only 38 percent of retail transactions in 1995, and are expected to account for only 21 percent in 1998.[205]

As these pressures increase, the concept of a branch is changing. Banks are looking for more value-added products to offer and are building a higher sales and advice component into the functions of branch personnel. Further, many branches will continue in a scaled-down or modified way, such as kiosks or limited service branches in retail outlets, agencies in post offices, and mobile banking facilities. Nevertheless, many conventional branches will succumb to the pressures and close. There is no escaping this fact. The costs of the traditional distribution systems for traditional financial services products, including those of the banks, cannot be supported indefinitely in the face of rapidly growing, more efficient and appealing alternative channels.

The loss of a branch can cause serious dislocations within communities, particularly for small businesses and customers who are not comfortable with electronic alternatives. Current policy with regard to branch closures carries no obligations for deposit-takers other than the need to inform customers of the location to which their account has been transferred. There is also no industry policy among the banks with respect to branch closings.

[204] A U.S. study estimates that a typical bank branch occupies 5,000 square feet and costs $1.4 million per year to operate. For $50 million in deposits, these non-interest costs amount to 2.8 percent, which compares with an expense ratio for money market funds of between 0.5 and 1.0 percent. See Daniel K. Gilow, Lawrence J. Radeck and John Wenninger, *Ongoing Restructuring of Retail Banking*, Federal Reserve Bank of New York, Research Paper 9634, pp. 3, 4.

[205] McKinsey, *The Changing Landscape*, Exhibit 3-6.

We believe that if reasonable notice is given of branch closings, and if financial institutions work constructively and proactively with the community involved to explore options, the dislocations can be eased in many ways. Replacement institutions could be sought; new ways of accessing financial services could be learned; modified or limited-type service arrangements may be feasible. There are a number of options that could be explored and what works will depend on the circumstances.

We do not believe that banks should be prevented from closing branches or that they should require regulatory approval to do so. But we do feel that there should be an obligation to inform the community of the intention to close a branch at least four months in advance of the closing date. Such notice should be posted prominently in the branch, communicated to all customers and relevant local authorities, and published in community newspapers. The institution should work with local government, community organizations and other financial institutions to find innovative ways of minimizing disruption to customers.

We recommend that such notice be required for all federally regulated deposit-taking institutions, and we urge provincial governments to consider a similar requirement.

The Availability of Micro-Credit

Micro-credit refers to small loans made to individuals to sustain self-employment or start up very small businesses. Often such individuals are marginalized in our society and are working to escape from social assistance and a cycle of poverty. There is no standard definition but the representatives of the groups that met with us stressed that most of the loans are quite small, amounting to a few thousand dollars. Many individuals seeking micro-credit are often "unbankable" in the traditional sense, and most micro-loans are made on the character of the borrower.

There are a number of micro-credit programs in Canada, usually sponsored by private organizations.[206] Each has its own distinctive features. Some use a "peer-lending" approach, where borrowers form small support groups and each vouches for the others' loans. Many programs have been successful in making loans and securing repayment, but they are not profitable enterprises and rarely cover all their costs.

The market for micro-credit is not well understood, there have been few studies that have addressed it, and there is a lack of data on this market segment.

[206] Such organizations include the Calmeadow Foundation, the Montréal Community Loan Association, the Community Opportunities Development Association in the Cambridge-Kitchener-Waterloo area, Results Canada (Vancouver and Montréal), and the Mennonite Central Committee in Calgary.

The CBA is currently involved in a study of the rural micro-credit market with a number of federal government departments and agencies.

Notwithstanding the lack of studies and data, we have heard success stories about micro-loan funds operating in many regions of Canada. We have also been impressed by the diversity of approaches that have been taken, and by the commitment and ingenuity of the sponsors. We believe that modest support from government and institutions has the potential to make a big difference in the effectiveness of micro-credit programs.

It is important for their effectiveness that micro-credit programs retain a local, community-based focus. The roles that national and provincial governments can play are limited, but they can still be effective. Federal and provincial governments should consider providing start-up and, possibly, some portion of basic overhead funding support to micro-credit organizations. The federal government can also play a role in encouraging and supporting greater communication among the various micro-credit activities under way in Canada. We do not think it necessary or appropriate for federal funding to be used to finance micro-loans.

Provincial governments should ensure that their social assistance programs do not provide disincentives to the use of micro-credit. We understand that in some provinces recipients must count micro-credit loans as income and forfeit the equivalent in social benefits. This practice seems perverse and we urge that it be discontinued.

We believe that financial institutions could form mutually beneficial partnerships with micro-credit organizations at the local level. Credit-granting institutions could assist such organizations by providing expertise to help assess business plans and proposals, and by providing administrative and operational support. We recommend that financial institutions consider developing partnerships and explore other ways of cooperating with micro-credit providers.

Partnerships with the Voluntary Sector

The Task Force received a submission from the Voluntary Sector Roundtable (VSR) outlining a number of ways in which the financial sector might work more closely with the voluntary sector in Canada.[207]

The voluntary sector plays a critical role in strengthening Canada's communities and, in light of reductions in governments' role, its importance is increasing. The financial services sector already makes a substantial contribution to

[207] The VSR is an unincorporated group of national organizations and coalitions formed in 1995 to strengthen the voice of Canada's charitable, voluntary sector. Its submission was received on April 8, 1998.

communities. The five biggest banks are by far the largest contributors to charitable causes, donating an estimated $78.5 million in 1997.[208] Banks and insurance companies are major employers, and their employees and agents have traditionally played leadership roles in community activities.

The issue raised in the VSR brief is whether it is possible, in an environment of change, to look beyond traditional activities and consider new forms of partnership between the financial and voluntary sectors that could help build stronger, healthier and more caring communities. The VSR identified a number of issues and opportunities that we believe are worth exploring further. One example is the possible linking of contribution opportunities to financial services products so that consumers have options to contribute to charitable causes while saving. In the United States, for example, the concept of a "shared return mutual fund," where investors can automatically allocate a portion of their return to a designated charity, has been implemented. Citizens Bank offers a savings account with similar properties. There are many other examples in the submission, some quite imaginative.

We believe that this is an opportune time for leaders of the financial and voluntary sectors to explore how new ways of serving Canadians can be developed. We would urge the early beginning of conversations among the leaders of the two sectors, with a view to developing pilot projects that could be implemented quickly. We see no particular role for government in this area, but the Government might wish to sponsor a round table to discuss the issues, problems and opportunities if this would be helpful to launch the process.

Accountability to Communities

We believe Canada should have a stronger accountability framework for financial institutions.

We received representations suggesting that we adopt a system similar to the Community Reinvestment Act (CRA), which applies to banks in the United States. The CRA requires banks to satisfy the service and credit needs of the communities where they are located, in a manner consistent with the safe and sound operation of the institutions.[209] It operates by requiring disclosure by banks of lending, investing and service activities within communities, including credit granted to small businesses. Regulators grade banks' efforts and the results are made public. Regulators take performance into account when permission is required to undertake major transactions or to change powers or structures.

[208] Canadian Centre for Business in the Community, reported in the *Globe and Mail*, January 29, 1998.

[209] Canadian Community Reinvestment Coalition, *An Accountability System for Financial Institutions in Canada*, p. 14.

The genesis of the CRA was the perception in the United States that banks denied loans to poor inner-city neighbourhoods, or discriminated against certain classes of borrowers. Allan Riding discusses the so-called “redlining” of neighbourhoods and quotes Senator William Proxmire, the sponsor of the CRA, as follows:

> By redlining ... I am talking about the fact that banks and savings and loans will take their deposits from a community and instead of reinvesting them in that community, they will invest them elsewhere, and they will actually or figuratively draw a red line on a map around the area of their city, sometimes in the inner city, sometimes in the older neighbourhoods, sometimes ethnic and sometimes black, but often encompassing a great area of their neighbourhood.[210]

It has not been established that similar conditions exist in Canada at this time, and no instances of the deliberate discrimination that “redlining” would entail were brought to the attention of the Task Force. In the absence of such concerns, and without stronger evidence that there is a real problem to address, we are not prepared to recommend a full-blown CRA approach for Canada. Such an approach would entail an onerous review process that would require the definition of relevant communities, the development of appropriate standards of behaviour, and regular intensive monitoring. It would add substantial regulatory burden and cost. This might be appropriate if there were clear indications that it would serve to correct some systemic problems that seriously disadvantaged particular groups or communities, but we have received no factual evidence that systemic problems exist.

The comprehensive small business data collection and monitoring program we are proposing will, we believe, help shed light on whether there is any active and persistent discrimination in the availability of small business credit to particular communities. Statistics Canada, Industry Canada and the industry should design the data collection program bearing in mind that objective, among others.

We believe that accountability of all financial institutions – not just banks – should be increased. This is one of the reasons why we have recommended the data collection, analysis and disclosure regime for small business financing, which will be more informative to the community and policymakers than a CRA-type program focussed solely on federally regulated deposit-taking institutions. This regime will strengthen and codify in legislation the current reporting practice. It will also extend it to non-bank providers of small business finance, including providers of equity as well as debt. Together with the annual Parliamentary review that we recommend, it will provide a public forum for

[210] Cited in Riding, *Financing Entrepreneurial Firms*, p. 32.

dialogue on an activity that is critically important to economic growth and job creation, by all financial institutions engaged in the practice: banks, trust companies, credit unions, insurance companies, pension funds, venture capital funds and unregulated lenders. We believe that focussed, open dialogue is essential to enhance the relationship between institutions and communities.

Accountability extends to actions of institutions that go beyond the financing of small business. In this chapter, we have discussed :

- relations with the voluntary sector;
- micro-credit; and
- the important question of access to services by low-income individuals.

Other relevant aspects of the relationship include, for example:

- philanthropy;
- investment in community development;
- support of community activities;
- participation of employees in community service;
- taxes paid to all levels of government; and
- employment provided.

Our major banks and other financial institutions today make a significant difference to the well-being of our communities, and all of us would be poorer without the contribution they make. But whether or not financial institutions are doing enough, there is no commonly accepted way for them to report on their performance in order to provide a basis for discussion on community needs and expectations. We therefore recommend that all federally regulated deposit-taking institutions and life insurance companies be required to produce annual Community Accountability Statements informing the public about their contribution to the community through activities such as those enumerated above, or about other issues that may be relevant. We also recommend that provincial governments consider similar requirements to apply to financial institutions within their jurisdictions.

The format and content of such statements should be left to the discretion of the individual institution. In particular, we believe that the institution itself should define the community or communities it serves in terms of how it chooses to present information. We would expect, however, that institutions would report on the aspects of the relationship highlighted above, as well as on any other issues they felt were relevant. For example, we have recommended that progress in achieving more comprehensible documents should be reported.

We would expect, as well, that institutions would report in a manner that would allow Canadians in all regions of the country served by the institution to be able to relate the information to circumstances relevant to them.

Institutions should make these statements publicly available through their retail outlets and electronically. They should file them with the Minister of Finance, who would table them with the House of Commons Standing Committee on Finance.

Conclusion

We hope and expect that the recommendations in this chapter will lead to an open, constructive dialogue between our major financial institutions and the communities they serve. Improvement in our understanding of SME financing issues and further progress in dealing with them will help meet public expectations about the financing of business. Progress on ensuring access for low-income Canadians, and support for initiatives that are important to communities – such as micro-credit and supporting the voluntary sector – will help meet public expectations about social performance.

The proposed Community Accountability Statements together with the comprehensive data collection program should, over time, foster a public dialogue leading to responsible action that will restore a healthy relationship between our institutions and our communities.

Chapter 9

Improving the Regulatory Framework

Introduction

This chapter discusses ways of ensuring that our prudential regulatory structure remains strong, is well focussed and supports broad national objectives. Our recommendations pertaining to market conduct and protection of consumers in transactions with providers and intermediaries are discussed and presented in Chapter 7. Our report does not deal with the regulation or supervision of mutual funds or of securities markets. These are strictly provincial areas; our understanding is that they are under review by the appropriate authorities within the provinces.

There are two rationales for prudential regulation. The first is safeguarding consumers against the risk of institutional failure. The reasoning is that individual consumers, particularly those with relatively small amounts of savings, cannot be expected to be aware of, and adequately assess, the risk of the institutions with which they entrust their savings or from which they purchase insurance. The second rationale is protecting the financial system from breakdown that can result from a general loss of confidence if one or more significant institutions fail.

The federal system of prudential regulation is administered primarily by OSFI, which supervises about 490 federally regulated financial institutions and some provincially regulated institutions. OSFI was created in 1987 by amalgamating the offices of the Inspector General of Banks and the Superintendent of Insurance. Canada was one of the first industrialized countries to bring the deposit-taking and insurance regulatory regimes together in one institution. The United Kingdom and Australia are only now moving in the same direction.

In addition to OSFI, the federal government supports a system of deposit insurance, administered through the Canada Deposit Insurance Corporation (CDIC), a federal Crown corporation which has been in existence since 1967 and protects individual deposits to the extent of $60,000 per insured deposit. Deposit insurance is an important part of the prudential regulatory framework. CDIC, in addition to protecting deposits, has a mandate to “be instrumental in the promotion of standards of sound business and financial practices for

member institutions."[211] This has resulted in CDIC's developing standards of appropriate business practices for financial institutions and introducing a Standards Assessment and Reporting Program (SARP) that requires management and boards to certify that these standards of appropriate behaviour are, in fact, being adhered to in their institutions.

Provincial governments also have prudential regulators that supervise trust and insurance companies doing business in their province, regardless of where they are incorporated. This means that a federal trust or insurance company, for example, is regulated not only by OSFI but also by provincial regulators. Some provincial regulators have adopted a "home jurisdiction" approach, whereby they accept the prudential regulation of the incorporating jurisdiction (federal or another province) and do not duplicate prudential regulation. Other provincial regulators have delegated, or are in the process of delegating, their responsibility for prudential regulation to OSFI. The system is becoming more rationalized and harmonized, but there is room for further progress.

On balance, Canada's regulatory regime works well and is effective. On a size-adjusted basis, it costs about one ninth as much as the regulatory regime in the United States.[212] Further, substantial progress has been made in the past few years in harmonizing and streamlining federal and provincial prudential regulation, particularly since the province of Ontario rescinded its "equals approach."[213]

As strong as our system is, however, there are new challenges that require consideration of whether it can and should be strengthened further. Many of these challenges have been discussed in previous chapters, and particularly in Chapter 3.

The balance of this section reviews recent international regulatory and coordinating activities, as a context within which to consider some specific issues that should be addressed in Canada.

211 CDIC Act, para. 7(b).

212 A 1993 study by the Department of Finance concluded, "The U.S. appears to expend considerably more resources on supervision per institution and total assets than Canada or the U.K. Supervisory costs per billion dollars of supervised assets are some nine times higher in the U.S. or the U.K. This differential would be even higher if the supervisory costs of the ... Federal Reserve Board and the FDIC ... were factored in." See ***The Cost of Supervision and Deposit Insurance in Canada, the United States and the United Kingdom***, Department of Finance, Working Paper, May 26, 1993, p. 1.

213 Ontario's "equals approach" was introduced in 1987. It applied Ontario regulatory rules to trust companies doing business in Ontario, regardless of where they were chartered. But it also applied Ontario regulatory rules to their activities in every province of Canada as long as they did business in Ontario. The Ontario rules were different from the federal rules and other provincial rules, which made the conduct of business difficult for trust companies subject to them. The "equals approach" was rescinded in 1997 and Ontario is currently negotiating with OSFI to allow OSFI to take over solvency regulation for all trust companies doing business in Ontario, including Ontario-chartered trust companies.

International Activities

The past decade has been a period of tremendous activity at the international level. New challenges have arisen in response to the convergence of functions within institutions, the ongoing formation of conglomerates, and globalization, which has led financial institutions and conglomerates to become increasingly active in many countries. These challenges have been intensified by the widespread adoption of sophisticated technology that has allowed institutions to develop new types of products and take on new types of risk. Regulators have been expending considerable effort, and making some progress, in coming to grips with the implications of these changes.

Ten years ago the Basle Committee on Banking Supervision, under the auspices of the Bank for International Settlements (BIS), 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. More recently, as change has accelerated, the Basle Committee has extended its work in three directions. It has continued to review and update the capital standards and amend them to reflect changing practices. In 1997, it developed 25 Core Principles for Effective Banking Supervision that were endorsed by the leaders of the governments of the Group of Seven (G-7) countries at their Summit in Birmingham, U.K., in May 1998. And it has also begun a process of developing principles and standards for the regulation of financial conglomerates, in cooperation with securities and insurance regulators. This latter process resulted in the formation of the Joint Forum on Financial Conglomerates, composed of an equal number of bank, insurance and securities regulators from 13 countries including Canada.[214] The Joint Forum is only beginning its work. It is concentrating on capital adequacy principles for financial conglomerates and principles of sound management.

In addition to these joint efforts, in 1992 insurance supervisors established an international coordinating group, the International Association of Insurance Supervisors (IAIS). The IAIS is developing regulatory principles similar to the core principles for banking noted above, and is also focussing on an appropriate regime for the effective regulation of companies doing business in many countries.

Canada has been a very active player in international regulatory and coordinating forums, particularly for banking and insurance. Because it combined banking and insurance in a single regulator, OSFI has played a major role in providing focus and leadership to the IAIS, and since 1997 has chaired the group. Because securities regulation is a matter of provincial jurisdiction and,

[214] Canada is represented by OSFI and the Ontario Securities Commission.

as a result, there are many regulators, Canada's voice is less effective in this area than it is in banking or insurance.

The continuing crises in Southeast Asia, Russia and Japan have made it clear that a sound financial system is fundamental to healthy economic performance. They underline that international coordination and regulation is not a substitute for a strong national regulatory system. The shared knowledge at the international level must be accepted, adopted and implemented by national regulators. There is a need to modernize regulatory and supervisory regimes, and to move from general principles and coordination to effective implementation.

Canada has been an active proponent of measures to implement best practices in all countries. Two recent initiatives are worthy of note. The first is the establishment of the Toronto International Centre for Leadership in Financial Sector Supervision. The Centre is supported by OSFI and the Schulich School of Business at York University, where it is located; it is sponsored by the World Bank and the federal government. It aims to help developing countries improve their regulatory systems for banking and insurance by providing practical leadership training for supervisors from those countries. Second, the Minister of Finance has urged a framework for enhanced surveillance of national regulatory and supervisory systems, based on the principle of peer review. This proposal was endorsed by heads of government at the last G-7 Summit, and the International Monetary Fund and World Bank are now working out details of how such a scheme might be implemented.

More detail on these initiatives, and Canada's role in them, is presented in Chapter 5 of Background Paper #5.

Implications for Canada

There are two implications that flow from our review of international efforts to strengthen regulation. The first is that we are moving into an era of unprecedented complexity with regard to how financial services providers can and should be regulated. The complexity has at least two dimensions. From the perspective of regulating providers, it encompasses the bundling together of risks that were previously isolated in separate legal entities, the emergence of new types of risk that regulators have not traditionally dealt with, and the increasing need to understand how risk is being managed on a global basis. From the perspective of protecting consumers, technology is opening up new horizons that allow provision of service from a distance, without the requirement to be physically present in countries with whose citizens providers are dealing. Both these sets of developments put a premium on the need to actively pursue international cooperation in developing regulatory standards and implementation agreements. National regulatory regimes should develop in ways that are consistent with and reinforce international cooperation.

At the same time, however, the experience of both regulation and international cooperation suggests that effective international cooperation will be slower in coming than is desirable. Markets move quickly, national regulatory systems move less quickly, and international systems even more slowly. For these reasons it will be imperative, while working for international cooperation, to ensure that our own system remains strong and supportive of national objectives.

In this connection, we believe that the existing system of prudential regulation can be improved by:

- broadening the mandate of OSFI and enhancing its governance structure;
- examining the governance of institutions from a regulatory perspective;
- revising the governance arrangements for the payments system;
- streamlining regulatory processes to remove overlap and duplication;
- integrating the existing deposit insurance and life insurance policy holder protection plans; and
- introducing some measures that will assist in protecting and informing consumers who wish to deal with financial service providers not physically present in Canada.

The Role of OSFI: Mandate and Governance

Broadening OSFI's Mandate

OSFI did not have a legislated mandate until 1996. To establish a standard by which OSFI could be held accountable to Parliament and the public, and against which to measure performance, the Government legislated a mandate for OSFI that, in brief, requires OSFI to:

- supervise financial institutions to determine that they are in sound financial condition and in compliance with the law;
- advise management if this is not the case and require remedial action to be taken;
- promote the adoption by management and boards of directors of policies to control and manage risk; and
- monitor events at the industry level that may negatively affect the financial condition of institutions.[215]

The Act also requires OSFI, in pursuing this mandate, to strive to "protect the rights and interests of depositors, policy holders and creditors of financial institutions having due regard to the need to allow financial institutions to compete effectively and take reasonable risks."

[215] The precise mandate is found in section 4 of the OSFI Act and is reproduced in Background Paper #5, p. 32.

We believe that OSFI's mandate needs revision in three areas.

First, OSFI in fact has an important responsibility for consumer protection. OSFI today administers the consumer protection provisions of federal financial institution legislation, including provisions related to disclosure and privacy. As set out in Chapter 7, we are recommending a number of areas where these provisions should be strengthened and OSFI's role enhanced. We believe that the responsibility to administer consumer protection provisions of federal financial institution legislation should be an explicit part of OSFI's mandate, and OSFI should have adequate resources to carry out the new responsibilities we are recommending.

Second, we believe that the mandate does not adequately reflect the need to balance safety and soundness considerations with the desirability of facilitating effective competition in domestic financial services markets. We do not believe that OSFI's role should be to actively promote or foster competition. It is, first and foremost, a prudential regulator. But within the scope of its activities, from time to time it will be called on to approve new entrants or to endorse new and innovative products or approaches brought forward by existing institutions. In these functions, we believe it is imperative that the impact on safety and soundness be weighed against the particular contribution to competition that such new entrants or innovations might bring to consumers, and that an appropriate balance be struck. In this context we are recommending that there be discretion for the Minister of Finance 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.

In Australia and the United Kingdom, both of which are currently implementing a single regulatory office along the lines of OSFI, proposed legislative mandates explicitly require that the benefits to consumers of competition and innovation be recognized and balanced with other considerations.

Finally, it seems to us that in carrying out its prudential mandate, the current obligation of OSFI to protect the rights of creditors is inappropriate. Governments do not work to protect creditors of any other institutions, and OSFI may be able to sustain greater focus if its obligations are confined to policy holders and depositors.

Enhancing OSFI's Governance

The Superintendent of Financial Institutions is responsible for the administration of OSFI, its role in policy development and its operations. The Superintendent reports directly to the Minister of Finance. We believe that adding a board of directors would enhance the governance structure of OSFI. An independent, non-partisan and effective board would provide oversight of

the conduct of OSFI's business and administrative operations. It would approve major OSFI policies and strategies. It would monitor achievement of OSFI's progress against its strategic plans and statutory mandate. And it should play a particularly strong role with respect to human resource policies. OSFI will require highly skilled, dedicated individuals to fulfil its responsibilities adequately in a much more complex environment. The board should ensure that OSFI is appropriately staffed and that compensation policies are effective in achieving OSFI's objectives. In this connection, the board would approve senior management appointments within the office and provide recommendations to the Minister on the appointment of the Superintendent.

Other organizations within the federal financial institutions policy community (for example, CDIC and the Bank of Canada) now have boards of directors that function well and add value to those institutions. Further, the new prudential regulatory structures in the United Kingdom and Australia are being established with a board of directors as an integral part of their governance structure.

Our recommendation is that a relatively small board, with responsibilities as highlighted above and described more fully in Chapter 2 of Background Paper #5,[216] be introduced. It 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. One of the independent directors should chair the board. The Superintendent, the Chair of CDIC, the Deputy Minister of Finance, and the Governor of the Bank of Canada should also be members by virtue of their office.

The governance structure that we recommend is not intended to change the present accountabilities of either the Superintendent or the Minister with respect to operating decisions. For this reason the board should not play a role in the operating decisions with respect to troubled institutions, but should conduct appropriate assessments after the fact to understand the decisions made and to ensure that the lessons from experience are built into ongoing strategies and policies.

It will be critical to clearly articulate the role of the board in the enabling legislation so that there will be no confusion as to responsibilities.

[216] See particularly pp. 38-40.

The Governance of Financial Institutions

Like regulators in other countries, OSFI increasingly relies on high standards of corporate governance in financial institutions to better ensure the good business practices and effective risk management that are essential to safety and soundness. 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. This reliance has led OSFI to look to sound corporate governance as one of the key factors in ensuring excellence in risk management and other business functions.

In recent years, there have been three streams of development with respect to the governance of financial institutions.

In December 1994, the Toronto Stock Exchange Committee on Corporate Governance in Canada released its report entitled *Where Were the Directors?* (the Dey Report),[217] which made significant recommendations for improving governance in Canadian public companies. Securities regulators now require that companies report regularly to their shareholders on their governance procedures, including the extent to which they comply with the Dey Report recommendations.

For financial institutions, the 1992 legislative changes added important new governance requirements. These included a requirement for one third of the directors to be unaffiliated, the creation of a conduct review committee and the imposition of a strict set of restrictions against self-dealing.

At the operating level, both OSFI and CDIC have taken steps to highlight the importance of governance and to firmly and unambiguously make directors aware of their obligations and accountability, through initiatives such as the Standards Assessment and Review Program.

We have not conducted a detailed study of corporate governance practices in regulated financial institutions. We did, however, review steps taken by some major financial institutions in recent years to respond to these new governance expectations. It is clear that much has been done. In particular, boards of directors either have organized their structures and procedures to respond to the recommendations of the Dey Report and to the other legislative and regulatory requirements and guidelines, or are in the course of doing so. Pressure continues from shareholder interest groups to make further changes.

[217] Report of the Toronto Stock Exchange Committee on Corporate Governance in Canada, *Where Were the Directors? Guidelines for Improved Corporate Governance in Canada*, December 1994.

Although we have not undertaken a comprehensive review of corporate governance, we believe that there is one area where further action should be considered by financial institutions. That is the separation of the positions of board chair and CEO. The Dey Report recommended that either the positions be separated or there be a lead director who would not be a member of management. We understand that most, if not all, financial institutions have complied with this second recommendation. We urge that this be done at a minimum. But we also feel strongly that effective governance is enhanced by the presence of a non-executive chair, with adequate resources and time to fulfil the responsibilities of the position.

Because we indicated in our Discussion Paper that we were unlikely to consider governance issues, and because we did not solicit and did not receive submissions on this subject, we are not prepared to put our conclusion forward in the form of a recommendation for legislative action. We wish to encourage a public discussion of the pros and cons of non-executive chairs in the post-report debate, and we hope that this discussion might lead to action.

More Effective Governance of the Payments System

At present the governance of the payments 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. By-laws require the approval of the Governor-in-Council but rules established by the board do not.

In recent years, the CPA has moved to provide channels for outside advice through establishing a Stakeholder Advisory Council, where the perspectives of a variety of interested groups are brought to bear, and a Consultative Committee with the Department of Finance that examines broad public interest issues related to payments system developments.

The governance of the payments system was examined by the Advisory Committee and is discussed in a recent paper issued by the Department of Finance.[218]

We recommend that, in order to ensure that payments system decisions are consistent with the public interest, the Minister of Finance have the authority to review and revoke any changes in the rules of the CPA, as well as the power to approve in advance the by-laws of the CPA or any changes to the by-laws. The Minister should also have the power to issue directives to the CPA board to make changes to by-laws, rules or operating practices when such changes are deemed to be in the public interest.

[218] Department of Finance, *Payments System Review: Discussion Paper*, July 1998.

Streamlining Regulatory Processes

Duplicative and conflicting regulation, together with cumbersome approval processes, lead to higher costs of compliance that can disadvantage regulated institutions when they are competing with unregulated providers of particular services. It can also discourage new entrants and suppress innovation. 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.

There are three areas that we have considered:

- intergovernmental overlap;
- overlap between OSFI and CDIC; and
- streamlining approvals.

Intergovernmental Overlap

As indicated above, particularly since Ontario abandoned its "equals approach," strides have been made in harmonizing regulation among the provinces and introducing more effective federal-provincial operating procedures.

For example, Ontario now leaves the prudential regulation of federal trust companies to OSFI and is negotiating with OSFI to transfer to it responsibility for prudential regulation of Ontario-chartered trust companies. OSFI examines Manitoba trust and insurance companies operating in the province on behalf of the provincial regulator, and British Columbia has generally delegated prudential regulation of trust companies operating in the province to the regulator of the home jurisdiction.

In the case of federally regulated life insurance companies, the provinces almost always accept the examination of OSFI for purposes of determining capital adequacy. Quebec has worked with OSFI and the industry to develop common standards of sound business and financial practices for the industry, paralleling those developed by CDIC for deposit-takers.

Initiatives that could be taken to make further progress toward reducing duplication and achieving harmonization include:

- developing common capital adequacy tests for regulated financial institutions, and accepting the opinion of the "home" regulator (that is, the regulator in the jurisdiction of incorporation) for capital adequacy and corporate reorganizations;
- establishing a central, electronic data base with standardized reporting formats and required information that could be accessed by both federal and provincial regulators; and

- delegating solvency regulation of trust, loan and life insurance companies to OSFI, as is already done in some instances.

We recommend that these initiatives be seriously pursued. In particular, OSFI should agree to take the lead on the possibility of establishing a common data base as described above, and on developing common capital adequacy tests.

Overlap between CDIC and OSFI

CDIC has no direct supervisory role. Its mandate, however, requires that it be "instrumental in the promotion of standards of sound business and financial practices for member institutions." This requirement overlaps with that part of OSFI's mandate that requires it to "promote the adoption by management and boards of directors of financial institutions of policies and procedures designed to control and manage risk."

In fulfilment of its mandate, CDIC developed standards of sound business and financial practice and, since 1995, has required management and boards to attest that these standards are being followed. The standards overlap in many cases with regulations or guidelines published by OSFI.

CDIC is also introducing a system of risk-based premiums and is in the process of collecting extensive information as a basis for administering the system.

We believe that the portion of CDIC's mandate that requires it to promote standards for members overlaps with OSFI's role for no valid purpose. We recommend that CDIC's mandate be amended to remove this overlap.

The responsibility for the standards and the assessment program should be transferred to OSFI. CDIC should continue to have responsibility for setting the basic parameters of the risk-based premium system, but institutions should be categorized within the system on the basis of information collected by OSFI and made available to CDIC.

We considered whether CDIC and OSFI should be amalgamated. We believe that the insurer and the regulator have different purposes that are clearly distinct and should remain so. Further, the insurer and the regulator have different objectives with respect to failing institutions: the regulator's interest is in rehabilitation and the insurer's interest is in minimizing exposure. We believe that there is a healthy tension between these objectives that serves public policy best when they are not combined in a single institution. Although we see no reason why CDIC should have or require supervisory or regulatory responsibilities, an effective system will require very close cooperation between CDIC and OSFI. For this reason, we recommend that the CDIC Chair be a member of the OSFI board, and we also recommend that CDIC have a right to review and comment on proposed regulatory initiatives that will affect its operations.

Streamlining Approvals

OSFI has put forward a number of proposals for streamlining the approval process. These proposals fall into two broad categories: reducing the number of situations requiring approval, and improving the efficiency of the approval process. The proposals are highly technical and are described in more detail in Chapter 2 of Background Paper #5 and a submission to the Task Force by OSFI.[219]

We have not analysed these proposals in detail but we endorse the initiative and direction that OSFI is taking. We believe that OSFI should strike a working committee with Department of Finance and industry representation to develop these proposals further with a view to early implementation.

Overseeing this process would be one of the immediate tasks of the new OSFI board. We also urge that, in this process of elaboration, priority be given to proposals that can provide the greatest regulatory relief to the institutions.

One particular area in the current approval process seems to us anachronistic. The Governor-in-Council currently has approval authority for many aspects concerning the entry and activities of foreign banks in Canada. This seems to us less relevant in today's environment than it may have been in 1980, when the wisdom of foreign bank entry was being considered. We recommend that these approval authorities be transferred from the Governor-in-Council to the Minister of Finance.

Integrating Deposit Insurance and Policy Holder Protection Plans

The Canada Deposit Insurance Corporation (CDIC) insures deposits at banks and most trust companies.[220] 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. The Canadian Life and Health Insurance Compensation Corporation (CompCorp) provides compensation coverage for policies issued by life insurance companies. CompCorp is a corporation established and funded by the life insurance industry. It does not have any government guarantee behind its obligations. The structure, powers, mandates, membership, coverage and other characteristics of CDIC and CompCorp are compared in detail in Chapter 3 of Background Paper #5.[221]

[219] See Background Paper #5, pp. 47-49, and Office of the Superintendent of Financial Institutions, *Streamlining Regulatory Approvals*, Submission to the Task Force. Ottawa, July 7, 1998.

[220] Some trust companies are insured by provincial government plans. Deposits in credit unions and caisses populaires are protected by deposit insurance or guarantee plans that vary from province to province.

[221] See in particular Exhibit 3.4 (p. 63) and discussion, pp. 56-62.

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. This is due to a perception among consumers that CDIC, with the strength of the Government of Canada behind it, provides more secure protection than CompCorp. We have reviewed survey data relating to these issues and have received evidence that customers have selected products of deposit-takers rather than competing products of life insurance companies because of the strength of the CDIC "brand."[222] In our view, the perception is real and it is well founded. CDIC does provide potential strength, because of the federal guarantee, that CompCorp cannot. This market reality creates a disadvantage for life insurance companies in competing against banks and trust companies.

We believe that it is important and timely to address this competitive inequity. In our vision of the ideal financial services sector, we emphasize open and competitive markets as the most critical factor that will bring benefit to consumers and ensure that Canadians are well served. Our markets now are highly concentrated and one of the greatest public policy challenges is to encourage vibrant, alternative institutions that can compete head-to-head with the large banks across the country. We have presented a number of recommendations aimed at achieving this, including – with respect to life insurance companies – facilitating demutualization and providing access to the payments system. We believe that these initiatives will place life insurance companies in a better position to offer meaningful competition for wealth management services. We would be disappointed, and we believe Canadians would be ill served, if this potential competition were unnecessarily frustrated by government backing for bank deposits that disadvantaged competing products offered by life insurers.

When this issue was discussed in the past, equality of treatment was rejected on the basis that the primary objective of deposit insurance was to promote systemic stability through preventing runs on institutions that were members of the payments system. It was suggested that life insurers posed no threat to system stability, and that therefore their liabilities did not merit protection by an agency of the government.

Events have moved on since that earlier consideration, and there are three principal reasons why we believe it is timely to reconsider the issue.

[222] Canadian Life and Health Insurance Association, ***Canada's Life and Health Insurance Industry: Consumer Compensation Arrangements***, Submission to the Task Force, October 1997, p. 17. See also Angus Reid Group, Inc., "Consumer Protection Plans," in ***Confidence in Financial Institutions***, April 1997, and "Consumer Evaluation of Regulatory Issues," in ***Confidence in Canada's Financial Institutions***, 1992.

First, we note that the risk management characteristics of the payments system are being strengthened, through the introduction of the Large Value Transfer System and the explicit regulatory role and responsibilities of the Bank of Canada. We believe that deposit insurance is relatively less important than it may have been in the past as a mechanism to avoid payments system crises. Moreover, we are recommending that life insurance companies become members of the payments system as soon as reasonably possible.

Second, we believe that 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. On the basis of this argument, we see no reason why consumers who wish to save through a deferred annuity issued by a life insurer should have second-class coverage compared to those purchasing a GIC issued by a bank.

Indeed, as life insurers become members of the payments system and their customers choose to leave claims or benefit payments on deposit with them, we see no reason why they should not be entitled to the same quality of coverage that they would have if they moved the funds to a deposit-taking institution.

Finally, we believe that deposit insurance plays a role in levelling the playing field for deposit-taking competitors to the banks that lack the brand advantage held by the major banks, and that without deposit insurance would have difficulty attracting consumer deposits. On the basis of this argument, we see no reason why similar products should not be insured through similar arrangements, regardless of the nature of the institution that provides them.

For all these reasons, we believe that the time has come to put CDIC and CompCorp on a common footing. We believe that the two plans should be integrated, and we propose three principles that should guide the government in this integration:

- The minimum that is required is to put CDIC and CompCorp on the same basis with respect to the Crown guarantee, which should apply to the obligations of both or neither, and with respect to the ability to borrow from the Consolidated Revenue Fund (CRF), which should apply to both or neither.
- Convergence at both the product level and the institutional level requires a parallel convergence of compensation plans. There should be one plan for both deposit-taking institutions and life insurance companies, with a common administration and parallel coverage, but with separate funds and separate premiums.
- Compensation plans should not have supervisory responsibilities.

A single, integrated plan would offer other potential benefits besides achieving a level playing field. It would assist in reducing current consumer confusion about insurance coverage, and it would provide an administrative framework within which to pursue comparability with respect to coverage, priorities in the event of liquidation, and payout practices for products that are essentially the same although sold by different institutions.

In Background Paper #5, we present two alternative models for an integrated plan, each of which respects the principles set out above.[223] In brief, the first plan would see CompCorp integrated into CDIC, which would retain its Crown corporation status, its current governance structure and its current powers with the exception of supervisory responsibilities, which would be transferred to OSFI, as recommended above. The second model would see the creation, by legislation, of an independent insurer that would take on the responsibilities of both CDIC and CompCorp. It would have an independent board appointed by the Minister of Finance. It would not be a Crown corporation and would not have a government guarantee, although the Minister of Finance would be empowered to authorize liquidity loans from the CRF to the insurer if necessary and under strict conditions. In this model, safeguards would be introduced to ensure that insurance was available at reasonable rates to all regulated financial institutions. In both models, premium payments would be appropriate to the risks covered by the funds, and both funds would establish minimum balances through pre-funding.

In our view, either of these models would achieve the purposes we believe to be necessary to effective competition, and would well position the integrated plan to deal with the complexities of a world in which the boundaries between products and institutions are continuing to erode.

Regulating Market Entry without a Physical Presence

As technology increases the scope for foreign firms without a physical presence in the country to provide financial services to Canadians, it is becoming increasingly clear that there is a significant gap in the regulatory structure. This is not a problem specific to Canada. In Chapter 5 of Background Paper #5, we review some of the activity going on at the international level with respect to the regulation of electronic commerce, and the electronic provision of financial services in particular. In general, governments are continuing to rely on existing laws and regulations rather than enacting comprehensive new measures. National governments, as well as the international community, tend to be taking a wait-and-see attitude. There is a real concern that international cooperation is necessary for effective action, and that premature domestic regulation may stifle innovation and experimentation.

[223] See Background Paper #5, pp. 66-69.

In considering options for dealing with foreign providers without a physical presence, we started with three objectives:

- There should be no restriction on Canadians' ability to choose from the widest possible selection of financial service providers and products.
- To the greatest extent practicable, information should be easily available about providers so that Canadians can make informed choices.
- Any regulatory regime considered must be workable and not discourage entry into Canada.

We also made a distinction, which we believe is quite important, between providers that wish to lend money to Canadians and those that wish to solicit money from Canadians in the form of deposits or premiums.

The current legislative regime is described in some detail in Background Paper #5.[224] In brief, the Bank Act contains a definition of "foreign bank" that is extremely broad and far-reaching. Having defined a foreign bank, the Act prohibits any foreign bank from directly or indirectly undertaking any "banking business" (an undefined phrase) in Canada. There are then a number of exceptions to this prohibition, but all the exceptions are premised on having a physical presence in Canada.

For a foreign bank or any other provider that wishes to operate from outside the country, there is no clear legislative framework that applies because there are no criteria to judge whether such an entity is undertaking banking business in Canada when it enters into transactions with Canadians. Because there is no legislative framework, a foreign bank that wishes to operate from outside the country in compliance with Canadian law and with the permission of the regulator is faced with significant uncertainty as to what it can and cannot do. For example, when Wells Fargo approached OSFI to seek permission to lend money to Canadians from the United States, the only course open to OSFI was to require business arrangements that made it absolutely clear that Wells Fargo was not undertaking any banking business in Canada. The business requirements necessary to achieve this outcome make no sense from a business or a prudential point of view, and deny some economic activity to Canada that we otherwise could have enjoyed.

In considering the nature of a legislative and regulatory regime that might begin to address these problems and provide a basis for further action, we start from the principle that it is desirable that providers of services to Canadians follow Canadian consumer protection rules and submit to Canadian jurisdiction, to the greatest extent that this can be practically attained. In order to develop such

[224] See pp. 75-79.

a regime, three requirements are necessary. First, the class of potential providers must be identified and regulatory authority assigned for dealing with them. Second, potential providers should be divided into those that wish to lend money to Canadians and those that wish to take money from them. Third, appropriate measures should be developed to deal with each category of provider.

The Definition and Regulation of Foreign Providers

As noted above, the definition of "foreign bank" in the Bank Act is broad. Those who fall within that definition, but who do not want to establish a physical presence in Canada, have difficulty determining whether their provision of financial services to Canadians from outside the country does or does not constitute "banking business," which is undefined in the Bank Act.

In order to facilitate the conduct of business in Canada by such foreign providers, we recommend that there be a limited definition of "banking business" to make it clear that it includes the provision of financial services by foreign banks without a physical presence that undertake mass solicitations or target marketing to Canadians. Such an amendment would clarify the present uncertainty by bringing foreign banks that do business in Canada in this way within the regulatory regime. The activity would be proscribed but there would be a clear authority in the Bank Act to obtain regulatory permission to carry on the activity in the case of lending.

We also recommend that this same regulatory regime be extended to all providers, whether or not they fall within the present definition of a foreign bank, who might wish to offer financial services to Canadians through mass solicitation or target marketing and without establishing a physical presence in Canada.

For both classes of providers, the condition required to obtain permission to carry on lending activities would include providing the binding undertaking described in the next section.

A Framework for Lenders

A foreign lender wishing to extend credit to Canadians without establishing a physical presence should be able to obtain certification from OSFI, upon providing a binding undertaking that the lender will comply with market conduct rules applicable to banks in Canada, will disclose that it is not regulated in Canada, and will provide a mechanism for dispute resolution in Canada. Certification should allow lenders to develop an appropriate business plan that would not deny Canada economic benefits from ancillary activities such as call centres.

Certified lenders could be entitled to exhibit an OSFI-approved logo in their advertising. On its Web site, OSFI should maintain a list of the institutions it certifies.

A Framework for Deposit-Takers

Extracting money from Canadians for deposits or insurance has the potential to create far more serious problems than lending money to them. For this reason, the current situation that allows these activities to take place only through a regulated Canadian institution subsidiary or branch of the foreign provider should remain in place, and efforts should continue at the international level to encourage a common approach based on mutual recognition of home-country jurisdiction. Ultimately, a similar accreditation system may be possible based on regulatory confidence about the quality of supervision applied by the home-country regulator, although the existence of deposit insurance will make this objective difficult to achieve.

In the meantime, public policy should recognize that in the world of the Internet there is no effective way to bar foreign-based institutions from soliciting Canadians. The appropriate short-term response is to provide as much information as possible to allow Canadians to make informed decisions. OSFI currently publishes on its Web site two lists of institutions: those it regulates and a "Warning Circular" listing over 200 entities that have come to its attention as possibly operating in Canada illegally. We recommend that this practice be continued; that the first list of regulated institutions include all regulated institutions operating in Canada (not only those regulated by OSFI); that a third list be added of lenders that have obtained certification from OSFI as described earlier in this section; and that all three lists be given a much more prominent position on OSFI's Web site and more widespread exposure through other channels.

Electronic Commerce

We considered one further initiative with respect to foreign service providers that have no physical presence and are not accredited by OSFI, and that was to deem such providers to be subject to the jurisdiction of Canadian courts. Doing so would create the possibility for Canadians to seek judgments against them, if wronged, even though those judgments might not be capable of being enforced in Canada. We consider that this idea has merit, but it is premature for us to make a firm recommendation. It requires further consideration in the context of federal-provincial jurisdictional issues and the broader question of electronic commerce. We recommend that Industry Canada, as part of its deliberations on the appropriate legal framework for electronic commerce, give further consideration to such an initiative.

Summary

We are confident that the recommendations we are making to improve the operation of prudential regulation will assist in achieving national objectives of enhanced competition, without sacrificing the high quality of safety and soundness that our financial sector now enjoys. The new OSFI mandate and governance structure will broaden the scope of OSFI as its operational capacity is strengthened. The considerable streamlining of regulatory oversight that we envisage – through rationalizing CDIC and OSFI overlap, through reducing OSFI's approval processes and making them more efficient, and through encouraging harmonization among governments – will reduce costs and assist the process of product and service innovation. Restructuring CDIC and CompCorp will assist the life insurance industry to become a stronger competitor to the banks. And the framework that we have begun to sketch out for foreign entry with no physical presence will offer the ability to attract economic benefits to Canada from foreign lenders while enhancing information to Canadian consumers so as to allow them to make meaningful choices among potential providers.

Chapter 10

List of Recommendations

This chapter sets forth the recommendations of the Task Force. They are organized by reference to the four basic themes of the report:

- enhancing competition and competitiveness;
- empowering consumers;
- Canadians' expectations and corporate conduct; and
- improving the regulatory framework.

Enhancing Competition and Competitiveness

General

1) Because the financial services marketplace in Canada, as in the rest of the world, is in a state of rapid change, governments and institutions should respond promptly to this report. In the case of the federal government, the implementation of these recommendations should not await the regular review of federal financial institutions legislation scheduled for 2002.

2) Sound corporate governance practices in individual institutions lie at the heart of ensuring a Canadian financial services sector that is both competitive and prudentially safe and sound. In light of this:
   (a) The Task Force urges OSFI and other Canadian regulators to emphasize the constant improvement of corporate governance in their regulatory work.
   (b) The Task Force encourages further active public discussion of ways to improve the governance of publicly traded Canadian financial institutions, including the requirement that there be a non-executive board Chair with adequate resources and time to fulfil the important responsibilities of such a position.

3) Canadian public policy should continue to support the Canadian control of large regulated financial institutions carrying on business in Canada. Specifically:

(a) There should be a redefined widely-held rule applicable to all large federally regulated financial institutions, designed to foster continuing Canadian control of a significant part of the financial services sector.

(b) The other existing legislative requirements designed to achieve Canadian control should be maintained.

(c) The legislation should be strengthened by a provision to make it clear that the principal executive functions of widely held, federally regulated financial institutions are required to be carried out in Canada.

Enhancing Competition: Facilitating New Entrants to the Market

4) The criteria and processes for the incorporation and regulation of financial institutions should be revised to facilitate the establishment and growth of new financial institutions. Specifically:

(a) The Minister of Finance should have discretion to allow a new financial institution, including a bank, to incorporate with less than the $10 million in capital currently required, subject to approval by OSFI of the institution's business plan.

(b) OSFI should streamline its processes to ensure that applications for approval of the establishment of new financial institutions are processed as efficiently as possible and within a period of time not to exceed 120 days as the norm.

(c) Ongoing regulatory requirements should be revised from a "one size fits all" policy. The administrative burden of regulation for smaller or niche institutions should be commensurate with their size and the nature of their business activities, and not determined by requirements designed for large multi-product financial conglomerates.

5) There should be a 10-year holiday for new financial institutions from federal capital tax (including both large corporation and Part VI tax). The Task Force urges provincial governments to introduce similar holidays to encourage new entrants in their jurisdictions, free from the debilitating impact of capital taxes on start-ups.

6) Ownership rules should be revised as described under the heading "Ownership Rules and Enhanced Competition" to permit the establishment of new closely held banks and cooperative banks.

7) There should be a clearer regulatory framework within which providers of financial services from outside Canada can do business with Canadians. See Recommendation 119.

8) Withholding taxes should be removed for interest on all arm's-length borrowings, regardless of their term, to encourage non-resident lenders to compete in extending credit to borrowers in Canada.

9) Canadian public policy should encourage foreign financial institutions to carry on business in Canada in order to broaden the choice of providers of financial services to Canadians. To that end:

   (a) Foreign banks should be able to carry on any banking business in Canada, other than the taking of retail deposits (i.e., deposits below $150,000), through branches of the foreign banks as well as through subsidiary corporations, as is now the case.

   (b) The Task Force endorses the conditions for branch entry outlined in the Department of Finance consultation paper published in September 1997, except that:

      (i) the proposed condition that the foreign bank must have $25 billion in assets worldwide should be revised to permit smaller, well-capitalized foreign banks to compete in the Canadian marketplace through branch operations; and

      (ii) the requirement that the foreign bank should have international experience should be restated to encourage entry from competent banks that may not have international experience, but may still be able to contribute to enhancing competition in Canadian markets.

   (c) Foreign banks that wish to take retail deposits in Canada should continue to do so through subsidiaries and branches of those subsidiaries, to ensure adequate depositor protection.

   (d) The regulatory regime applicable to foreign bank subsidiaries and branches should be as light as possible. Prudential regulation should be substantially reduced where the foreign bank does not take retail deposits.

10) OSFI's statutory mandate should be revised to make it clear that OSFI should balance competition and innovation considerations with its present responsibilities in respect of safety and soundness. See Recommendation 112.

11) To facilitate the early adoption in Canada of electronic commerce in financial services and the added competition it will bring, governments at all levels should make it a priority to ensure that all legislation is compatible with an electronic commerce market environment.

Enhancing Competition: Equity in Consumer Insurance Plans

12) In order to promote more effective competition between banks and life insurance companies, there should be the same level of support from the federal government for the insurance plans protecting customers of deposit-taking institutions and customers of life insurance companies. See Recommendation 117.

Enhancing Competition: Expanded Business Powers

Payments Systems Issues

13) The Canadian Payments Association Act should be amended to permit financial institutions other than deposit-takers to become members of the Canadian payments system upon designation by the Minister of Finance as meeting criteria related to their solvency, liquidity, and regulatory and legal frameworks. The Department of Finance, working with the Canadian Payments Association, should give high priority to determining the classes of institutions which should be eligible. The Task Force expects life insurance companies, securities dealers and money market mutual funds to qualify with few, if any, restrictions.

14) The Minister of Finance, rather than the Governor-in-Council, should have the power to approve new by-laws of the Canadian Payments Association or changes in existing by-laws. In addition, the Minister of Finance should have the power to review all new or revised rules of the Association, and to revoke any new rule or revision to existing rules which the Minister determines to be contrary to the public interest.

15) The Minister of Finance should also have the power to issue a directive to the Canadian Payments Association to require a change in a by-law, rule or operating practice which the Minister determines to be in the public interest.

Access to Other Networks

16) The Minister of Finance should monitor the operations of all networks in Canada to ensure that they are operated in a manner designed to enhance competition in financial services and competitive equity among financial services providers. If significant anti-competitive practices are found, legislation should be considered to ensure network access to all competitors on reasonable terms and conditions, and with fair compensation to network sponsors.

17) The members of Interac should take the necessary steps so that the Interac network is fully functional to permit the network to be used for as many functions as the technology permits, including the making of deposits through any ATM to any participating deposit-taking institution.

Retailing Insurance by Deposit-Taking Institutions

18) Subject to the adoption of appropriate privacy and tied selling regimes, federally regulated deposit-taking institutions should be permitted to retail insurance through their branches and to use their customer information files to assist in retailing insurance.

    (a) Deposit-taking institutions with less than $5 billion in shareholders' equity should be permitted to retail insurance through their branches and to use their customer information files to assist in retailing insurance, as soon as legislation in respect of privacy and tied selling is in place.

    (b) All other companies should have access to the new powers on January 1, 2002.

19) Employees of deposit-taking institutions who are engaged in the sale of insurance should comply with applicable provincial requirements with respect to the education and licensing of insurance salespersons, so long as such requirements are non-discriminatory.

20) The insurance and deposit-taking sectors should work with the provinces to develop a model code for licensing and consumer protection issues arising from the sale of insurance at branches of deposit-taking institutions.

Light Vehicle Leasing

21) Subject to the adoption of appropriate privacy and tied selling regimes, federally regulated deposit-taking institutions and life insurance companies should be permitted to lease light vehicles, including automobiles, to consumers.

    (a) Deposit-taking institutions and life insurance companies with less than $5 billion in shareholders' equity should be permitted to lease light vehicles as soon as legislation in respect of privacy and tied selling is in place.

    (b) All other companies should have access to the new power on January 1, 2002.

Enhancing Competition: The Cooperative Sector

22) Federal legislation should permit cooperative banks and other financial institutions to be chartered as new institutions, with ownership and governance to be based on cooperative principles. Subject to compliance with applicable provincial legislation, provincial credit unions and credit union centrals should be able to continue as cooperative banks under the Bank Act.

23) Federal and provincial governments should take such steps as may be available, within their respective jurisdictions and subject only to prudential constraints, to remove legislative and other regulatory barriers to the success and growth of the cooperative financial services sector, including in particular credit unions and caisses populaires.

24) Restrictive provisions contained in the Cooperative Credit Associations Act upon the business activities of credit union centrals should be removed except to the extent that they are necessary for prudential reasons. Specifically:

    (a) A credit union central should have the ability to provide wholesale financial services to another financial institution without the present requirement that the other institution first make an investment in a subsidiary service corporation of the credit union central.

    (b) Credit union centrals should have the ability to provide retail financial services directly to members of local credit unions.

    (c) Where credit union centrals act in concert in relation to an investment, they should be treated as one entity for purposes of the Minority Investment Regulations.

    (d) The credit union movement, OSFI and the Department of Finance should establish a Working Group to resolve any prudential issues.

Enhancing Competition: More Flexible Corporate Structures

25) There should be no restrictions on corporate structures available to financial institutions unless required by safety and soundness considerations.

26) Federally regulated financial institutions should have the option of being organized as subsidiaries of regulated financial holding companies incorporated under a new Financial Holding Companies Act. Specific principles to be applicable in the holding company regime would include the following:

    (a) The regulatory requirements applied to the holding company and its unregulated subsidiaries should be as non-intrusive as possible.

    (b) The ownership requirements, and the other prescribed indicia of Canadian control which are applicable to regulated financial institutions, would also be applicable to financial holding companies.

    (c) The holding company would be required to have a controlling interest in its principal Canadian operating regulated financial institutions.

(d) The holding company should be capitalized in such a way as to avoid double gearing and so that the holding company can serve as a source of strength for the group.

(e) The holding company would be a non-operating company and its permitted investments and downstream subsidiaries should mirror those of operating regulated financial institutions conducting business under the financial institution parent model.

(f) Related-party rules would apply to transactions between the holding company and its subsidiaries.

(g) OSFI should have full access to information from all companies in the corporate group.

(h) There should be disclosure rules to ensure that persons dealing with unregulated entities in the corporate group are clearly informed that the entities are not regulated, that their securities are not deposits and are not insured or guaranteed by CDIC or any other government-sponsored insurance program, and that related regulated financial institutions do not provide guarantee support. Unregulated entities within the group should not be able to use the name "bank."

(i) A reorganization of a regulated financial institution as a subsidiary of a holding company under the Financial Holding Companies Act would require the approval of OSFI.

27) Existing unregulated holding companies should be grandfathered so that they would not be required to comply with the provisions of the Financial Holding Companies Act, subject to OSFI's continuing to be satisfied with the quality and substance of undertakings in respect of prudential issues. The grandfathered status would be lost if the grandfathered company controlled both a bank in Canada and a foreign bank.

28) The Department of Finance and OSFI should review the present downstream restrictions on subsidiaries and minority investments with the objective of determining:

(a) whether activities that are currently required to be conducted in the parent financial institution could be permitted to be conducted either in a permitted subsidiary or in minority investment form; and

(b) whether functions which are now required to be carried on in a subsidiary could be permitted to be carried on by way of minority investment.

Enhancing Competition and Competitiveness: Ownership Rules

29) The ownership rules should be designed to foster:

   (a) entrepreneurship and competition;

   (b) the safety and soundness of the system; and

   (c) the preservation of Canadian control of substantial parts of the financial services sector.

30) In respect of large financial institutions, the maintenance of Canadian control and the better assurance of safety and soundness by the separation of commercial and financial interests are key principles underlying the ownership rules. For those reasons, large financial institutions should be widely held, as defined in Recommendation 33. It is important to foster entrepreneurship and competition in the start-up and growth of new financial institutions; accordingly, smaller financial institutions should not be required to be widely held.

31) Any holding of more than 10 percent of any class of shares in a federally regulated financial institution by a person or group of persons acting jointly or in concert should continue to require the prior approval of the Minister of Finance, on a "fit and proper person" test.

32) There should be a single ownership regime, consistent across the financial services sector, which is based on the size of the institution measured by its shareholders' equity. The essential parameters of the ownership regime would be as follows:

   (a) In order to foster start-ups and competition, institutions with less than $1 billion in shareholders' equity would be able to be closely held, including sole ownership by one person or company.

   (b) In order to provide enhanced corporate governance in the interest of safety and soundness for growing institutions, financial institutions with more than $1 billion but less than $5 billion in shareholders' equity would be required to have at least 35 percent of their voting participating shares widely held and publicly traded.

   (c) The Minister of Finance would have the authority to exempt a subsidiary of a foreign financial institution from the requirement to have a 35 percent public float.

   (d) The largest financial institutions, those with shareholders' equity in excess of $5 billion, would be required to be widely held as described in Recommendation 33.

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

(f) Where a single owner or group of related owners has effective control of more than one regulated financial institution, the applicable ownership rule will be determined on the basis of the combined shareholders' equity of the controlled financial institutions.

33) Large financial institutions, i.e., those with shareholders' equity in excess of $5 billion, would be subject to the following widely-held requirements:

(a) As described in Recommendation 31, no person, or group of persons acting jointly or in concert, would be allowed to own or control more than 10 percent of any class of shares without the approval of the Minister of Finance.

(b) The Minister of Finance should have discretion to permit ownership positions in any class of shares in excess of 10 percent and up to 20 percent. Shareholders permitted by Ministerial order to own more than 10 percent should not collectively own or control more than 45 percent of any class of shares.

(c) The Minister of Finance should also have the discretion to permit a shareholding, on a temporary basis, in excess of the 20 percent limit, subject to the Minister's approving a plan from the shareholder to divest to an agreed percentage (not to exceed 20 percent) within a fixed time period. The Minister should be empowered to obtain and enforce undertakings from any person holding such an excess shareholding, both to confirm the agreement in respect of the divestiture of the shares and to assure that voting rights will not be exercised on the shares in excess of 20 percent during the period prior to disposition.

34) Although the discretion of the Minister of Finance to permit a shareholding in excess of 10 percent for institutions that must be widely held should not be constrained by statute:

(a) The discretion should be exercised when the Minister concludes that the excess shareholdings would:

(i) enhance competition or competitiveness in the financial services sector;

(ii) enhance the safety and soundness of the Canadian financial services system; or

(iii) foster the growth of the Canadian financial services industry by, for example, facilitating a business alliance or an acquisition by a Canadian financial institution.

(b) The increased shareholding limit should not be generally available for passive investments in which the excess shareholding would add no value to the business beyond the investment of the shareholder.

(c) The Minister should issue guidelines to identify the circumstances in which the Minister would be prepared to consider an application to exercise the discretion.

35) An institution which reaches the $1 billion and $5 billion thresholds, and which therefore becomes subject to new ownership criteria, should have a reasonable period of time, to be determined with the approval of the Minister, to comply with the applicable requirements of the ownership regime.

36) Businesses organized in the cooperative or mutual form of ownership should be deemed to comply with the widely-held rules by definition and without the need for special exemption, whatever their size.

37) In respect of financial institution holding companies, the ownership rules should apply to the holding company on the basis of the combined shareholders' equity of the regulated financial institutions controlled by the holding company.

38) In respect of demutualized life insurance companies, they should become subject to the general, size-based ownership regime after a transition period of three years from the date of demutualization. Demutualized companies with shareholders' equity in excess of $5 billion would have to be widely held and remain so from the date of demutualization. Transition guidelines for the three-year period should assure that all demutualized companies, as a matter of principle, are not subjected to hostile takeover bids or amalgamation proposals. The guidelines should therefore provide that the smaller demutualizing companies should also be widely held for the three-year transition period. The transition guidelines should also provide that, in the normal course, the Minister of Finance should not approve any proposal for merger or acquisition of any newly demutualized company. However, should any demutualized company and its board of directors propose a transaction that, in the opinion of the Minister, is clearly in the public interest and desirable to conclude within the three-year transition period, it should be allowed to proceed.

39) The Government should have the power, to be used only in exceptional cases, to approve the acquisition of a large widely held Canadian financial institution by a foreign purchaser, free from the impact of the widely-held rules. Any such transaction should be subject to:

(a) the completion of the usual processes for merger approval (i.e., review by the Competition Bureau and OSFI, and Ministerial approval following the completion of the Public Interest Review Process); and

(b) the following additional criteria being met:

(i) the buyer should be a widely held, regulated financial institution approved by OSFI;

(ii) the acquisition should be approved by the Governor-in-Council on the recommendation of the Minister of Finance that the acquisition would be in the Canadian public interest by enhancing competition or competitiveness in the financial services sector or by enhancing the safety and soundness of the Canadian financial services system; and

(iii) enforceable undertakings should be provided by the buyer to the Minister to ensure that the transaction provides its intended benefits to Canada.

40) A Schedule I bank which is subject to the present 10 percent rule but which would not, by reason of its size, be subject to the new size-based, widely-held regime would initially be subject to the new widely-held rule but would have the right to be recategorized into the class of financial institution, with the resulting ownership rules, which would apply by reason of its shareholders' equity. This recategorization would require the approval of the board of directors of the bank, confirmed by a special resolution of the shareholders and the approval of the Minister of Finance.

41) A company with share ownership not conforming to the new ownership rules at the time of their introduction should be permitted to continue business without altering its ownership structure, subject to the Minister being satisfied with the quality and substance of the undertakings provided by any controlling shareholder in respect of prudential issues. Such a company should not be permitted by reason of its grandfathered status to acquire an institution that, by virtue of its size, must be widely held. There would be no requirement for the dilution of the share ownership of the control block, whatever the shareholders' equity of the financial institution might be at any time. A regime should be adopted so that, over time, the non-conforming institution would come into compliance with the ownership regime. Particulars of options which the Task Force suggests should be available to the controlling shareholder are set out in Background Paper #2.

Enhancing Competitiveness: Accounting Principles

42) Canadian accounting principles relating to the creation and amortization of goodwill in business combinations should be revised to eliminate their present negative impacts on financial sector restructuring in Canada and on the ability of Canadian financial institutions to successfully compete for acquisitions outside Canada. To that end:

   (a) The Task Force urges the Canadian Institute of Chartered Accountants, working with OSFI and the financial institutions, to develop a mutually acceptable interim solution, to be applicable until such time as Canadian and U.S. accounting principles in respect of business combinations are harmonized.

   (b) If the Canadian Institute of Chartered Accountants is not able to determine a solution, OSFI should use its power to specify principles for business combinations and goodwill accounting so as to (i) facilitate consolidations of small and mid-sized Canadian financial services companies into stronger competitors in the Canadian marketplace, and (ii) permit Canadian companies to participate on a competitive basis in pursuing acquisition opportunities.

43) The Canadian Institute of Chartered Accountants, in its ongoing work, should be sensitive to changes, and the timing of changes, in Canadian accounting principles and practices that might negatively affect the international competitiveness of Canadian financial institutions or impede the start-up and growth of new Canadian financial institutions.

Enhancing Competitiveness: Taxation

44) Governments in Canada should recognize the importance of financial institutions to the Canadian economy, both as strong domestic industries with significant international potential and as vital contributors to the health of other Canadian enterprises. Because the level of taxation of Canadian financial institutions is damaging to the competitive position of Canadian companies and is increasing costs to Canadian users of financial services:

   (a) As fiscal conditions permit, governments should take steps to reduce the level of taxation so that the financial services industry is equitably treated vis-à-vis other sectors in the Canadian economy, and competitively taxed vis-à-vis financial institutions in other countries.

(b) In particular, steps should be taken both at the federal and provincial level as soon as possible to address the burden which special capital taxes place on financial institutions:

(i) Special capital taxes on financial institutions should be eliminated. If this is not possible, the recommendations in (ii), (iii) and (iv) should be pursued.

(ii) To the greatest extent possible, the tax burden should be shifted from capital and toward profits.

(iii) The federal government should work with the provinces to define a common tax base related to capital.

(iv) Efforts should be made to define a capital tax base that would tax capital in excess of that required for regulatory purposes very lightly or not at all, so as to encourage Canadian financial institutions to be well capitalized.

(c) The Task Force urges provincial governments to be sensitive to the double taxation consequences of transaction taxes on insurance premiums (such as the GST, sales taxes and premium taxes) and their impacts on consumers and, over time, to take measures to alleviate those impacts.

Preserving Competition: Consolidation and Mergers

45) There should be no general policy which prevents large institutions from entering into business combinations with other large institutions, whether by amalgamation, acquisition or in other ways. The "big shall not buy big" policy should not apply to any federally regulated financial institution, including the Schedule I banks.

46) Business combinations involving a federally regulated financial institution should be assessed by (a) the Competition Bureau under the Competition Act in respect of competition concerns, (b) the Office of the Superintendent of Financial Institutions in respect of prudential issues, and (c) the Minister of Finance in respect of general public interest considerations. Relevant information should be shared on a confidential basis among these parties as part of the review process.

47) In respect of the review by the Competition Bureau:

(a) The Task Force endorses the general approach proposed by the Director of Investigations and Research in his submission to the Task Force in November 1997, as amended by the Merger Enforcement Guidelines for Financial Institutions issued on July 15, 1998.

(b) The Task Force agrees, in particular, that the Director should not assess mergers on a "first in, first out basis," but rather should consider all merger proposals separately and in combination, as the Bureau makes its determination.

(c) The Director should pay particular attention to the competition concerns of small and medium-sized business, users of personal financial services who may still be branch-dependent, and regional markets where there are few alternative suppliers.

(d) The Director should consider the new competitive choices which already exist in respect of certain product lines and which are also likely to emerge as a result of the emergence of new channels of distribution and liberalization of public policy constraints.

(e) Where necessary, the Director should actively pursue remedial options.

(f) In reviewing merger proposals and in carrying out other responsibilities under the Competition Act, the Director should consider the extent to which the terms and conditions of access to networks, and their functionality, inhibit effective competition.

48) In respect of the review by OSFI:

(a) The Superintendent's attention should be directed at identifying any new prudential risks that may arise by reason of the transaction.

(b) OSFI should be prepared to provide assistance, including the secondment of personnel, to the Competition Bureau to ensure that it has sufficient expertise, with industry experience and awareness, to assess and protect the public interest from the competition perspective.

49) In respect of the review by the Minister of Finance:

(a) The approval of the Minister should be required for all business combinations involving one or more federally regulated financial institutions, except for a transaction between two federally regulated institutions which does not require pre-notification under the Competition Act. This should be subject to approval by the Superintendent.

(b) If two or more institutions, at least one of which is federally regulated, propose to combine to form an enterprise with shareholders' equity of more than $5 billion and where each of the combining institutions has at least $1 billion of shareholders' equity, the Minister should require a formal Public Interest Review Process prior to determining whether to grant approval. The Minister should have the right to invoke the Public Interest Review Process in the case of other transactions.

(c) The Minister should issue Public Interest Review Process guidelines to describe the mechanics of the process. The guidelines should require merger proponents to submit a detailed Public Interest Impact Assessment (i) describing their business plan and objectives; (ii) clearly identifying the benefits and costs to the nation and the public of the proposed transaction, including the considerations described in (d) below and such other considerations as the Minister may specify; and (iii) outlining any remedial or mitigating steps in respect of public interest costs, and any assurances in respect of public interest benefits, which are proposed by the merger proponents.

The Public Interest Impact Assessment should be available for public comment for a reasonable time period to be specified by the Minister. The decision of the Minister on the proposed transaction should be made as promptly as possible following the public comment period.

(d) In assessing whether approval should be given, the Minister should review the recommendations of the Director and the Superintendent, and the views obtained in the Public Interest Review Process, in light of all relevant public interest considerations, including:

(i) the costs and benefits to individual customers and small and medium-sized business;

(ii) regional impacts;

(iii) international competitiveness;

(iv) employment;

(v) the adoption of innovative technologies; and

(vi) the extent to which approval may create a precedent.

50) Merger proponents should endeavour to structure their proposals in a manner that is consistent with public interest goals. It should be the objective of all parties to balance (a) institutional interests, e.g., the achievement of substantial efficiencies and enhanced competitiveness from the merger, with (b) public interest objectives, e.g., continued competitive markets, the mitigation of public interest costs and the maximization of public interest benefits. The Minister should be prepared to work with merger proponents to help them structure transactions with important public interest considerations in a manner which will better assure the public good.

51) Mergers of large financial institutions should be permitted as long as, after implementing any necessary remedial or mitigating steps, the Minister is of the opinion that markets will remain competitive, that there are no material safety and soundness concerns, and that the transaction is in the public interest.

52) The Minister should have legislative authority to seek and obtain enforceable undertakings from merger proponents to ensure that commitments made to address competition and other public interest concerns are fulfilled:

    (a) The Department of Finance should monitor compliance with such undertakings and report regularly to the Minister, who in turn should report to Parliament.

    (b) The Governor-in-Council, on the recommendation of the Minister of Finance, should have the authority to issue directions in respect of undertakings, including a direction to cease from committing an act, or to perform such act, as in the opinion of the Minister is necessary to remedy a situation where an undertaking is not being met.

    (c) Strong sanctions should be provided for non-compliance with undertakings given by merger proponents and directions of the Governor-in-Council.

Empowering Consumers

General

53) An efficient, competitive marketplace requires that the market conduct practices of suppliers of financial services should be such as to ensure full, plain and adequate disclosure to consumers; fair, reasonable and non-abusive transaction practices; and adequate redress mechanisms to resolve disputes. Governments and financial institutions should work together to achieve those goals.

54) The federal government should ensure that market conduct regulation, within areas of its constitutional jurisdiction, embodies best practices, bearing in mind the criteria described in Recommendation 53.

55) To ensure consistent market conduct treatment across Canada and across the spectrum of financial services providers, the federal government and the provinces should intensify harmonization and coordination efforts in respect of the standards of market conduct.

56) An efficient and competitive financial services marketplace requires continuing consumer vigilance and advocacy. To that end:

    (a) The Task Force urges consumer advocacy groups to work together to pursue the concept of the establishment of a Financial Consumers Organization to ensure that there is effective consumer advocacy in the sector. Once a broad consensus of the groups is reached, governments and financial institutions should work with the sponsors to facilitate the organization's success.

(b) OSFI, the Department of Finance and Industry Canada should ensure that adequate resources are available to support project research on consumer issues and to fund relevant consumer advocacy groups to participate fully in important public policy initiatives relating to consumer protection, including those recommended in this report.

Disclosure and Transparency

57) Because the level of transparency in many financial services consumer contracts and marketing documents in Canada falls short of what Canadian consumers have a right to expect and industry is capable of delivering, financial institutions and their industry associations should intensify efforts to improve transparency and disclosure, using the following "best practices" guidelines:

(a) *Timing*: All essential information should be provided to the customer before a transaction is entered into, including the terms of the agreement between the provider and the customer.

(b) *Presentation clarity*: Documents should be presented in a manner which is capable of ready comprehension by a reasonably intelligent consumer in the marketplace.

(c) *Organizational clarity*: Documents should be formatted to highlight information that is important to the customer.

(d) *Brevity*: Documents should be as brief as possible, given the need for reasonable completeness from a commercial and legal perspective.

58) The federal government, working with the provinces, industry and consumer groups, should establish a multipartite Working Group to carefully review Canadian financial services contracts and marketing documents and to assess the extent to which Canadian institutions meet the best practices of transparency and disclosure. Where they fall short in a significant way, the Working Group should establish an action plan so that appropriate remedial action is taken, whether at the institutional level or by regulation. The Working Group should consider the feasibility of developing model forms for routine transactions, as has been done in other countries, and of establishing basic standards of document readability and comprehensibility.

59) Leaders of financial institutions should make increased disclosure and transparency high, visible corporate priorities, and should ensure that adequate resources are available to ensure best practices, including participation in the multipartite process described in Recommendation 58. Institutions should set milestones and benchmarks against which to assess their progress, should monitor it by periodic user testing programs, and should

report progress in their annual Community Accountability Statements described in Recommendation 99.

60) Whenever governments review financial institutions or market conduct legislation on an ongoing basis, they should take all appropriate steps to improve disclosure and transparency. To that end, they should remove or reduce regulatory requirements that prevent the use of clear language, and should give positive reinforcement in law to the results reached by the multipartite Working Group.

61) Market conduct regulators, at both the federal and provincial levels, should audit financial institutions on a regular basis for best practices in respect of transparency and disclosure in transaction documents, in light of the benchmarking conclusions arising from the activities of the Working Group. OSFI should have this responsibility at the federal level.

62) To provide more adequate disclosure, fees and commissions paid to employees or third parties in respect of any financial services transaction should be required to be clearly disclosed before the transaction is entered into.

63) There should be a statutory prohibition on contract terms that permit the unilateral amendment of financial services consumer contracts by financial institutions.

Privacy

64) The Task Force supports the announced intention of the Government to legislate a comprehensive privacy regime applicable to all commercial enterprises. With respect to financial institutions, we recommend that the legislation be based on the premise that privacy of personal information is a fundamental right. The legislation should prescribe Basic Minimum Privacy Standards.

65) The Basic Minimum Privacy Standards should include the following requirements:

   (a) The customer should be able to specify the relationship the customer seeks with the financial institution and information collected should be specific to that relationship.

   (b) The financial institution should specify what information may be sought from third parties, in accordance with the relationship sought by the customer.

   (c) Customer consent to the collection, use or disclosure of information should be express and not implied, and the customer should be able to revoke or alter consent at a subsequent time.

(d) Target marketing should be subject to the customer's express agreement in writing.

(e) The customer should have access to the customer's personal information files and the right to require the correction of erroneous data.

66) Federally regulated financial institutions, either individually or through industry associations, should be required to develop an acceptable, legally binding privacy code, building upon the CSA Model Code and incorporating the Basic Minimum Privacy Standards. Provisions of the codes should expand the Basic Minimum Privacy Standards when appropriate. OSFI should have the responsibility to certify the codes of federally regulated financial institutions and to ensure that compliance is audited.

67) Medical information should receive special protection in the privacy regime. In particular:

(a) The same employee of a financial institution should not be engaged in both insurance sales and credit granting functions.

(b) There should be strict segregation within institutions of information collected for insurance and credit purposes.

(c) An insurance company should not be allowed to share medical information with a deposit-taking institution, whether or not it is affiliated, even with customer consent.

68) Consumers should have redress in respect of privacy matters to the financial services sector Ombudsman and, in addition, should have appropriate civil remedies, including punitive damages.

69) The federal government should work with provincial governments with the objective of ensuring that there is harmonized privacy legislation applicable to all regulated and unregulated providers of financial services in their dealings with individuals and small businesses. Provincial governments, where they have not already done so, should legislate a privacy regime which incorporates the Basic Minimum Privacy Standards.

Coercive Tied Selling

70) Because of the inequality of information and bargaining power between financial institutions and their customers, financial services legislation in all jurisdictions should unequivocally enshrine the freedom of financial services customers from coercion in their dealings with financial institutions.

71) There should be a specific legislative ban on coercive tied selling by banks and other financial institutions. With that aim, section 459.1 of the Bank Act should be proclaimed with amendments to broaden its scope to include

all credit products, insurance and such other products or services as might be prescribed by regulation. Similar legislation should be applicable to all federally regulated financial institutions. As contemplated in section 459.1, regulations should be passed to further elaborate on the statutory terms "undue pressure" and "coercion."

72) Prior to entering into any financial services contract for the sale of insurance or the granting of credit, suppliers and intermediaries should be required to provide the customer with a clearly written description of what constitutes coercive tied selling and advice that coercive tied selling is not legal. The Government should work with industry and consumer groups to develop a common, easily understood notification statement.

73) The legislation should provide appropriate remedies for breach of the prohibitions against coercive tied selling, which would include prosecution, and private recourse through the ombudsman and court systems. Civil remedies should include punitive damages.

74) Suppliers and intermediaries should be required to ensure that every salesperson is trained to avoid coercive sales practices, including coercive tied selling. Initiatives such as the Canadian Bankers Association Code should be pursued.

75) Financial institutions should endeavour to itemize and price separately the different components of a package of services offered to customers which, under reasonable business practices, might be priced and sold separately.

Redress

76) Consumers of financial products and services should have improved means of private redress in the case of a dispute with a financial services provider, including a dispute arising from unfair or illegal market conduct practices.

77) Federal legislation should establish an Ombudsman office to which all federally regulated financial institutions and their subsidiaries would be required to belong.

78) The Ombudsman system should also be made available, on a voluntary basis, to provincially chartered and unregulated financial institutions. Provinces should require provincially regulated institutions to opt in to the Ombudsman system so that there would be a common redress system available to all Canadians, regardless of the financial institution with which they do business.

79) Each member financial institution should be required to make available an internal ombudsman who would be the first recourse for consumers.

80) The Ombudsman office should be structured in a way which will engender public confidence in its independence, mandate, accessibility and reliability, and which will be readily visible in the community. To that end:

(a) *In respect of independence*: The Ombudsman office should report to Parliament through the Minister of Finance. It should be under the management and direction of a board of directors, with representation from financial institutions, but with a majority of independent directors, all of whom would be appointed by the Minister of Finance. The board would appoint the Ombudsman, would approve funding arrangements, would recommend terms of reference of the Ombudsman for approval of the Minister, and would determine issues of policy.

(b) *In respect of mandate*: The mandate of the Ombudsman office should include all issues of fairness and maladministration by a financial institution, determined by reference to its legal obligations, good practice and the institution's established policies and practices.

(c) *In respect of accessibility*: Individual and small business customers should be able to access the system. Other customers should have access at the discretion of the Ombudsman. Costs of the Ombudsman office should be borne by the industry members on an assessment basis determined by the board of directors and approved by the Minister.

(d) *In respect of reliability*: Disputes should be resolved in a cost-effective, informal environment, entailing mediation where appropriate, and with the Ombudsman having the power to issue a ruling where mediation fails. To ensure cost-effective and non-legalistic proceedings, the rulings should not be binding. Any ruling of the Ombudsman which is not complied with by an institution should be made public, with the name of the defaulting institution and with appropriate protections to ensure the privacy of the complainant. Should financial institutions act in a manner to frustrate or impede the effectiveness of the Ombudsman process, including any persistent failure to follow the Ombudsman's recommendations, binding decisions should be considered.

(e) *In respect of visibility*: The existence and nature of the Ombudsman office, together with means of access to it, should be made widely known. Regulated financial institutions should be required to include information about the Ombudsman system, in an agreed format, in regular mailings to customers.

Proficiency Standards

81) Because an effective marketplace requires both that consumers be informed and that salespersons be well equipped to provide sound advice, there should be more effective training of persons who deal with the public in the sale of financial services products, including both intermediaries and employees of financial services institutions.

82) Well-defined and adequate proficiency standards should be adopted for market intermediaries, including a post-secondary diploma for new entrants, adequate examination standards and enhanced continuing education requirements.

83) Proficiency standards should be harmonized to the greatest possible extent across jurisdictions.

84) Given marketplace characteristics and consumer interests, the Task Force supports the regulation of financial services market intermediaries under provincial jurisdiction by a single regulator in each province.

85) Licensing restrictions for intermediaries based on occupation should be removed. Provincial governments should remove restrictions mandating full-time employment and should enter into reciprocal licensing agreements relating to residence of intermediaries, with the objective of improving service and lowering costs to the consumer.

86) The Task Force supports provincial review of:

   (a) the current exemptions from provincial licensing requirements to determine whether those who benefit from the exemptions do in fact have training and supervision which is equivalent to the standards proposed for licensed market intermediaries; and

   (b) the status and training of market intermediaries who are not currently covered by any proficiency regime even though they deal with retail consumers.

Canadians' Expectations and Corporate Conduct

General

87) There should be greater disclosure and transparency in respect of the performance of financial institutions in meeting community expectations. Government, institutions and concerned public interest groups should cooperate in identifying and resolving issues of unmet public expectations as they arise.

Responding to Expectations about Social Performance

Access

88) The Task Force affirms that access by low-income Canadians to basic transaction services of banks and other deposit-taking institutions is a very important policy objective, and it urges the Government, financial institutions and social interest groups to continue to work constructively together to attain it.

89) Federally regulated deposit-taking institutions should aggressively pursue the implementation of the agreements reached between the Government and major banks in February and December 1997 concerning the opening of accounts and other access questions. Provincially regulated deposit-taking institutions should implement arrangements that are at least as effective.

90) To ensure access to basic banking services:

   (a) The federal and provincial governments should make low-cost personal identification available to anyone requiring it, so as to eliminate problems of access arising from lack of satisfactory identification.

   (b) Financial institutions, governments and social interest groups should work together to develop a common basket of services included in a standard basic account to be offered by all deposit-taking institutions. The basic account should recognize the impact of technology on basic banking services and, accordingly, should include a debit card as well as the right of the holder of a basic account to a specified number of withdrawals without additional charge.

   (c) Deposit-taking institutions should make standard basic accounts available at reasonable charges. There is no need to legislate the price to be charged by financial institutions as long as the basic accounts are readily available at a reasonable price. From time to time, the Department of Finance should monitor the basic account prices charged to ensure that they remain reasonable.

   (d) Deposit-taking institutions should be required to post prominently in each branch the terms and conditions of their most economic transaction account, together with the identification requirements needed to open one.

   (e) In order to encourage access to accounts, governments should use direct deposit for all government programs that provide regular benefits. There should be provision for master accounts where appropriate. Although such programs should be optional for those who do not want to receive direct deposits, every effort should be made to encourage participation.

(f) To eliminate any reason for financial institutions to place holds on government cheques when adequate identification is presented, governments should implement indemnity programs with financial institutions pursuant to which low-income people, whether or not they are customers of the institutions, can gain immediate access to their funds. Financial institutions should ensure that there are no holds when indemnification agreements are in place.

(g) Financial institutions should continue to work with community groups to develop and implement effective training programs for staff, reinforced by incentive and compensation policies at the branch level, to ensure that the objectives of the February and December 1997 agreements on access are achieved.

91) The Task Force notes the absence of solid data on the number of "unbanked" in Canada and the reasons why persons remain outside the system. The Department of Finance should immediately undertake a careful survey to benchmark the extent and nature of the access problem so as to better develop public policy and enable financial institutions to be fully responsive. The Government should regularly monitor progress toward improved access through "mystery shopping" and other methods, and should repeat the benchmark survey at regular intervals.

92) Although the Task Force would prefer to see access problems resolved by a cooperative effort of governments, financial institutions, and social interest and community groups, it must be recognized that in a modern society access to financial services is of vital importance. Therefore, if significant progress is not made within a reasonably short time to resolve access issues, the Government should legislate the terms of the February and December 1997 agreements, with appropriate sanctions for non-compliance.

Branch Services Access

93) In order to provide customers and affected communities with a reasonable time to adjust and seek alternative services when the branch of a deposit-taking institution is to be closed:

(a) Federally regulated deposit-taking institutions should be required to provide at least four months' advance notice before closing branches. The notice should be posted prominently in the branch, communicated to all customers and relevant local authorities, and published in community newspapers.

(b) The financial institution should work proactively with the community to explore alternatives and to ease the transition.

(c) The Task Force urges provinces to consider a similar requirement for provincially chartered deposit-taking institutions.

Micro-Credit

94) The Task Force recommends that governments, financial institutions and community groups establish partnerships to promote micro-credit programs that assist individuals to establish and build new businesses and thereby contribute to self-employment.

95) Governments should participate in micro-credit by providing basic start-up and infrastructure support to pilot micro-lending programs that can demonstrate soundly based loan plans and that are unable to secure administrative financing from other sources. Governments should not fund loans under micro-credit projects.

96) Governments should review all social assistance programs to ensure that micro-credit loans do not reduce social assistance benefits, thereby creating a disincentive for individuals seeking self-reliance through micro-credit financing.

97) Banks and other financial institutions should be encouraged to develop partnerships with micro-credit programs in local communities. For example, credit-granting institutions could provide administrative support and know-how to micro-credit enterprises to develop systems, such as loan application evaluation procedures, or could fund program overhead costs.

Partnerships with the Voluntary Sector

98) Financial institutions should work with the voluntary sector to develop new, innovative partnerships that would help build stronger, healthier and more caring communities. Leaders in the financial institutions and in the voluntary sector should work together to this end, beginning with innovative pilot projects.

Community Accountability Statements

99) Each federally regulated deposit-taking institution and life insurance company should be required to make available to the public and file with the Minister of Finance one or more annual Community Accountability Statements to describe its contribution to the community and to identify emerging community needs to which it intends to respond. The Minister should table all such statements with the Standing Committee of the House of Commons on Finance. The Community Accountability Statements will serve as the basis for a continuing dialogue between leaders of the financial institutions and the community.

100) Provincial governments should consider implementing similar requirements for Community Accountability Statements from financial institutions within their jurisdiction.

Responding to Expectations about Business Financing

SME and KBI Finance Issues

101) The Government should undertake a substantial program of information collection and analysis to ensure that there is adequate information relating to the financing needs of small and medium-size businesses (SMEs) for effective public policy development. To that end:

(a) Statistics Canada should collect data on the supply of debt and equity financing to small and medium-size enterprises, including in particular coverage of knowledge-based industries (KBIs), aboriginal enterprises, and other sectors or subsectors determined from time to time to be of particular public interest. The data collection program should cover all regulated and unregulated private- and public-sector financial institutions engaged in significant loan, lease, equity investment, or securitization activity in the small business market. Details of the information collection program, which should be comprehensive, should be determined by Statistics Canada in consultation with data providers, potential users in the community, and representatives of Industry Canada.

(b) Financial institutions should be required to publicly release their responses to Statistics Canada, with appropriate modifications to protect the confidentiality of commercial relationships.

(c) On a regular basis, Statistics Canada should publish compilations of the data collected for public review and analysis.

(d) Industry Canada should assume responsibility for coordinating an annual survey of SME attitudes to examine the availability of financing from the perspective of small businesses. The survey would be similar in concept to the studies currently being conducted under the auspices of the Canadian Bankers Association. The scope of the studies would be extended to cover all substantial providers.

(e) In addition, Industry Canada should conduct and publish periodic benchmark surveys of small business users, including knowledge-based firms, to provide a comprehensive benchmark picture of the financing they require and the sources of finance upon which they rely, as markets evolve. An initial benchmark survey should be completed

as soon as possible, and follow-up benchmark surveys should be conducted once every three to five years. These surveys would complement the annual information collected by Statistics Canada and Industry Canada.

102) The Task Force urges deposit-taking institutions, particularly banks, to find new and creative ways to address the problem in small business financing created by the frequent turnover of business account managers, including the establishment of career paths and compensation incentives that provide long-term meaningful careers for community-based SME account managers.

103) The Task Force urges banks to continue to decentralize decision making in respect of credit-granting authority and collection practices, including a meaningful delegation to the local level.

104) The Task Force urges Canadian financial institutions to be prepared to make credit available to higher-risk borrowers with more innovative financing packages and appropriate pricing.

105) There should be more systematic and rigorous policy analysis of small business finance needs. To that end:

(a) An SME Finance Group should be established within Industry Canada to undertake continuing research on SME finance, including KBI enterprises. The SME Finance Group should oversee the user surveys, analyse the data collected by Statistics Canada and report annually to the Industry Committee of the House of Commons on the state of small business financing.

(b) The SME Finance Group should also pursue a program of special research on topical small business finance issues, such as the regional availability of finance, gender discrimination in SME finance, and aboriginal finance.

106) In order to better understand the financing needs of knowledge-based industries, the SME Finance Group should give priority to the adoption of a common definition of "knowledge-based industries" for purposes of data collection and analysis of the sector.

107) The Task Force urges financial institutions to pursue their recent KBI initiatives, with a focus on seed and venture capital, and to ensure a vigorous rate of investment in innovative KBI firms, subject to appropriate due diligence and prudential constraints.

108) The Industry Committee of the House of Commons should hold annual hearings on the state of KBI finance, at which the chief executive officers of the major banks would be invited to appear and update the Committee on the progress being made by their institutions to support the industries of the "new economy."

Financing Aboriginal Business

109) The Task Force endorses the recommendation of the National Aboriginal Financing Task Force that, subject to reasonable consensus within the aboriginal community, changes be made to federal legislation so that movable personal property situated on reserves may be used as security, thereby facilitating the provision of credit by financial institutions to aboriginal individuals and institutions.

110) The Task Force urges financial institutions to continue to pursue initiatives which are supportive of the economic development initiatives of aboriginal peoples and, for that purpose, to establish and maintain tailored, innovative financing programs.

111) The data collection programs to be undertaken by Statistics Canada and Industry Canada should include detailed information gathering on aboriginal financing issues to fill the void in data identified by the National Aboriginal Financing Task Force.

Improving the Regulatory Framework

OSFI Mandate and Governance

112) There should be revisions to the OSFI statutory mandate to better describe its ongoing responsibilities with regard to the federally regulated financial services sector.

(a) OSFI should have a clearly defined statutory responsibility to administer the consumer protection provisions of federal financial institutions legislation, including legislation in respect of disclosure and transparency, privacy and coercive tied selling.

(b) Given the importance of effective competition in the Canadian financial services sector and the rapidly changing competitive environment, the OSFI mandate should be revised to make it clear that OSFI has the responsibility to balance competition and innovation considerations with its present statutory obligations in respect of safety and soundness.

(c) It should be made clear in the OSFI mandate that OSFI is required to protect the rights and interests of depositors and policy holders, but that it has no special responsibility to other creditors of financial institutions.

113) The governance structure of OSFI should be strengthened to make it more appropriate to the increasingly complex needs of regulation and its revised mandate. To that end:

(a) The OSFI Act should be amended to provide for a board of directors for OSFI, made up of a majority of independent directors, including experienced independent businesspeople and persons familiar with consumer issues, together with the Superintendent of OSFI, the Chair of CDIC, the Governor of the Bank of Canada and the Deputy Minister of Finance. An independent director should serve as board chair.

(b) The board of directors would be responsible for:

(i) overseeing how OSFI conducts its business and administrative affairs;

(ii) approving major OSFI policies and strategies;

(iii) monitoring the achievement by OSFI of progress against its strategic plans and statutory mandate; and

(iv) ensuring that there is effective senior management, particularly in the position of the Superintendent, who should be appointed by the Minister of Finance on the recommendation of the OSFI board.

Regulatory Overlap

114) To eliminate regulatory overlap at the federal level, OSFI should have the sole responsibility for promoting standards of sound business and financial practices in financial institutions and for establishing policies and procedures to manage and control risk. To that end, the present overlapping statutory mandate of CDIC on these subjects should be repealed. OSFI should collaborate closely with CDIC in establishing business standards, financial practices and risk management policies, and should act on behalf of CDIC in monitoring compliance.

115) Governments should work aggressively to eliminate overlap in prudential regulation, both between the federal and provincial governments and among provincial governments. To that end:

(a) In consultation with provincial regulators, OSFI should establish a central, electronic data base which would permit common reporting formats and single-window electronic filings.

(b) The provinces should be encouraged to delegate solvency regulation of trust, loan and life insurance companies to OSFI so that, over time, prudential regulatory responsibilities for financial institutions could be consolidated in a single, well-resourced, and experienced regulator, applying common practices and international standards.

(c) To the extent that delegation cannot be achieved, the federal government and the provinces should harmonize the laws and regulations relating to trust, loan and insurance companies, including in particular the development of common capital adequacy tests and the recognition of home-jurisdiction regulation.

116) Regulatory procedures at the federal level should, wherever practicable, be streamlined. Among other things:

(a) Approvals of regulatory action should be taken at appropriate levels within government. Wherever practicable, the Superintendent of OSFI should be mandated to provide approvals without the need for referral to the Minister of Finance, except where matters of policy are involved.

(b) Decisions on the entry into Canada of foreign banks should, in routine cases, be made by the Superintendent of OSFI rather than the Governor-in-Council. Only in cases involving significant policy issues should the approval of the Minister of Finance be required.

(c) Wherever possible, approvals should be replaced with notice filings or eliminated entirely for non-material matters and in other circumstances in which there is little or no prudential risk.

(d) Mechanisms such as blanket or consolidated approvals and fast-track approvals or advance rulings should be developed to streamline the regulatory process.

To implement this proposal, a committee should be struck with representation from OSFI, the Department of Finance and the affected financial services industries to review streamlining options, with priority to be given to easing requirements which entail the greatest regulatory burden.

Consumer Insurance Plans

117) In order to promote effective competition between banks and insurers, to eliminate public confusion and to provide equivalent protection to Canadians, regardless of their choice of financial services provider, the insurance plans for federally insured deposit-taking institutions and life insurers should be amalgamated. The Task Force proposes that one of two possible models be adopted:

(a) The continuation of the Canada Deposit Insurance Corporation (CDIC) as a Crown corporation, with access to the Consolidated Revenue Fund, but with an expanded scope to cover the activities now conducted by the Canadian Life and Health Insurance Compensation Corporation (CompCorp).

(b) A new independent organization, established by statute and with provision for a liquidity backup borrowing authority from the Consolidated Revenue Fund, but without Crown corporation status.

Details of each of these structures as proposed by the Task Force are contained in Background Paper #5.

118) The amalgamated insurance plan would, in the first instance, maintain separate pre-funded insurance pools for deposit-taking institutions and for life insurers. It would also have the mandate to review and, where possible, to develop a common framework for priorities in insolvency, product coverage and other matters where there are now different legal rules or differing CDIC and CompCorp policies.

Provision of Financial Services from Outside Canada

119) The Bank Act should be amended to make it clear that all providers of financial services that undertake mass solicitations or target marketing of financial services to Canadians without establishing a physical presence in Canada are required to comply with federal financial institutions legislation. For a lender, such compliance would entail the need to obtain certification from OSFI, which would be available upon the lender's filing a binding undertaking to comply with consumer protection rules applicable to banks in Canada, to disclose that it is not regulated in Canada, and to provide a mechanism for dispute resolution in Canada.

120) The certification process would not be available to financial services companies wishing to take deposits from, or sell insurance products to, Canadians from outside Canada. Such providers would continue to be required to conduct these activities through a regulated Canadian subsidiary or branch.

121) The Task Force affirms its belief that an important element of consumer protection in an age of electronic service providers will be the provision of timely and accurate information, designed to inform consumers accurately about the status of providers. To that end, OSFI should regularly publish on its Web site, and periodically make visible to Canadians through other appropriate media and means, accurate information whereby consumers will be able to know:

(a) the companies that are regulated by OSFI or other Canadian regulators;

(b) the companies that do not have a physical operation in Canada but have obtained OSFI certification of their lending activities to Canadians; and

(c) the companies which OSFI believes to be offering financial services to Canadians illegally.

122) Industry Canada, as part of its deliberations to develop an appropriate framework for electronic commerce, should consider deeming Internet providers of financial services to have agreed to permit dispute resolution in Canadian courts and by the application of Canadian law, thereby providing Canadians who are wronged by such providers located outside Canada with a means of redress in Canada.

123) OSFI should actively participate in international discussions designed to develop an appropriate regulatory regime applicable to trans-border Internet providers of financial services so that Canadian law and regulatory practice, in a timely manner, incorporate international best practices to protect Canadian consumers.

124) Canada should continue to play an active role in international initiatives to improve standards and processes for the regulation of financial institutions and, where required, should make timely changes to Canadian financial sector legislation and regulatory practices to implement international best practices.

Chapter 11

Concluding Observations

We have presented an integrated set of recommendations.

Our recommendations will make Canada's financial services sector more vibrant and dynamic by enhancing competition. We see stronger and more aggressive credit unions and life insurance companies emerging to challenge the dominant position of the major banks. Mutual funds will become even stronger competitors as they gain access to the payments system. New, dynamic and well-financed competitors will enter our markets, both from abroad and domestically.

Our recommendations will make our financial services sector more responsive to consumers. We see empowered consumers making informed choices that will force institutions to provide consumer value in their products, pricing and service. Consumers will have a greater sense of security about the protection and use of their private, sensitive information, and easier and more effective access to corrective action when they have complaints.

Our recommendations will make our financial services sector healthier by strengthening the relationship between our financial institutions and the communities they serve. We see continued, substantial progress in making basic financial services accessible to all.

We see new, productive partnerships being formed with the voluntary sector and with community organizations. Further progress in financing small business and the new economy will take place, and our recommendations for data collection and analysis will increase our understanding of what the problems are and what needs to be done. The new Community Accountability Statements will provide a basis for constructive, focussed dialogue on how our financial institutions can serve Canadians better.

Our recommendations will make our financial sector regulatory framework more flexible and more forward-looking. We see the development of a new culture of prudential regulation that will strive to balance the need for safety and soundness with the need to facilitate competition and innovation in our financial system.

Our recommendations will create a public policy framework that is well positioned to respond to the challenges that change will bring.

Within this framework, Canada's institutions must develop their own business strategies to adjust to ever-changing realities in ways that build on their own strengths and that secure their ability to grow and prosper. Our recommendations will accelerate the trends to greater competition already in the marketplace, and they will make it imperative that our large banks and insurance companies, in particular, focus on which strategies are desirable for them.

Public policy should assist this process. In an increasingly competitive, global marketplace, strong and internationally competitive Canadian financial institutions bring benefits to all Canadians. A vibrant, dynamic Canadian-controlled industry, with major players active and competitive in world markets, provides benefits at home by importing best practices from around the world, by repatriating export earnings, and by assisting Canadian businesses to operate abroad. Competitive domestic institutions also contribute to thriving financial centres that offer value-added economic activity, innovation, higher tax revenues, and high-quality employment that can keep our talented young people in Canada.

We have recommended a process that can be used by the Government to judge whether further consolidation of our industry through merger is in the best interest of the country. This process is an open, transparent one that will get the facts on the table and allow informed judgments to be made, hopefully in an environment that can be as free from rhetoric and emotion as possible. We believe the process offers opportunity for Canadians to assess whether proposed mergers are in the public interest and, if they are not, to explore whether they can be conditioned or reconfigured so that opportunities for win-win situations are not missed.

Our recommendations, taken together, will help move us toward our vision of the financial sector that will best serve Canadians.

But we close with two cautions.

First, change is accelerating and time is short. We expect and look forward to public discussion of our report. We also urge, however, that debate be focussed and that action be timely. To delay is to deny opportunities that we think can be achieved and to make the challenges facing us harder to manage.

Second, a framework is merely a framework. It is important, but change will come through the actions of leaders, entrepreneurs and innovators. Allowing banks to be started more easily doesn't mean that they will be. Providing greater transparency of documents doesn't mean that consumers will take the time to read them or to make responsible decisions. Giving the Government more regulatory flexibility doesn't mean that it will be well used. All Canadians have a role to play, in their own spheres of influence, if we are to work successfully together toward achieving our vision.

Appendix 1:

Terms of Reference

Given that:

- access to a full range of financial services at reasonable prices is important for Canadian consumers and Canadian businesses;
- an efficient, safe and sound financial services sector is essential if Canada is to succeed in the pursuit of its goals of economic growth and job creation;
- the financial services sector, with more than 500,000 employees, is itself an important sector of the Canadian economy;
- the financial services industry is now a globally competitive industry;
- the changing nature of financial products is affecting the degree and types of risks borne by financial institutions;
- globalization and developments in technology have dramatically changed, and will continue to change, the environment in which the financial services industry operates; and
- the rapidity of changes in this sector necessitates a review,

a Task Force on the Future of the Canadian Financial Services Sector is established. The Task Force will inquire into public policies affecting the financial services sector and make recommendations to enhance:

1) the contribution of the sector to job creation, economic growth and the new economy;
2) competition, efficiency and innovation within the sector;
3) the international competitiveness of the sector in light of the globalization of financial services, while at the same time maintaining strong, vibrant domestic financial institutions;
4) the ability of the sector to take full advantage of technological advances as they occur and to meet the competitive challenges resulting from the introduction of new technologies; and
5) the contribution of the sector to the best interests of Canadian consumers.

The Task Force will supervise research and analysis of relevant issues which it considers necessary to provide the basis for arriving at recommendations and will draw upon the Payments Systems work of the Department of Finance and

its Advisory Committee as appropriate. It may make recommendations on the full range of public policy issues that affect the environment within which financial service providers operate. The Task Force will report to the Minister of Finance with its findings and recommendations by September 1998.

Appendix 2:

List of Submissions and Presenters

List of individuals and organizations providing submissions to the Task Force

Abshez, C.
Accord Business Credit Inc.
Ackerman, J.
Acorn Partners Ottawa
Ad Hoc Committee on Islamic Financial Institutions, Canada
AGF Management Limited
Alberta – Provincial Treasurer
Association des courtiers d'assurance de la province de Québec
Association des intermédiaires en assurance de personnes du Québec
Association of Canadian Financial Corporations
Association of Canadian Insurers
Association of International Automobile Manufacturers of Canada
Assurlife Group, The

Ballan, E.
Bank of Montreal
Bank of Nova Scotia, The
Bélanger, H.
Bélisle Automobile
Bellan, S.
Berrigan, G.
Biddell, J.L.
Bleakney, D.
Bousquet, J.J.
Box, B.A.
Brender, A.
Brière, J.
British Columbia – Ministry of Finance and Corporate Relations
British Columbia Automobile Association
Bullock, J.P.

Caisse Centrale Desjardins
Caldwell Securities Ltd.
Calgary West Insurance Ltd.
Canaccord Capital Corporation
Canada Trust
Canadian Alliance of Individual Investors
Canadian Association of Factors and Credit Insurers
Canadian Association of Financial Institutions in Insurance
Canadian Association of Insurance and Financial Advisors
(formerly Life Underwriters Association of Canada)
Canadian Association of Mutual Insurance Companies
Canadian Automobile Dealers Association
Canadian Bankers Association
Canadian Banking Ombudsman, The
Canadian Community Reinvestment Coalition
Canadian Federation of Independent Business
Canadian Finance & Leasing Association
Canadian Fraternal Association
Canadian Imperial Bank of Commerce
Canadian Institute of Chartered Accountants
Canadian Labour Congress
Canadian Life and Health Insurance Association Inc.
Canadian Life and Health Insurance Compensation Corporation
Canadian Payments Association
Canadian Real Estate Association, The
Canadian Retail Building Supply Council
Canadian Vehicle Manufacturers' Association
Canadian Youth Foundation
Capital One Financial Corporation
Carney, L.
Chelton Group
Chrysler Credit Canada Ltd.
Collerman-Elias, D.
Committee on Monetary and Economic Reform
Competition Bureau (Industry Canada)
Consumers' Association of Canada
Co-operators Group Limited, The
CoreStates Financial Corp
Credit Union Central of Canada
Credit Union Central of Ontario
Crowell, A.
Crown Life Insurance Company

Daily Bread Food Bank
Deutsche Bank of Canada
Dimond, S.
Dixon, C.M.
Dorais, P.
Dubé, W.E.

Eidelman, J.M.
Enchin, E.
Equal Justice for All Organization Inc.
Equifax Canada Inc.
Ernst & Young
Ernst, R.

Fair Isle Ford Sales
Fegan, W.
Fitzpatrick, D.
Ford Credit Canada Limited
Fort York Small Business Association
Fournier, G.
Fulton, G.M.
FundSERV Inc.

Garand, D.
General Motors Acceptance Corporation of Canada, Limited
Georgian Bancorp Inc.
Gollinger, B.
Greenspan, H.
Grubel, H.G.
Guarantee Company of North America, The

Heide, I.
Hodgson, K.L.
Hogan Group, The
Holt Agencies Insurance Ltd.
Hongkong Bank of Canada
Hyndman & Company Ltd.

IFC Vancouver
Independent Investment Dealers
Independent Life Insurance Brokers of Canada
Insurance Brokers Association of Canada

Insurance Consumer's Group
Insurance Council of Canada (formerly Insurance Bureau of Canada)
Interac Association
International Molecular Reactor Power Co. Inc.
Investment Dealers Association of Canada
Investment Funds Institute of Canada, The
Irwin, D.A.

Jones, J. & M.A.

Kelly, F.
Kings Mutual Insurance Company, The
Kivenko, K.

L'Entraide, Mutual Life Insurance Company
Laba, P.
Lackie, J.
Lafferty, Harwood & Partners Ltd.
Laimon, S.
Lancaster, J.
Laurentian Bank of Canada
Lefebvre, J.
Leland, D.
Lewis, R.
LIFE*SPIN
Lloyd, J.E.
Lloydminster Credit Union
Local Anti-Poverty Organisation
London Life Insurance Company
London Life Policyholders' Association
Lord, R.C.
Lowry, D.

Macdonald, B.
Mackenzie Financial Corporation
Mackenzie, M.
Manitoba – Minister of Consumer and Corporate Affairs
Manufacturers Life Insurance Company, The
McKenzie, A.R.
McMurtry, J.
Menka, F.

Mennonite Central Committee Employment Development
Merkas, D.
Metro General Insurance Corporation Ltd.
Michael Doyle & Associates
Montréal Automobile Dealers Corporation, The
Motels Ontario
Musgrave, A.
Mutual Life of Canada

National Action Committee on the Status of Women
National Bank of Canada
National Council of Welfare (Canada)
National Council of Women of Canada, The
New Brunswick – Premier
Newcourt Credit Group
Newell, J.C.
Nolan, N.
Nordic Communications Corp.
Norwest Financial, Inc.
Nova Scotia – Minister of Business and Consumer Services

O'Regan National Leasing
Office of the Superintendent of Financial Institutions (Canada)
Option consommateurs (formerly ACEF-Centre)

Padlesky, D.
Portage La Prairie Mutual Insurance Company, The
Power Financial Corporation
Privacy Commissioner of Canada
Public Interest Advocacy Centre

Quebec Association for the Protection of Savers and Investors Inc.

R.E.A.D.Y. Centre, The
Rankin-Stokes & Associates Inc.
Regroupement des assureurs de personnes à charte du Québec
Regroupement des cabinets de courtage d'assurance du Québec
Reniers, P.
Results Canada
Riddell, W.
Rideout, G.

Robertson, M.
Roy, J.
Royal Bank of Canada
Royal Insurance Company of Canada

Samson, D.B.
Saskatchewan Action Committee, Status of Women
Saskatchewan Federation of Labour
Secor
Self Employment Development Initiatives
Senior Power of Regina
Sharwood and Company
Silbernagel, M.E.
Slawsky, B.
Smith, B.J.
Southern Cross Sheepskins Inc.
Speers, R.D.
Spourdalakis, C.
Standard Life Assurance Company
Starbuck, S.
Stein, B.
Suikki, C.
Sun Life Assurance Company of Canada
Szolnyanszky, T.

Taskforce on the Churches and Corporate Responsibility
TelPay/CTI-ComTel Inc.
Toews, K.
Toronto Small Business Support Organization
Toronto-Dominion Bank
Trans Canada Credit Corporation
Travis, R.
Trimark Investment Management Inc.
Trust Companies Association of Canada, The
Tsutsumi, C.
Tucker, R.

United Way of Greater Toronto

Veith House, The
Vipond, V.R.
Voluntary Sector Roundtable
Voogd, H.

Ward, W.D.
Watson, M.L.
Wawanesa Mutual Insurance Company
Wells Fargo & Co.
White, A.M.S.
Women & Rural Economic Development
World Sceptre Challenger

Yonge Street Small Business Association

Participants in the Task Force Outreach Program

Charlottetown, September 3, 1997
Fair Isle Ford Sales
Hyndman & Company Ltd.
Insurance Company of PEI

Halifax, September 4, 1997
Campbell, T.
Canadian Bankers Association
Kings Mutual Insurance Company, The
O'Regan National Leasing
Veith House, The

St. John's, September 5, 1997
John Howard Society
Metro General Insurance Corporation Ltd.
R.E.A.D.Y. Centre, The
St. John's Board of Trade

Vancouver, September 15, 1997
British Columbia Automobile Association
Canadian Banking Ombudsman, The
Grubel, H.G.
Honda City
Insurance Brokers Association of British Columbia
Results Canada

Calgary, September 16, 1997
Credit Union Central of Alberta
Kosh Lincoln Mercury Sales
Mennonite Central Committee Employment Development
Peace Hills Trust
Results Canada
Shaw GMC Pontiac Buick
World Sceptre Challenger

Regina, September 18, 1997
Crown Life Insurance Company
First Nations Bank of Canada
Lancaster, J.
Pacific & Western Trust
Saskatchewan Action Committee, Status of Women
Saskatchewan Federation of Labour
Senior Power of Regina

Winnipeg, September 18, 1997
Feinberg, D.
Insurance Brokers Association of Manitoba
Portage La Prairie Mutual Insurance Company, The
TelPay/CTI-ComTel Inc.
Wawanesa Mutual Insurance Company
Western Canadian Wheat Growers Association

Ottawa, October 6-7, 1997
Acorn Partners Ottawa
Bélisle Automobile
Canadian Community Reinvestment Coalition
Canadian Payments Association
National Council of Welfare (Canada)
National Council of Women of Canada, The
Newcourt Credit Group
Price Waterhouse
Standards Council of Canada

Montreal, October 8-10, 1997
Association des intermédiaires en assurance de personnes du Québec
Assurlife Group, The
Canadian Life and Health Insurance Association Inc.
Imasco Limited
Insurance Consumer's Group
Lafferty, Harwood & Partners Ltd.
Montréal Automobile Dealers Corporation, The
Option consommateurs (formerly ACEF-Centre)
Quebec Association for the Protection of Savers and Investors Inc.
Regroupement des assureurs de personnes à charte du Québec
Regroupement des cabinets de courtage d'assurance du Québec
Results Canada
Roy, J.

Toronto, November 10-14, 1997
Ackerman, J.
Ad Hoc Committee on Islamic Financial Institutions, Canada
Association of Canadian Insurers
Association of International Automobile Manufacturers of Canada
Bellan, S.
Canadian Alliance of Individual Investors
Canadian Association of Factors and Credit Insurers
Canadian Association of Insurance and Financial Advisors
(formerly Life Underwriters Association of Canada)
Canadian Association of Mutual Insurance Companies
Canadian Automobile Dealers Association
Canadian Bankers Association
Canadian Federation of Business and Professional Women's Clubs –
Ontario Board
Canadian Fraternal Association
Canadian Institute of Chartered Accountants
Canadian Vehicle Manufacturers' Association
Canadian Youth Foundation
Capital One Financial Corporation
Committee on Monetary and Economic Reform
CoreStates Financial Corp
Credit Union Central of Canada
Credit Union Central of Ontario
Daily Bread Food Bank
Dominion of Canada General Insurance Company, The
Fort York Small Business Association
General Electric of Canada
Greenspan, H.
Independent Life Insurance Brokers of Canada
Insurance Brokers Association of Canada
Insurance Council of Canada (formerly Insurance Bureau of Canada)
International Molecular Reactor Power Co. Inc.
Investment Dealers Association of Canada
Investment Funds Institute of Canada, The
LIFE*SPIN
Local Anti-Poverty Organisation
Nicholas, T.
Nordic Communications Corp.
Power Financial Corporation
Royal Bank of Canada – Banking Ombudsman
Self Employment Development Initiatives

Sharwood and Company
Speers, R.D.
Standard Life Assurance Company
Sutherland, I.
Taskforce on the Churches and Corporate Responsibility
Toronto Small Business Support Organization
Trust Companies Association of Canada, The
Wells Fargo & Co.
White, A.M.S.
Women & Rural Economic Development
Yonge Street Small Business Association

Appendix 3:

List of Research Studies

The Changing Landscape for Canadian Financial Services
New forces, new competitors, new choices
by McKinsey & Company

Competition Policy Issues
by Donald G. McFetridge, Carleton University

Ownership Restrictions and the Value of Canadian Bank Stocks
by Gerald Garvey and Ron Giammarino,
University of British Columbia

Impact of Taxation on the Financial Services Sector
by Kevin J. Dancey Coopers & Lybrand

Canadian Financial Institutions and their Adoption of New Technologies
by Ernst & Young

Corporate Banking Relationships in Canada: The CFO View
by The Conference Board of Canada

Background Report on Extending Bank Powers to Include Light Vehicle Leasing
by DesRosiers Automotive Consultants Inc.

Consumers in the Financial Services Sector
Volume 1: Principles, Practice and Policy – the Canadian Experience
Volume 2: International Experience
Edited by Robert R. Kerton, University of Waterloo

Financing Entrepreneurial Firms: Legal and Regulatory Issues
by Allan L. Riding, Carleton University

Financing Knowledge-Based Small Business
by Groupe Secor Inc.

Privacy and Financial Services in Canada
by Richard C. Owens, Smith Lyons

Canada's Social Payment Disbursement System and the Financial Services Sector
Moving to a Mandatory Direct Deposit Scheme: The Case of Alberta
by Michael Grant, Grant Insights

Deposit Insurance and Other Compensation Arrangements
by A. Warren Moysey

Public Opinion Research Relating to the Financial Services Sector
by Ekos Research Associates Inc.

The Property/Casualty Insurance Industry
by Coopers & Lybrand

Mechanisms for Public Participation in Economic Decision-making
1. A Description of Experiences
2. Three Case Studies of Foreign Bank Mergers
by Jean Roy, Ph.D.

Corporate Restructuring: Workforce Adjustment Strategies
by The Conference Board of Canada

The Canadian Venture Capital Industry
Sources of Capital and Implications for Industry Structure
by Macdonald & Associates Limited

Appendix 4:

Interim Report of July 1997

July 11, 1997

The Honourable James Peterson, P.C., M.P.
Secretary of State
International Financial Institutions
140 O'Connor Street
21st floor, East Tower
Ottawa, Ontario
K1A 0G5

Dear Minister:

I am pleased to submit, on behalf of the Task Force, the attached Report which responds to your letter of June 24, 1997 requesting the preliminary views of the Task Force on appropriate criteria which the Government should take into account in reviewing particular transactions.

The Report represents the unanimous view of the Task Force on the issues considered.

The Report sets out a framework for consideration of transactions of the type you have asked us to consider. Such transactions exclude the merger of Schedule I banks and any transactions that would require a change to the current 10% ownership rule for Schedule I banks.

We note that you have not asked us to consider specific transactions and we have not done so. We would add that we do not believe such consideration would be within our mandate and, indeed, as we set out in the Report there are others who have the responsibility and the tools to conduct such reviews. The framework we propose is intended to help those with such responsibility to conduct their reviews and their assessments.

The framework contains recommendations of general applicability to such transactions, outlines a process that should be followed by the Director of the Competition Bureau, the Superintendent of Financial Institutions and the Minister of Finance in reviewing specific transactions, and suggests a number of criteria that should be considered in such assessments.

The Report recommends that:

1. a “big shall not buy big” policy, as it affects transactions between entities other than two Schedule I banks, should not have general application and that any such proposed transactions be reviewed for approval on their merits.
2. the impact of mergers on the state of competition (both wholesale and retail) in local or regional markets should be given careful attention and efforts should be made to develop practical operational definitions of such markets.
3. the Director of the Competition Bureau seek, and the parties to such transactions supply, a waiver under Section 29 of the Competition Act that would allow the Director to share information, subject to appropriate arrangements to protect confidentiality, with OSFI and the Department of Finance.
4. the Superintendent of Financial Institutions acting with other appropriate regulatory bodies should, where transactions are approved, put in place at the outset arrangements to ensure that customers are informed, in a meaningful way, of the relationship between the two institutions that would be under common ownership, including appropriate information on the relevant product insurance or compensation plans that apply.

These recommendations are of general applicability to the class of potential transactions we have considered.

In assessing any specific transaction, we suggest a number of criteria that should be applied by the Director, the Superintendent and the Minister. These include Competition, Safety and Soundness, and the Public Interest.

With respect to the public interest, we specify that among the factors that the Minister may wish to consider, he give particular attention to the impact of any proposed transaction on international competitiveness, benefits to customers, employment, the adoption of innovative technologies, and the precedential impact of the transaction.

Our reasoning behind the recommendations and our discussion of the criteria are contained in the Report.

I hope you find the Report helpful and I wish to assure you that members of the Task Force and its staff would be pleased to discuss the analysis and recommendations in this letter with you or your officials.

Sincerely,

Pierre Y. Ducros
Interim Chairman

Report of the Task Force on the Future of the Canadian Financial Services Sector in response to a request by the Secretary of State (International Financial Institutions)

July 11, 1997

I. Introduction

This Report is the Task Force's response to your letter of June 24, 1997, requesting the preliminary views of the Task Force on the appropriate criteria the Government should take into account in reviewing particular transactions. The Report contains recommendations as to the policy framework and analytical approach that the Government should use to assess such transactions. It also sets out criteria that should give guidance to such assessment. It does not attempt to apply the framework, approach or criteria to any specific transaction. You have not asked us to do this. Moreover it is something the Task Force was not created to do and would be reluctant to undertake. Also, you are not requesting at this time our views on the 10% widely-held rule for domestic banks, or the appropriateness of a merger of Schedule I banks.

Although our work is at an early stage we have concluded that we can responsibly provide you with this Report. We stress, however, that the Report has been prepared without benefit of public discussion, submissions on the issues raised in the Discussion Paper, and the results of the research in progress. We therefore ask you to recognize that we will undoubtedly be reviewing these issues further and that our recommendations at this time do, indeed, represent "preliminary views." We understand that you intend to make this Report public and we endorse that approach. We believe that the issues we address in this Report are important and that the process that you are about to follow with respect to the particular transactions to which you must respond, as well as our ongoing process of preparing a final report, will benefit from public comment on this Report.

II. Background

There are three main points of background to this Report that we wish to emphasize:

i) It is important to recognize that the past ten years have seen an increasing integration of financial services not only in Canada but in all countries. Our preliminary research has indicated clearly that technology, demographics, and globalization are driving a process of consolidation in the financial services sector and the pace of that consolidation is accelerating. The ways in which people are choosing to save and invest are changing, and technology

is facilitating the ability of providers, including new providers, to meet customer needs more effectively. New competitors are emerging, new alliances are being formed, new and innovative product offerings are being developed, and new distribution channels are emerging. Many organizations are being redefined along functional lines as major financial service providers increasingly seek to serve global markets and the standards needed to be internationally competitive continue to increase.

In every major country, legislative regimes are under review to ensure that they facilitate the effective adaptation of the financial services sector to these forces of change, so that the sector can continue to serve the efficient operation of the economy, contributing to economic growth, customer choice and employment. This Task Force has been set up to examine these issues, but it is important to note that Canada's legislative framework for the financial services sector has already evolved considerably in ways that support these trends. Canada has over the past decade, been on the leading edge of change in the framework governing the regulation and supervision of financial institutions. It is important that this be maintained.

ii) We note that there is nothing of general applicability in current legislation that precludes transactions considered in this Report from going ahead. Indeed, from 1992 forward, our legislative framework has allowed banks to own trust companies or insurance subsidiaries; insurance companies can own trust companies and widely-held insurance companies can own Schedule II banks. In response to this legislative freedom, many insurance companies now have deposit-taking subsidiaries, all major banks now have trust company subsidiaries and almost all major banks have insurance company subsidiaries.

Transactions such as those considered in this Report may be subject to review under the *Competition Act*, and in the course of such review issues may arise that call into question, on the basis of anti-competitive impacts, whether such transactions should be allowed to proceed. Any such issues would, however, result from the specifics of such transactions and not from any general legislative prohibition. Similarly, such transactions require the approval of the Minister of Finance. The Minister, in reviewing the specifics of such transactions, may conclude that they are not in the public interest and should not be approved. Again, we stress that such a conclusion would be based on the specifics of such transactions rather than any general legislative prohibition.

iii) Notwithstanding the legislative framework, there is a general perception that Government policy has, for some time, precluded large financial institutions from acquiring other large financial institutions. This "big shall not buy big" policy has no legislative base. It appears to reflect two concerns:

the first is that a merger of two major players could give rise to anti-competitive behaviour; the second is that as the traditional four pillars began to break down in the mid-1980s it was felt desirable that institutions have an opportunity to adjust to the new competitive challenges and opportunities free from the immediate threat of major new competitors emerging as a result of the consolidation of industry leaders.

III. Relevant Factors

Against these three background points, we wish to record the following relevant factors that have helped shape this Report:

1. With respect to these types of transactions, you are seeking preliminary views on criteria that would apply ***within the existing legislative framework***. While we accept that assumption for purposes of this Report, we caution that our further work could result in proposals to change the legislative framework in ways that might affect transactions such as these in the future.
2. The major question at issue is whether "big shall not buy big" should apply as a general policy, for transactions not involving the merger of two Schedule I banks.
3. The process for reviewing these transactions will involve: obtaining clearance from the Director under the *Competition Act*; obtaining a recommendation from the Superintendent of Financial Institutions with respect to prudential consequences of the proposed transactions; and, finally, review by the Minister of Finance taking into account these factors and any other relevant factors.

IV. Approach

Our approach to the issues considered in this Report is set out in Sections 1.10 and 1.11 of the Discussion Paper released June 13, 1997. In brief, we feel that Government intervention in the market should be limited to that necessary to give effect to public policy objectives and that where Government does intervene, care should be taken that the degree of intervention does not exceed what is reasonably necessary to attain these objectives. We put considerable emphasis on the roles that competition and disclosure can play as controllers of market conduct. We believe that effective competition and disclosure, together with well-targeted regulation, will provide an environment wherein the ability of financial institutions to adapt successfully to the forces of change will be maximized. Successful adaptation of the sector to those forces will enhance its efficiency and competitiveness. A healthy, well-functioning, competitive financial sector will enhance economic growth, customer choice in financial services, and employment.

This approach is buttressed by our analysis to date of the structure of the financial services sector. On conventional economic tests, the sector as a whole contains no dominant player and is exposed to the forces of competition. As at December, 1996, the major chartered banks are the largest participants in the sector. Together the six major banks account for 62% of deposits, 50% of residential mortgage loans, and 65% of consumer loans. But the largest of them accounts for only about 17% of deposits, 13% of residential mortgage loans, and 16% of consumer loans. The five largest life and health insurance companies have 47% of the market for individual life insurance, with the largest company having 16% of the market. The property and casualty insurance sector is less concentrated, with the five largest firms having 28% of the market.

The preceding paragraphs are not intended to suggest that there are no anti-competitive implications in such transactions, or that the overall state of competition in the Canadian financial services sector is as healthy as it might be. And we caution that, as transactions such as the types considered in this Report are reviewed, concerns about competition should extend beyond considerations of whether the transactions themselves would result in anti-competitive impacts and include questions of whether the overall framework of regulation encourages competition to the extent it might. In this connection we note the recent measures that the Government proposed with respect to foreign bank branching as positive and we return to this issue of competition when we discuss Benefits to Customers later in this Report.

V. Recommendations and Criteria to be Applied

On the basis of the background we have sketched above, the relevant factors we have identified, and our approach, we set out below four general recommendations and a number of criteria that we conclude should be examined by those responsible for reviewing the specific transactions.

1. **We recommend that a “big shall not buy big” policy, as it affects transactions between entities other than two Schedule I banks, should not have general application and that any such proposed transactions be reviewed for approval on their merits.**

We expect that any transactions that may be considered between now and the time the Task Force reports will be considered within the existing legislative framework, and we also indicated the possibility that the Final Report of the Task Force might recommend changes to the legislative framework that would affect such transactions. We do not expect the world to wait for our Final Report. Changes are taking place quickly, decisions must be made and it would be unrealistic to put everything on hold until our processes have concluded. We do believe, however, that if the Government in response to our Final Report

makes legislative changes that would affect transactions that occur after our Final Report is submitted, such changes should – to the degree practical – also apply to any transactions that are approved between the submission of this Report and our Final Report. We want to be clear that we are not proposing that completed transactions be unwound. But if there are conditions of behaviour that are sought from participants in future transactions then it seems reasonable to us that such conditions be sought from participants in the type of transactions we are now considering, to the extent it is feasible for such conditions to be met.

Once it is determined that a specific transaction should not be prohibited by the "big shall not buy big" rule, it should be assessed on its merits. Prior to consideration by the Minister, such transactions should be reviewed by the Director of the Competition Bureau in order to assess whether the merger results in a substantial lessening of competition, and by the Superintendent to assess safety and soundness considerations. There is no reason why these reviews need be sequential in timing. They could proceed together.

Then the Minister, with advice from the Superintendent, would consider the request for approval, applying criteria felt to be relevant to a determination of the public interest. For analytical purposes, we assume the Superintendent deals primarily with safety and soundness while the Minister deals with the public interest elements, although we recognize that in practice there is no such sharp distinction between their areas of responsibility.

In what follows, we comment on the criteria that we think should be employed in assessing Competition, Safety and Soundness, and the Public Interest.

A. Competition

In considering competition we draw a distinction between wholesale and retail markets. In wholesale markets it is generally the case that customers are large, relatively sophisticated, and have access to multiple suppliers of financial services, both domestic and international. It is true that there are exceptions to this, but as a general presumption it is a useful distinction between wholesale markets and retail markets where, more often, individual customers (including small businesses) are provided with financial services by suppliers that tend to be resident in a specific geographic area. Again, one can find exceptions for some services provided to retail customers (such as credit cards) but as a general characterization we think this distinction between retail and wholesale is a useful one.

The operational significance of this distinction is to underscore the necessity to examine the potential anti-competitive impacts of transactions such as those considered in the Report in terms of "local or regional" markets. As we use the

term, a local market is one in which a particular segment of customers in a particular geographic area is highly dependent on providers of particular financial services products that are resident in that area. The paradigm situation today may well be retail depositors in a geographical area, but small business lending is likely also to be within this category.

The appropriate geographic area for analysis is not obviously apparent nor is the list of financial products that fall within this definition. The definition of a local market in an antitrust context is important but could become a very labour-intensive process when considering the impact of a financial sector merger. The Task Force recognizes this and also recognizes that, as technology continues to change the nature of financial services products and the way in which they are offered, operational definitions of both "locality" and product range will continue to evolve.

The economic and legal literature, the established practice of the Competition Bureau and experience in other countries is broadly consistent with our emphasis on local markets as being the prime concern in an assessment of the potential anti-competitive impact of a merger. But there is a lack of consensus as to the methodology by which to assess the extent of the competitive impact in those markets.

2. **The Task Force recommends that the impact of mergers on the state of competition (both wholesale and retail) in local or regional markets should be given careful attention and efforts should be made to develop practical operational definitions of such markets.**

A merger can have favourable impacts, bringing to customers the benefits of efficiency and cutting-edge competition. In assessing potential negative impacts, the emphasis in competition law generally is on the ability of the merged entity to dictate and sustain a price increase, although other factors such as choice, quality and innovation are also considered. In the financial services sector related issues such as the potential for discriminatory pricing and coercive tied selling may merit greater concern than is generally the case with mergers in other sectors of the economy. This may be of particular importance when the influence of a merged entity in a specified geographic area results in substantial market positions in a number of complementary products, such that the potential for discriminatory pricing or coercive tied selling is less easily diminished by the ready availability of competitive offerings.

This is a topic we will analyse in our ongoing work. We cannot at this time predict whether any recommendations will emerge for changes in policy or regulations to address the issues, although we do not expect that our recommendations would lead to denial of any mergers that would pass scrutiny under the analysis set out in this Report.

We are also addressing in our work the more traditional concern of competition law with the ability of the merged entity to dictate and sustain a price increase. In March 1991, the Director published Merger Enforcement Guidelines that contain percentage principles to guide the Director in this analysis. If the Director follows these guidelines (which he is not obligated to do), it would mean that he would not challenge a merger transaction based on impact on competition within a market unless the transaction results in market shares that exceed these thresholds.

At this stage of our work we are not in a position to reach a firm conclusion about the appropriateness of these guidelines to mergers of financial institutions. We intend to pursue this issue in our research and may be prepared to offer more definitive conclusions in our final report.

Section 29 of the *Competition Act* precludes the Bureau from disclosing any information to which it is entitled to conduct its examinations "except to a Canadian law enforcement agency or for the purpose of the administration or enforcement" of the *Competition Act*. The Director can, with the approval of the merging parties, disclose to other parties information provided to him and his position relating to this information.

3. **The Task Force recommends that the Director of the Competition Bureau seek, and the parties to such transactions supply, a waiver under Section 29 of the *Competition Act* that would allow the Director to share information, subject to appropriate arrangements to protect confidentiality, with OSFI and the Department of Finance.**

B. Safety and Soundness

We have not conducted research as to the analysis used by the Superintendent of Financial Institutions in the application of safety and soundness standards to the consideration of a proposed acquisition or merger. This is, obviously, a critical element of the approval process but we have no reason to believe that any change is needed in the approach adopted to date by the Superintendent.

We expect the Superintendent will take into account any potential dilutive impact of a transaction on the capital of the merging institutions, and the accounting implications, for example as to the treatment of goodwill.

Among the additional questions to be considered in a safety and soundness analysis is whether prudential considerations flow from differences in activities of the merging institutions. In the United Kingdom, for example, there has been discussion of the prudential implications of a merger between a major bank and a major life insurance company. The discussion focuses on differences in the types of risk undertaken by the two businesses, on accounting differences and

on how best to formulate capital requirements for the consolidated enterprise. We do not refer to these considerations by way of suggestion that they should defeat such a transaction, but rather as matters the Superintendent should consider in the course of the safety and soundness review.

The Superintendent should identify any transaction-specific concerns that merit consideration. For example, the Superintendent might wish to consider all of the transparency implications if the acquiring institution proposes to continue to distribute products of the acquired institution under a name that is different from the acquiring institution. We recognize that this is an issue that concerns the Superintendent and on which the Office has acted in past transactions.

4. **The Task Force recommends that the Superintendent of Financial Institutions acting with other appropriate regulatory bodies should, where transactions are approved, put in place at the outset arrangements to ensure that customers are informed, in a meaningful way, of the relationship between the two institutions that would be under common ownership, including appropriate information on the relevant product insurance or compensation plans that apply.**

C. The Public Interest

Under the process outlined above, the Minister of Finance must assess the broad public interest considerations that ought to be brought to bear. In our view, if a financial institution merger of the type considered in this Report does not have anti-competitive considerations and does not involve difficulties from a safety and soundness standpoint it ought ordinarily to be approved, subject to considerations such as those noted below. In appropriate cases it is and should be open to the Minister to consider other policies. Areas where consideration could well be appropriate include:

- The impact of a proposed transaction on the international competitiveness of the financial system; on the benefits to customers, on employment; and on the adoption of innovative technologies.
- The precedential implications of the transaction for the development of the financial system.

International Competitiveness

As discussed above, financial services are going through a major transition in all countries. Some analysts conclude that the financial market for wholesale services is now effectively global and that technological advance is leading quite rapidly to a similar internationalization in the supply of retail services. These trends imply greater choice and lower prices for customers. They also imply that competition worldwide will continue to intensify.

Our major domestic institutions (both banks and life insurance companies) have historically conducted a considerable part of their business and derived substantial revenues from their operations outside of Canada. Their success abroad has been based in large part on their strength in the domestic market and has, in turn, enhanced their ability to serve Canadian customers well. The Task Force is undertaking research to understand better the relation between size and international competitiveness. This research is at an early stage and we have no firm conclusions to put forward at this time. But we do believe that it is important to recognize that we have been well served in Canada by financial institutions that have, historically, been internationally competitive and the extent to which such transactions contribute to more internationally competitive enterprises should be an important criterion in the Minister's assessment.

Benefits to Customers

The Task Force believes that transactions such as those under consideration should provide benefits to customers. We use the word customer in the most general sense as including both individuals and businesses, small and large, that use the services of financial institutions. A finding under the *Competition Act* that such transactions do not substantially lessen competition is a necessary condition for such benefits to be provided. As indicated above we assume that such examination will extend to the assessment of potential for anti-competitive practices that go beyond pricing to include behaviour such as price discrimination and coercive tied selling. Even where it is concluded, however, that competition is not substantially lessened it does not automatically follow that the competitive structure in the marketplace (and particularly in some markets) will be robust enough to provide reasonable assurance that the efficiencies, synergies and innovative results of the transactions will be reflected in benefits to customers in the short term as well as in the longer run. It is open to analysis and examination as to whether such transactions need to be reviewed with regard to their particular impacts on, for example, access to financial services for low income Canadians, confidentiality of personal information, and availability of finance to small businesses or knowledge based industries.

At this stage in its deliberations the Task Force has no specific recommendations to make in this area. It does recognize, however, that these concerns that impact on the benefit to customers may be best examined in the context of the specific characteristics of individual transactions.

It is also important that individual transactions be examined against the background of existing and potential competition in particular sectors. To the extent that the general policy framework is conducive to new sources of competition, one can be more confident that the market environment will lead to

customers reaping the expected benefits of such transactions. This is an important area that the Task Force will examine.

Employment

The impact of transactions on employment is a significant criterion in assessing the public interest. It is important to distinguish between indirect and direct effects, and long-term and short-run impacts. By indirect effects we refer to the impact on employment elsewhere in the economy that comes from the contribution of the transaction to efficiency and economic growth, as distinct from the direct employment impacts of the transaction itself. Long-term impacts include not only the indirect impacts on the rest of the economy, but also the longer-term direct impacts that result from the future growth of the merged entity. Short-term impacts refer to the employment consequences of merging the operations of the parties to the transaction.

One would normally expect the indirect impacts to be positive and the longer-term direct impacts might be positive or negative, depending upon the nature of the transaction. Short-term impacts will usually be negative.

An important consideration to take into account in assessing employment impacts is the rapid internationalization and increasing competitiveness of the worldwide financial system. Canada is not an island unto itself, and it is unlikely that attempts to preserve the status quo in a rapidly changing world will best serve the public interest. The Task Force believes that mergers that can be shown to increase competitiveness, enhance innovation and benefit customers will – over the longer term – contribute to greater economic growth and greater employment opportunities for Canadians than we would otherwise enjoy. But in the short run there will most likely be transitional impacts that result in job loss.

The Task Force intends to examine these issues further. It will consider areas such as the importance of attrition and severance and retraining packages and it may, in its Final Report, provide conclusions and recommendations about ways in which transitional impacts can be most appropriately managed. At this stage of our work, we flag this as an important public policy issue for the Minister to take into account in reviewing the transactions.

The Adoption of Innovative Technologies

This is an area in which the Task Force has commissioned research that will provide insight as to the effectiveness of our domestic financial institutions in adopting new technologies that can provide a broader range of choice to customers and contribute to a vibrant financial sector. The changes that are taking place in the world are leading to a competitive advantage for institutions that can maintain themselves at the leading edge of technological developments. To

do so increasingly requires relatively large expenditures. The Minister of Finance should consider whether transactions have a positive or negative impact on the capacity of institutions to adopt innovative technologies.

Precedential Impact

As a final comment, we point out that approval for certain transactions – in the context of relaxing the "big shall not buy big" rule – may have precedential impact on decisions in the sector. We do not feel that these potential impacts are so serious at this time to cause us to reconsider our recommendation that the "big shall not buy big" rule not apply. However, we recognize that this is an issue that the Minister may legitimately wish to address.

VI. "Failing Firms" Doctrine

There is a well-recognized exception in competition law to accommodate a merger that rescues a failing firm, even if the merger might not otherwise have been acceptable. Historic practice of the Minister in considering the approval of financial sector transactions recognizes similar considerations. We believe this exception should be preserved, and we recommend that it be applied where appropriate. The nature of a financial institution's business is such that serious problems can occur very quickly after the deterioration process has begun.

VII. Conclusion

The Task Force believes that this Report will be helpful to the Minister of Finance in providing criteria to assist in his review of transactions. We do stress again, however that these views are preliminary and we will be continuing to consider them as our work progresses.

Appendix 5:

Members of the Task Force

Chairman

Harold MacKay (Regina) Mr. MacKay is a partner and Chairman (on leave) of the law firm MacPherson Leslie & Tyerman. He served as a director of the Federal Business Development Bank from 1975 to 1981 and as its chairman from 1981 to 1985. He was also a member of the Board of Directors of the Bank of Canada from 1995 to his appointment to the Task Force. In 1996, he was appointed by the Saskatchewan government as Special Representative of the Minister of Post-Secondary Education & Skills Training to make recommendations in respect of university level education in the province. He is a director of IPSCO Inc. (Regina), IMC Global Inc. (Chicago), Weyerhaeuser Canada Ltd. (Vancouver), and other privately held companies. Mr. MacKay was named Queen's Counsel in Saskatchewan in 1980.

Vice Chairman

Pierre Ducros (Montreal) Mr. Ducros is currently a private investor. He was formerly Chairman and CEO of DMR Group Inc., which he co-founded in 1973. DMR's focus is information technology consultancy and system integration. Mr. Ducros' prior affiliations include Chairman, Information Technology Association of Canada, from 1991 to 1993, and Director of the Chambre de Commerce de Montréal.

Members

Neil Baker (Toronto) Mr. Baker is Chairman and founding partner of The Ridgeline Corporation, a company founded to supply entrepreneurial capital to ventures not funded by traditional sources. He was formerly a Senior Partner, Gordon Capital. Other prior affiliations include Investors Group, Edper Investments and Winnipeg Supply.

Norm Bromberger (Calgary) Mr. Bromberger was Chief Executive Officer of Credit Union Central of Saskatchewan from January 1973 to January 1994. Mr. Bromberger's past activities in the financial sector include those of Director of the Canadian Payments Association from 1981 to 1993 and membership on the Advisory Committee to the Minister of State for Finance on Regulation of Financial Institutions from 1983-1984.

Donald Brown (Toronto) Mr. Brown is a lawyer with the law firm of Blake, Cassels & Graydon. Prior to entering private practice, he was an Assistant Lecturer in the Faculty of Law at the University of Singapore and an Assistant Professor at Osgoode Hall Law School in Toronto. He is a director of the Tokai Bank of Canada and an officer or director of a number of other private companies. He was Chairman of the Administrative Law Section of the Canadian Bar Association in 1982 and in 1987-88, and has served in various other capacities with the association. Mr. Brown was named Queen's Counsel in Ontario in 1983 and was made a Fellow of the American College of Trial Lawyers in 1996.

Moya Cahill (St. John's) Ms. Cahill is founder and president of MNC Group Inc., a Business Management and Engineering Consulting company based in St. John's and Halifax. She is chairman of Marine Atlantic, director of a number of associations including Atlantic Provinces Economic Council (APEC), Premier's Advisory Council on the Economy and Technology and past president of Newfoundland's Ocean Industry Association. In 1994, she was recipient of the Canadian Women Entrepreneur (1994).

John McArthur (Boston, Massachusetts) Mr. McArthur is Dean Emeritus, Harvard Business School. Born in Vancouver he was educated at University of British Columbia and Harvard University. He has honorary degrees from Simon Fraser University, Queen's University, Middlebury College, University of Western Ont., and University of British Columbia. He is Senior Advisor at the World Bank Group and consultant to numerous companies and government agencies in Canada, Europe and the United States.

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