Recent Changes to Canada's Financial Sector Legislation

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- *Canada's federal financial-institutions legislation is reviewed at least every five years. The most recent update took place in October 2001 with the coming into force of Bill C–8.*
- *The legislation maintains the principle of wide ownership of large banks.*
- *The legislation provides a holding company option that could give banks and life insurance companies additional flexibility in the way they structure their organizations.*
- *A process has been established to review merger proposals among large banks.*
- *The Financial Consumer Agency of Canada has been created, with responsibility for enforcing the consumer-related provisions of statutes governing federal financial institutions.*
- *The new Canadian Payments Act makes changes to the Canadian Payments Association as well as the access to, and governance of, the payments system.*

Since 1992, when significant changes were made to the statutes governing federal financial institutions,[1] the practice of reviewing the legislation governing Canada's banks on a regular basis was extended to reviewing the legislation governing all federal financial institutions. Most recently, on 24 October 2001, Bill C–8, the legislation to reform Canada's financial sector, was implemented with the coming into force of some of the key technical regulations that are essential to the operation of the Act.[2] Bill C–8, which capped a process that began in 1996, addressed the legislative framework for the financial sector, which includes domestic and foreign banks, insurance companies, trust companies, the credit union system, and other financial institutions.

This article chronicles the significant legislative developments that have occurred in the financial services sector over the past decade and gives an overview of some of the key provisions contained in Bill C–8. The first part of the article provides background information on some of the major restructuring trends that have taken place in the sector since the early 1990s. The next section reviews the legislative changes that affected federal financial institutions over the period 1992-–2001, including financial-institution supervision and deposit insurance, and oversight of payments

1. For a description of how the institutional framework of Canada's financial sector evolved up to the early 1990s, as well as a more complete discussion of the 1992 financial sector legislation, see Daniel, Freedman, and Goodlet (1992–93).

2. Bill C–8, "An Act to establish the Financial Consumer Agency of Canada and to amend certain Acts in relation to financial institutions." The legislation was introduced in Parliament in June 2000 as Bill C–38, but that legislation died on the Order Paper when Parliament was dissolved with the call of the 2000 federal election.

and other clearing and settlement systems. This is followed by an outline of the process that led to the 2001 financial sector legislation and an examination of some of the important measures it contains. Finally, the new Canadian Payments Act, including broadening access to the payments system, is discussed.

Financial Sector Restructuring

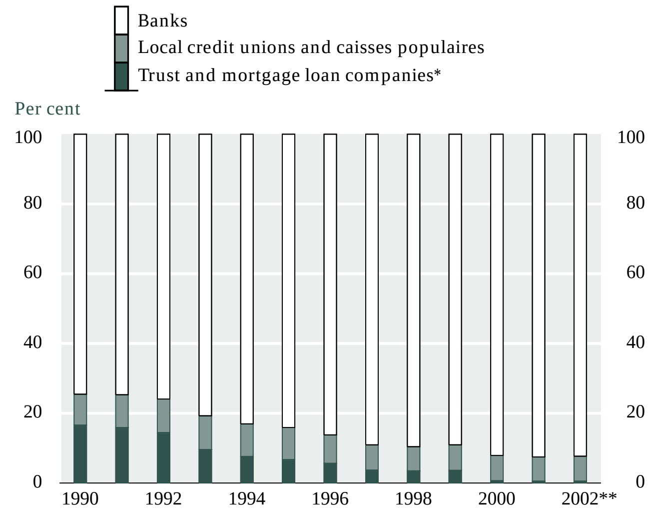
Canada's financial sector experienced significant changes over the past decade as it responded to such factors as technological innovation, globalization, and a low and stable rate of inflation. Shifting demographics also exerted important effects, as Canada's aging population increased its focus on retirement savings and asset accumulation. This change in savings behaviour contributed to a convergence of functions among financial institutions as they sought ways to position themselves to maximize their share of the asset- and wealth-management business.

Some important legislative developments also facilitated the changes in the financial sector. Over the years, legislative amendments have accommodated the desire of financial institutions to diversify their activities, resulting in the continued blurring of distinctions between the various types of financial institutions. As well, large financial groups or conglomerates that offer a variety of financial products and services have been created. This trend has been particularly evident in the banking sector, where some institutions own specialized subsidiaries that provide different financial service products.[3] Another feature of the restructuring in recent years has been the demutualization of several large life insurance companies (discussed on p. 6).

In addition, considerable consolidation has occurred during the past 15 years in the deposit-taking sector through mergers and acquisitions. With the acquisition of several large trust companies by chartered banks, non-bank-owned trust companies now constitute a relatively small segment of the deposit-taking industry (see Chart 1). The life insurance sector has not only been affected by merger and acquisition

Chart 1

Canadian Deposit-Taking Institutions: Total Assets



* Excludes bank-owned trust and mortgage subsidiaries
** 2002 refers to data up to second quarter
Source: Bank of Canada

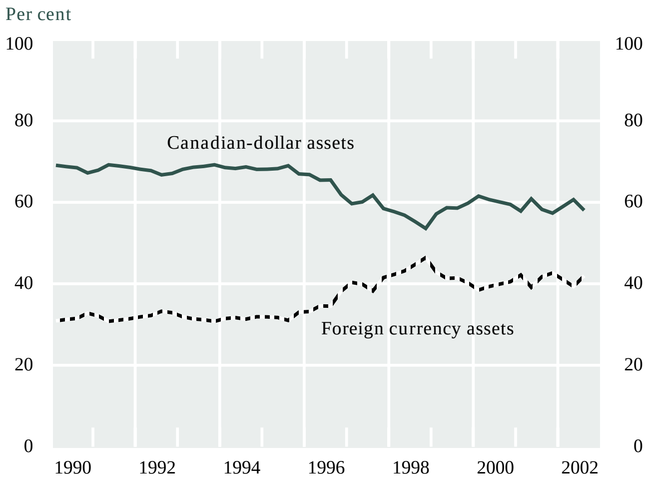
activity, but has also experienced a number of withdrawals resulting from foreign insurers selling their operations to Canadian insurance companies as well as some company failures. Cross-sector acquisitions between deposit-taking institutions and insurance companies have not played a major role in the consolidation of the financial sector in Canada.

With regard to their geographical reach, Canadian banks have long had extensive foreign operations, booked primarily in foreign currencies. This reflects Canada's important trade activities, as well as the sophistication of Canada's banks and their efforts to seek growth opportunities outside the country. Foreign currency assets account for roughly 40 per cent of total Canadian bank assets (see Chart 2). Some Canadian banks have adopted a market strategy that focuses on North America and involves such business activities as wealth management, corporate and investment banking, and electronic banking. The international operations of Canadian life insurance companies have also become increasingly important. More than one-half of their total premium income currently derives from foreign sources, compared with slightly more than one-third in 1990 (see Chart 3).

3. For example, since 1987, federal financial institutions have been allowed to own securities dealers. Since then, the major banks have made substantial investments in the securities business by buying existing investment dealers or by creating their own securities operations. Currently, bank-owned securities dealers dominate the integrated, full-service market, while several smaller securities dealers offer niche services to retail and institutional clients.

Chart 2

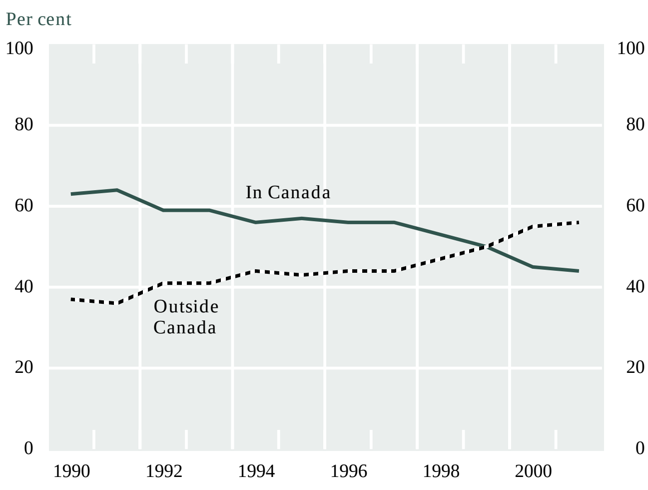
Canadian Banks: Trend in Canadian-Dollar Assets versus Foreign Currency Assets



Source: Bank of Canada

Chart 3

Canadian Life and Health Insurers: Premium Income



Source: *Canadian Life and Health Insurance Facts, 2002*
Figures are for both federally and provincially incorporated companies

Legislative Developments, 1992–2001

Legislation governing federal financial institutions

In 1992, the process of updating the regulatory framework for federal financial institutions[4] was made more formal when the government incorporated sunset clauses in the relevant acts requiring that the legislation be reviewed at five-year intervals.[5] The primary statutes forming this framework are the Bank Act, the Insurance Companies Act, the Trust and Loan Companies Act, and the Cooperative Credit Associations Act.

1992 amendments

The 1992 legislation continued the process of removing the legal barriers separating the activities of various types of financial institutions. It involved significant changes to the statutes governing banks, trust companies, and insurance companies and dealt with the powers of financial institutions, ownership, and ways of managing self-dealing[6] and conflicts of interest.

The amendments gave federal financial institutions the power to diversify into new lines of business through financial-institution subsidiaries, as well as through increased in-house powers.[7] Institutions without the power to provide fiduciary services (e.g., trustee, executor, and administrator services), such as banks and life insurance companies, were allowed to own trust companies. Similarly, banks and trust and loan companies were permitted to own insurance companies. Finally, widely held, regulated, non-bank financial institutions were permitted to own Schedule II

4. In Canada, banks are under exclusive federal jurisdiction, while trust and loan companies and life insurance companies can be incorporated under either federal or provincial legislation. The cooperative credit union system operates almost entirely under provincial jurisdiction, although the Credit Union Central of Canada, which is a national organization that provides credit unions with technical and financial support services, is incorporated under federal legislation.

5. This practice sets Canada apart from most other countries. Of course, the government can revisit the legislation prior to the five-year reviews, if necessary, to address any immediate concerns. Among the various statutes regulating financial institutions before 1992, only the Bank Act contained a sunset clause that called for a review of that legislation every 10 years.

6. Self-dealing refers primarily to transactions between a financial institution and either its controlling ownership group or non-financial and unregulated financial affiliates controlled by the owner.

7. There were certain limitations to these powers, in particular, restrictions on the networking of most types of insurance through branches of federal deposit-taking institutions and the prohibition on federal financial institutions from engaging in car leasing or owning a car-leasing company.

banks, i.e., closely held banks, without the requirement that applies to other entities for divestiture of significant positions within 10 years.[8] As for in-house powers, life insurance companies were generally given full consumer and commercial lending powers, and banks were permitted to offer portfolio-management advice. As a result of the 1992 amendments, Canadian financial institutions were able to develop into conglomerates operating in a variety of financial areas. But limitations on investments in non-financial businesses meant that they could not become universal banks with downstream links to commercial companies.

The 1992 legislation also addressed the competitive equity aspect of imposing non-interest-bearing reserve requirements on banks and not on other deposit-taking institutions. Reserve requirements on banks were phased out over two years, removing the unequal treatment of institutions competing for the same business.

1997 amendments

The primary objective of the 1997 review of financial-institutions legislation was to determine whether the substantial changes implemented in 1992 were functioning as intended. In the event, it was felt that the legislative framework was generally working well, and only minor changes were implemented to update and fine-tune the legislation. The 1997 amendments also included provisions to deal with consumer privacy and tied selling.

Demutualization of life insurance companies

Legislation in March 1999 allowed Canada's largest mutually owned life insurance companies (i.e., those owned by insurance policyholders) to convert to public stock companies owned by shareholders, through a process known as demutualization. The legislation set out the procedures required to demutualize, including the requirement to secure the approval of the converting company's policyholders with voting rights. The regime also contained a number of safeguards to protect policyholder interests throughout the demutualization process. For companies choosing to demutualize, there are many benefits. Policyholders can realize on the value of their company through the shares they receive upon demutualization, the firm can have increased and more flexible access to markets to raise capital, the firm's common shares can be used as an acquisition currency in purchasing other financial service firms, and the firm can use options and share-purchase plans to attract and keep highly skilled employees. At the same time, demutualized companies can become potential takeover targets.

The legislation required that, in the two years following demutualization, demutualized insurance companies remain widely held, i.e., no individual or entity would be allowed to own more than 10 per cent of the shares of the company. In addition, no mergers among, or acquisitions of, demutualized firms were allowed during this two-year transition period.[9] These restrictions were intended to give management of the newly demutualized companies time to adjust to operating as stock companies.

Before the coming into force of the demutualization legislation, four of the five largest Canadian life insurance companies were mutually owned. Within a year of implementing the legislation, Canada's five largest life insurance companies were stock companies.[10]

Entry of foreign bank branches into Canada

In June 1999, legislation was passed allowing foreign banks to establish operations in Canada without having to set up Canadian-incorporated subsidiaries.[11] Foreign banks can establish full-service branches or lending branches. Full-service branches are not permitted to take deposits of less than $150,000, while lending branches are not permitted to take any deposits from the public and are restricted to borrowing only from other financial institutions.[12] Except for these restrictions on deposit-taking, foreign bank branches have essentially the same business powers as foreign bank subsidiaries and domestic banks.

An important reason for allowing foreign banks to enter Canada via branch banks is to enable them to use their larger home capital base to support lending activities in Canada. Because foreign bank branches

8. For a more detailed description of Schedule II banks, see footnote 23, below.

9. The 2001 financial sector legislation set a common end-date of 31 December 2001 for the two-year transition periods of the demutualized insurance companies (see p. 10, below).

10. The following companies demutualized after the legislation came into force: Canada Life Insurance Company, Manufacturers Life Insurance Company, Sun Life Assurance Company of Canada, and Clarica Life Insurance Company (formerly The Mutual Life Assurance Company of Canada).

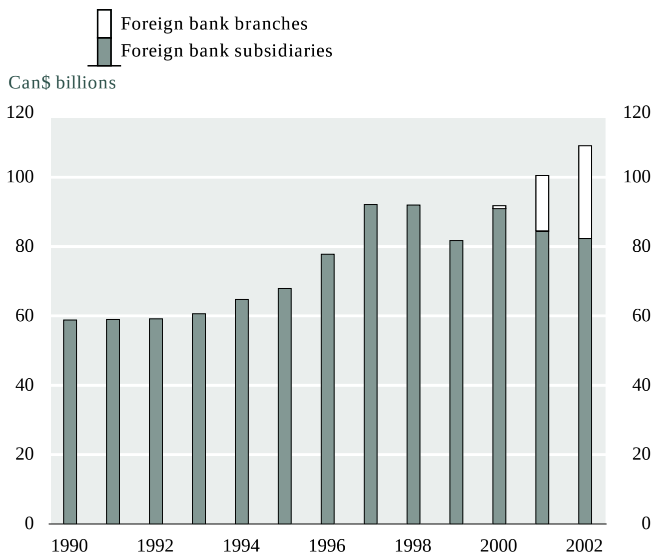
11. In February 1997, the government announced its intention to allow foreign banks to branch into Canada. It issued a public consultation paper on foreign bank entry policy later that year.

12. One reason for restricting retail deposit-taking by foreign bank branches is that it would entail prudential risks if deposit insurance were provided to entities where the primary regulator was in a foreign jurisdiction and where there was no legal corporate entity in Canada.

are not permitted to take retail deposits, they also face somewhat lighter Canadian regulatory requirements than foreign bank subsidiaries. Overall, the foreign bank entry regime offers foreign banks greater flexibility with respect to how they provide financial services in Canada. Foreign banks that are interested in entering Canada primarily to provide commercial banking services may wish to enter Canada as foreign bank branches; those that want to engage in retail deposit-taking also have the option of establishing a separate subsidiary in Canada for that purpose. (Total assets of foreign bank subsidiaries and foreign bank branches are shown in Chart 4.)[13]

Chart 4

Foreign Bank Subsidiaries and Foreign Bank Branches: Total Assets



Source: Office of the Superintendent of Financial Institutions

Financial-institution supervision and deposit insurance

Following the failure and near-failure of a number of non-bank financial institutions in the late 1980s and early 1990s, the federal government undertook a review of the prudential regulation and supervision of Canada's financial sector. The government emphasized the importance of a policy of early intervention in, and resolution of, institutions experiencing financial difficulty.[14] The review culminated in legislation in June 1996 that gave the Office of the Superintendent of Financial Institutions (OSFI), which is responsible for the prudential supervision of federal financial institutions, a clearer statutory mandate. OSFI's mission includes safeguarding policyholders and depositors from undue loss. It also promotes and administers a regulatory framework that provides for the early identification and resolution of compliance or operational issues that could threaten the safety and soundness of financial institutions. There will be times when OSFI has to intervene to protect policyholders and depositors, but it is not OSFI's role to provide a failure-proof system; rather, the ultimate responsibility for running safe and sound institutions rests with the management and board of directors of each institution. To enhance the transparency of the intervention process, OSFI and the Canada Deposit Insurance Corporation (CDIC) jointly developed a guide setting out what measures they will take if the condition of a financial institution deteriorates. In addition, to reduce losses to depositors, policyholders, and creditors, the legislation was amended to make it easier for the Superintendent to close an institution in financial difficulty while it still has some capital.

The 1996 legislation also allowed the CDIC, which had a system of flat-rate deposit-insurance premiums, to develop a system of risk-based premiums, i.e., a premium system that is differentiated on the basis of the risk profiles of individual deposit-taking institutions. The main objective of using risk-based premiums is to provide an incentive for deposit-taking institutions to follow more prudent policies in the conduct of their business. In March 1999, the CDIC introduced a differential premium system. Under this system, CDIC member institutions are classified into one of four premium categories, with the classification based on a system that scores institutions according to certain quantitative and qualitative factors.

The 1997 amendments to the financial sector legislation allowed banks that accept only wholesale deposits ($150,000 or more), but do not take retail deposits, to opt out of CDIC coverage. Institutions opting out can thus avoid the reporting and other requirements associated with CDIC membership. CDIC bylaws on opting out were put in place in October 1999.[15]

13. As of December 2002, 68 banks were operating in Canada, of which 15 were domestic banks, 33 were foreign bank subsidiaries, 17 were full-service foreign bank branches, and 3 were foreign bank lending branches.

14. Canada (1995).

15. Since 1999, 12 foreign bank subsidiaries have chosen to opt out of CDIC membership.

Oversight of the payments and other clearing and settlement systems

The 1996 legislation to strengthen the supervisory and regulatory framework for federal financial institutions also established the Payment Clearing and Settlement Act (PCSA), giving the Bank of Canada responsibility for the oversight of payments and other clearing and settlement systems in Canada for the purpose of controlling systemic risk.[16] Under the PCSA, systems that have the potential to create systemic risk are designated as being subject to the PCSA. The Bank of Canada oversees designated systems on a continuing basis for the appropriate control of systemic risk. In addition, the PCSA contains provisions which, when combined with federal insolvency legislation, reinforce the legal enforceability of netting in designated clearing and settlement systems. Other PCSA provisions make the settlement rules of designated systems immune to legal stays or other legal challenges, even in cases where a participant in one of these systems fails.[17] Thus, the PCSA increases the certainty that the legal arrangements governing the operations of a clearing and settlement system will produce the expected outcome in periods of financial stress.

A consequence of the June 1999 legislation permitting foreign bank-branching in Canada was an amendment to the PCSA regarding the participation of foreign banks in major clearing and settlement systems. A provision was added to the PCSA to allow the Governor of the Bank of Canada to prohibit or impose conditions on the participation of a full-service branch or a lending branch of a foreign bank in a clearing and settlement system designated under the PCSA if the Governor is of the opinion that its participation poses, or is likely to pose, a systemic risk or an unacceptable risk to the Bank of Canada. If the Governor does not prohibit their participation, the legislation permits both types of branches to participate in designated clearing and settlement systems, provided they meet the requirements of those systems.

16. Systemic risk refers to domino or spillover effects, whereby the inability of one financial institution to fulfill its payment obligations in a timely fashion results in the inability of other financial institutions to fulfill their obligations in that clearing and settlement system or in other systems, or in the failure of that clearing house or other clearing houses. For a discussion of the PCSA, see Goodlet (1997).

17. In June 2002, the PCSA was amended to clarify that similar legal protections apply to certain securities and derivatives clearing houses that are not designated under the PCSA.

Background to the 2001 Legislation

In 1996, the government released a discussion paper emphasizing the important changes occurring in the financial sector that reflected the globalization of financial services markets, technological advances, and a changing competitive landscape.[18] The government also established the Task Force on the Future of the Canadian Financial Services Sector to undertake a comprehensive review of Canada’s financial sector and to provide advice on public policy issues related to the development of an appropriate framework. The work of the Task Force would help to shape the next round of amendments to the financial sector legislation, scheduled to take place no later than five years after the 1997 legislation was passed.

The Task Force had a broad mandate to address issues facing Canada’s financial services industry and to make recommendations on any public policy issues that affect the environment within which the providers of such services operate. In September 1998, after nearly two years of study and consultation, the Task Force delivered its final report.[19] The Task Force concluded that Canada’s financial system is strong, that it works well, and that institutions generally do a good job with the services they offer. Still, it identified several measures that could be implemented to help financial institutions better meet future challenges and offered 124 recommendations for enhancing competition and competitiveness, improving the regulatory framework, and empowering consumers.[20]

A Payments System Advisory Committee established by the Department of Finance in 1996 to study issues concerning payments systems also contributed to the work of the Task Force. Co-chaired by the Department of Finance and the Bank of Canada, the committee’s purpose was to analyze the implications of broadening access to the payments system, and to analyze whether modifications to its governance framework

18. Canada (1996). This document was also the basis for the 1997 amendments to the financial-institutions legislation.

19. “Change, Challenge, Opportunity,” Report of the Task Force on the Future of the Canadian Financial Services Sector (Canada 1998). The report is supported by 5 background papers and 18 research studies commissioned by the Task Force. The report, background papers, and research studies are available at the Task Force’s Web site (http://finservtaskforce.fin.gc.ca/index_e.htm).

20. The Appendix highlights a few of the recommendations contained in the report of the Task Force and the relevant initiatives in the 2001 financial sector legislation.

were needed for it to continue to develop in the public interest.[21] Discussions in the committee focused on three public policy objectives for the payments system: efficiency, safety, and the consideration of consumer interests. It did not make recommendations but discussed alternative legislative and regulatory arrangements for the various elements of the payments system and the trade-offs involved in choosing among them.

After the Task Force had completed its review, the government released a policy paper setting out the policy framework that became the basis for the 2001 financial sector legislation.[22]

The 2001 Legislation

The 2001 financial sector legislation was wide-ranging. Its objectives were to promote the efficiency and growth of the financial sector, foster greater domestic competition, improve the regulatory environment, and empower and protect consumers. Certain provisions in the legislation broaden the scope of investments that are permitted for federal financial institutions in-house or through subsidiaries, thereby providing them with opportunities to innovate and bring new products to customers. The legislation also makes it easier for these institutions to have significant partners in joint ventures and enhances the ability of regulated financial institutions to meet increasing technological and competitive challenges from, for example, unregulated and "monoline" firms specializing in a single line of business.

The remainder of this section discusses some of the major reform initiatives, including the ownership regime, the holding company regime, investment powers, merger-review policy, accommodating structural flexibility in the credit union system, regulatory streamlining, and provisions relating to consumers.

Ownership regime

Banks

Since 1967, Canada's bank-ownership regime has been based on the principle of wide ownership of major banks.[23] This policy has facilitated Canadian control of domestic banks and is one approach that can be used to address the prudential concerns related to the potential for solvency-threatening self-dealing. The 2001 legislation maintained the widely held ownership regime for banks but amended the Bank Act to provide for an ownership regime that is based on size. According to the legislation, banks are classified by size to be

- large (greater than $5 billion in equity)
- medium ($1 billion to $5 billion in equity), or
- small (less than $1 billion in equity)

Large banks are required to be widely held, as they were before the new legislation.[24] To give them the flexibility to enter into alliances or joint ventures, however, the definition of "widely held" was expanded to allow an individual investor to own up to 20 per cent of any class of voting shares and 30 per cent of any class of non-voting shares of a large bank.[25] Any transaction where an investor applies to acquire a significant interest of a large bank, i.e., more than 10 per cent, would require the approval of the Minister of Finance and would be subject to a "fit and proper" test and assessed against a guideline designed to prevent these institutions from becoming de facto closely held. The legislation allows medium-sized banks to be closely held, although they are required to

21. The committee considered four discussion papers prepared and issued by the Department of Finance and the Bank of Canada between March 1997 and January 1998. The papers are available at the Department of Finance Web site (www.fin.gc.ca) and the Bank of Canada Web site (www.bank-banque-canada.ca). Following the deliberations of the committee, the Department of Finance released a final discussion paper in July 1998, which is available at the Department of Finance Web site.

22. Canada (1999).

23. Prior to the 2001 legislation, the ownership regime made a distinction between Schedule I and Schedule II banks. Schedule I banks, which included the six largest domestic banks, were required to be widely held, with no single shareholder or group of associated persons holding more than 10 per cent of any class of shares. Schedule II banks could be closely held and commercially linked for the first 10 years of their existence, after which they were required to become widely held. Foreign banks and other eligible foreign and domestic financial institutions that themselves were widely held were permitted to hold Schedule II banks indefinitely in a closely held fashion.

24. Under the legislation, the widely held rule can be met by having the bank held by a bank holding company that itself is widely held.

25. Although the National Bank of Canada, the Laurentian Bank of Canada, and Canadian Western Bank each have equity of less than $5 billion, the new legislation treats these banks as entities with equity of more than $5 billion. Thus, these banks are subject to the ownership rules applicable to large banks. The Minister of Finance can revoke this treatment, in which case the bank would not have to be widely held. The government's policy is that the widely held requirement will not be revoked unless the Minister receives an application from the bank in question. Any request would be considered on its own merits and would take into account a number of factors, including safety and soundness, the prospects for the institution in the context of the global marketplace, the needs of consumers, the best interests of Canadians, and where the institution operates principally in a certain region, the best interests of those living in that region.

have a public float of at least 35 per cent of their voting shares. Small banks are not subject to any ownership restrictions. For the first time, the legislation permits commercial entities to own indefinitely, on a closely held basis, banks with less than $5 billion in equity.

Large banks are required to be widely held.

To introduce greater organizational flexibility, the new legislation allows banks to incorporate one or more Canadian banking subsidiaries. For example, a bank can establish a retail bank subsidiary or commercial bank subsidiary, and these subsidiaries could have significant outside investors.

Non-bank financial institutions

In contrast to the ownership regime for banks, traditionally there has not been a widely held rule for federally regulated trust and loan companies or insurance companies owned by shareholders. For these companies, approval from the Minister of Finance has been required for any shareholding in excess of 10 per cent.

The 2001 amendments to the Insurance Companies Act clarified the transitional rules regarding ownership restrictions affecting demutualized life insurance companies (discussed above, on p. 6). A common end-date of 31 December 2001 was set for the two-year transition period of these companies, during which no mergers among, or acquisitions of, demutualized firms were allowed. Following the transition period, merger restrictions applying to demutualized insurers with equity under $5 billion were lifted and these firms also became eligible to be closely held.[26] In addition, the government announced a policy whereby large demutualized companies with over $5 billion in equity are required to continue to be widely held; that is, no person may own more than 20 per cent of the company's voting shares or more than 30 per cent of any class of its non-voting shares.[27] In addition, as a matter of policy, large banks are not permitted to acquire or merge with large demutualized insurance companies, and vice versa. This restriction also applies to large bank holding companies and large life insurance holding companies.

The legislation also raised, from $750 million to $1 billion, the threshold above which trust companies, stock life insurance companies, and property and casualty insurance companies must have a 35 per cent public float.

Holding company regime

The 2001 legislation introduced a holding company regime for Canadian banks and insurance companies that permits the creation of regulated non-operating holding companies. The holding company regime does not expand the powers of banks or insurance companies—rather, its aim is to give institutions more flexibility in the way they structure their organizations, e.g., making it possible to shift various activities of the bank into different parts of the organization. For instance, a bank holding company could have a banking subsidiary, an insurance subsidiary, a securities subsidiary, and a subsidiary for its unregulated businesses. This type of organizational structure might be more understandable for investors and give the organization more flexibility to react to changes in the competitive landscape. It might also relieve unregulated activities from some regulatory oversight. The holding company structure would also permit a bank to separate various banking activities (e.g., consumer- or business-lending activities, or its credit card business) into separate affiliates.

The 2001 legislation introduced a holding company regime for Canadian banks and insurance companies.

26. After the transition period expired, Sun Life Financial Services of Canada Inc. (which had equity of more than $5 billion) acquired Clarica Life Insurance Company (which had equity of less than $5 billion). The transaction created the largest life insurance company in Canada, and one of the top five publicly traded North American life insurance companies, measured by market capitalization.

27. Unlike the restrictions on bank ownership, the ownership restrictions on life insurance companies were not placed in the legislation governing these institutions. The Minister of Finance has the authority to withdraw the ownership constraints that apply to large demutualized insurance companies.

Under the legislation, bank holding companies are regulated under the Bank Act and are required to have an investment in at least one bank. Likewise, insurance holding companies are regulated under the Insurance Companies Act and are required to have an investment in at least one life insurance company. The investments that are permitted in the case of a bank holding company are the same investments in permitted entities that a bank may make under the Bank Act. Similarly, investments permitted for an insurance holding company are the same as those permitted for a life insurance company under the Insurance Companies Act. Holding companies are subject to consolidated supervision by OSFI.

Market participants have expressed support for the government's initiative in introducing a holding company regime for banks and life insurance companies. However, they have also indicated that the extent to which institutions might adopt a holding company structure will depend on various factors, including whether it, in fact, results in lighter regulation for the less-regulated affiliated companies in the holding company group, how complex the self-dealing rules applied in the case of affiliated companies would be, and what capital rules would be applied to holding companies by OSFI.[28]

Permitted investments

A broader range of investments is permitted, including expanded opportunities for investment in the area of e-commerce.

The 2001 legislation has continued the approach of limiting financial-institution investments in commercial enterprises. However, within this general limitation, the new rules do provide some relaxation of the investment regime. A broader range of investments is permitted, including expanded opportunities for investment in the area of e-commerce. The legislation broadens the range of information-processing activities that federally regulated financial institutions can engage in to include data transmission systems, information sites, communication devices, and information platforms or portals. As a general principle, under the new legislation any activity permitted to be carried out in-house by a financial institution can also be carried out through a subsidiary of the financial institution or its holding company. This change is intended to give banks and insurance companies greater choice and flexibility in the way they structure their operations. For example, allowing banks to have additional subsidiaries could facilitate alliances and joint ventures.

New merger-review policy

The government introduced guidelines setting out a review process for merger proposals among large banks.

The government has acknowledged that large-bank mergers can be a viable business strategy.[29] Two issues that are relevant for public policy are determining the size an institution needs to be to compete in the global marketplace, and the importance of not unduly concentrating economic power or significantly reducing competition domestically. Along with the 2001 financial sector legislation, the government introduced guidelines setting out a review process for merger proposals among large banks and bank holding companies with over $5 billion in equity.[30] The review process includes a formal mechanism for public input.

Under the merger-review policy, the merger partners are required to prepare a public interest impact assessment (PIIA). This assessment covers various effects of the merger, such as job losses and branch closures, as well as the impact the transaction may have on the structure of the banking industry and the international competitiveness of Canadian banks. In the PIIA, the merger partners would also set out any remedial or

28. OSFI has been consulting with industry associations on a framework for capital adequacy for holding companies. At the time of writing, these consultations had not yet been finalized.

29. Canada (2001a).

30. Canada (2001b).

mitigating steps they would be prepared to take (such as divestitures, service guarantees, and other commitments) in respect of public interest concerns that they identify. The matter would then be referred to the House of Commons Standing Committee on Finance and the Standing Senate Committee on Banking, Trade, and Commerce for consideration and public hearings. Each of these committees would report to the Minister on the broad public interest issues raised by the proposed merger.[31]

The Competition Bureau and OSFI would also review the merger proposal and report to the Minister of Finance their views on the competitive and prudential aspects, respectively, of the proposed transaction. The Minister would make these reports public.

The Minister of Finance, after taking into account the various factors, would decide whether the proposal would be allowed to proceed in light of any prudential, competition, and other public interest concerns. If the Minister considered these concerns too great to be remedied, the transaction would be denied. Or, if these concerns could be addressed, the process would enter the negotiation of remedies stage.

The Competition Bureau would negotiate the competition remedies, and OSFI, the prudential remedies with the merger applicants, and the two agencies would work with the Department of Finance to coordinate a complete set of public interest remedies. Following successful negotiations, the Minister of Finance would approve the transaction with terms and conditions that reflect those remedies.

Proposed mergers involving demutualized insurance companies that have $5 billion or more of equity will not be subjected to the formal merger-review policy. Nevertheless, in any merger involving demutualized companies, the Minister is authorized to consider the Superintendent's opinion as to whether the newly merged company would present supervisory or regulatory concerns. In addition, the Competition Bureau can assess the transaction.

31. In October 2002, the Minister of Finance and the Secretary of State (International Financial Institutions) asked the House of Commons Standing Committee on Finance and the Standing Senate Committee on Banking, Trade, and Commerce for their views on the major considerations that would apply in determining whether a merger proposal between large banks is in the public interest. The Senate committee issued its report on this matter in December, and the House of Commons committee is expected to issue its report in early 2003.

Accommodating structural flexibility in the credit union system

The 2001 legislation enables the credit union system, if it wishes to do so, to move from the current three-tiered structure—local credit unions, provincial credit union centrals, and the national credit union central—to a two-tiered structure consisting of local credit unions and a national services entity. This could provide a mechanism for participating credit unions to take advantage of economies of scale, reduce costs, eliminate duplication and overlap, and promote stronger coordination with an enhanced national presence. To date, no initiatives from the credit union system involving the new provisions have been finalized.[32]

Streamlining regulatory approvals

The 2001 legislation made two improvements to streamline the regulatory-approval process and reduce the burden of compliance on federal financial institutions. First, several applications formerly requiring ministerial approval are now subject to OSFI approval. Second, OSFI has implemented a deemed approvals process in order to speed up the supervisory approvals required for certain corporate actions. Under this process, when institutions file an application with OSFI, the Superintendent has a 30-day period in which to raise concerns, seek further information, or indicate that there will be a delay. If none of these actions is taken, the transaction is deemed to have been approved. The Superintendent can also explicitly approve or deny the transaction before the end of the 30-day period.

Provisions relating to consumers

Consumer-related issues were an important focus of the 2001 financial sector legislation. A significant initiative was the establishment of the Financial Consumer Agency of Canada (FCAC). The purpose of the FCAC is to enforce the consumer-oriented provisions of the federal financial institution statutes, monitor the financial services industry's self-regulatory initiatives to protect the interests of consumers and small businesses, promote consumer awareness, and respond to

32. The Credit Union Central of British Columbia and the Credit Union Central of Ontario have announced their intention to explore a merger. The two provincially chartered credit union centrals provide a range of financial services to credit unions in their respective provinces, including liquidity management, wholesale lending, and settlement of cheques and electronic payment items. The proposed merger envisions creating a single, federally regulated organization to perform these functions.

general consumer inquiries. The FCAC consolidates the oversight of consumer-protection measures in the federally regulated financial sector, which previously had been dispersed among a number of federal entities. The FCAC can impose monetary penalties in cases of contravention or non-compliance with consumer-related statutes. The FCAC reports to the Minister of Finance.

The FCAC consolidates the oversight of consumer-protection measures in the federally regulated financial sector.

The legislation also requires institutions to be members of a third-party dispute-resolution mechanism. The government initially indicated that it would work with financial institutions to establish the Canadian Financial Services Ombudsman (CFSO), which banks would be required to join. Non-bank financial institutions could join either the CFSO or a different system for resolving third-party disputes. In December 2001, the government announced that it was suspending its plan to establish the CFSO, but that it would support a private sector initiative to develop a National Financial Sector Ombudservice (NFSO) that would handle consumer complaints involving various types of financial institutions. Work has proceeded on establishing this consumer-assistance service, now called the Financial Services OmbudsNetwork.

Another government initiative aims at making basic financial services accessible to all individuals. Under the legislation, the federal government has the authority to make regulations regarding the provision by banks of a low-cost account to customers. Currently, the government has chosen not to regulate low-cost accounts through legislation; instead, it is relying on the banks' commitment to provide such accounts through a self-regulatory approach.[33] The FCAC monitors banks to ensure that such accounts are offered and that they meet certain standards. Should the self-regulatory approach be unsuccessful, the government has the option of imposing regulations.

33. In February 2001, the government announced the signing of memoranda of understanding with several banks regarding the features that these low-cost accounts will offer. See Canada (2001c).

The Canadian Payments Act and Access to the Payments System

As part of the 2001 legislative package, the Canadian Payments Association Act has been renamed the Canadian Payments Act (CP Act). The CP Act contains some important changes for the Canadian Payments Association (CPA), a non-profit association created by an Act of Parliament in 1980. The CPA owns and operates Canada's two domestic currency payments systems through which all non-cash payments ultimately settle. The Large Value Transfer System (LVTS) is the principal system for clearing large-value and time-sensitive payments. The Automated Clearing Settlement System (ACSS) handles all other payments, such as paper cheques, automated bill payments, and debit card transactions. The CPA develops, implements, and updates the rules that govern the clearing and settlement of payments through the LVTS and the ACSS.

The CP Act extends eligibility for CPA membership to life insurance companies, securities dealers, and money market mutual funds.

Before the 2001 legislation was enacted, CPA membership was limited to the Bank of Canada; the other banks, trust and loan companies, credit unions and caisses populaires centrals; and other deposit-taking institutions. The CP Act extends eligibility for CPA membership to life insurance companies, securities dealers, and money market mutual funds. Under the previous legislation, the CPA had a twofold mandate to establish and operate the national clearing and settlements system and to plan the evolution of the national payments system. Under the CP Act, the statutory objectives of the CPA have been amended and are now as follows:

(i) to establish and operate national systems for the clearing and settlement of payments and other arrangements for the making or exchange of payments

(ii) to facilitate the interaction of the CPA's systems with others involved in the exchange, clearing, and settlement of payments, and

(iii) to facilitate the development of new payment methods and technologies.

In pursuing these objectives, the CPA promotes the efficiency, safety, and soundness of its clearing and settlement systems, taking into account users' interests.

The CP Act has increased the size of the CPA's Board of Directors from 11 to 16 members.[34] The increased size reflects the broader range of entities that are eligible for CPA membership as well as three new independent board members appointed by the Minister of Finance. In addition, the Stakeholder Advisory Council, which was established in 1996, has been enshrined in the CP Act. Its mandate is to provide advice to the CPA Board on the payments system from the perspectives of a variety of interest groups. The Stakeholder Advisory Council is made up of two CPA directors and up to 18 other members who are appointed by the CPA Board of Directors in consultation with the Minister of Finance.

The CP Act provides the Minister of Finance with certain oversight powers in relation to the CPA. All CPA rules and standards, including any amendments, are subject to a 30-day review period by the Minister of Finance, who can disallow any rule that is not deemed to be in the public interest. The Minister also has the authority to issue a directive to the CPA to make, amend, or repeal a bylaw, rule, or standard.

Under the CP Act, the Minister also has the authority, if it is considered to be in the public interest, to designate a particular payments system that is national in scope or that plays a major role in supporting transactions in the Canadian financial markets or the Canadian economy. In designating such a payments system, the Minister would consider the level of financial safety provided by that payments system to the participants and users, the efficiency and competitiveness of payments systems generally in Canada, and the best interests of the Canadian financial system. The Minister can issue directives to such payments systems with respect to the conditions for becoming a participant in the system, the operation of the payments system, its interaction with other Canadian payments systems, and the relationship of the system with users. To date, the Minister has not designated any system under the CP Act.

To facilitate the coordination of the Bank of Canada's oversight responsibilities under the Payment Clearing and Settlement Act and the Minister's oversight activities under the CP Act, as well as to address payment system issues in general, a non-statutory body called the Payments Advisory Committee (PAC) was formed. PAC is co-chaired by senior officers of the Department of Finance and the Bank of Canada.

As mentioned above, under the CP Act, life insurance companies, securities dealers, and money market mutual funds are eligible for membership in the CPA. Permitting these types of financial entities to join the CPA enables them to offer a wider range of services to their clients, thus promoting increased competition for the consumer's business. For example, life insurance companies would be able to offer payment services with features broadly similar to those of deposit accounts offered by banks.

The CPA had considered removing the minimum volume criterion as an eligibility requirement for participation as a direct clearer in the ACSS, which requires that at least 0.5 per cent of total payments volume in the ACSS be cleared by a direct clearer, but this criterion has been retained pending further study and consultation with the Bank of Canada and the Department of Finance on the implications of eliminating it. The study will identify issues that presently motivate this restriction and also examine alternative conditions that might be more effective and efficient than those currently in place. Meanwhile, the government has requested the CPA in its relevant bylaw to restrict the participation of life insurance companies and money market mutual funds to the status of indirect clearers; that is, these entities would be required to have a direct clearer acting as their agent in the ACSS clearing and settlement process.[35] As regards the LVTS, the newly eligible CPA members could become direct

34. The chair of the Board of Directors continues to be an officer of the Bank of Canada.

35. In its policy paper (Canada 1999, p. 41) the government explained that the legal framework within which these organizations operate is significantly different from those of other CPA members, and consequently their participation as direct clearers could impact the degree of risk assumed by other participants in the event of a default.

participants in the LVTS by complying with the criteria set out by the CPA.[36]

Conclusion

Significant changes have occurred in Canada's financial services sector during the past decade. While many factors were involved, amendments to legislation governing the sector facilitated the process of change by accommodating developments in the financial services industry. The result has been the creation of a more competitive, innovative, and efficient financial sector. At the same time, changes to the framework for the prudential supervision of financial institutions and the oversight of clearing and settlement systems have also contributed to public confidence in a strong financial system. Given the evolutionary nature of Canada's financial sector, the government and the financial industry will soon begin planning and preparing for the next legislative review required by the five-year sunset clauses.

36. To become a direct participant in the LVTS, an institution must be a member of the CPA, have certain operational capabilities, have a settlement account at the Bank of Canada, and enter into agreements relating to taking loans from the central bank and to pledging the appropriate collateral. To date, none of the institutions recently made eligible for CPA membership has applied to become a member in the CPA.

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Appendix

In 1996, the Task Force on the Future of the Canadian Financial Services Sector was given the mandate to make recommendations on any public policy issues that affect the environment within which Canada's private sector financial services providers operate. The recommendations contained in the 1998 report of the Task Force provided important input into the 2001 financial sector legislation. In some cases, initiatives recommended by the Task Force were implemented by the government prior to the 2001 financial sector legislation. For example, in 1999, legislation was passed regarding the demutualization of large life insurance companies as well as legislation allowing the entry of foreign bank branches into Canada. Overall, the 2001 legislative changes included several major recommendations proposed by the Task Force. In some cases, initiatives contained in the 2001 legislation were consistent with those recommended by the Task Force, although the provisions for implementation may have differed from those suggested by the Task Force.

With regard to the efficiency and growth of the financial sector, the 2001 financial sector legislation incorporated the Task Force recommendations that the definition of the widely held rule be broadened to provide for greater flexibility in setting up strategic alliances; a holding company regime be established to provide for greater structural flexibility; and a large bank merger-review process be created to examine whether merger proposals would be consistent with the public interest.

As to fostering competition, the Task Force suggested that there be direct access to the payments system for life insurance companies, mutual funds, and investment dealers. In this regard, the new Canadian Payments Act makes these entities eligible to become members in the Canadian Payments Association (CPA).[1] The Task Force also recommended that credit unions be permitted to form cooperative banks. Although a cooperative bank initiative was not included in the 2001 financial sector legislation, in April 2002 the government launched a consultation process to determine whether there is sufficient consensus to move forward with legislation implementing a cooperative bank model. The recommendation of the Task Force to allow banks and trust companies to offer insurance and auto leasing to their customers through their branches was not adopted in the legislation. Similarly, the legislation did not provide for the integration of deposit insurance for banks and compensation plans for life insurance companies, for reasons of competitive equity, as suggested by the Task Force.

The 2001 legislation followed up on the recommendations of the Task Force to streamline the process for regulatory approvals, although the suggestion that regulatory overlap be reduced by transferring the regulatory responsibilities of CDIC to OSFI was not adopted.

As for consumer-related issues, several initiatives contained in the report of the Task Force were included in the 2001 financial sector legislation, such as the establishment of an ombudsman. The Financial Consumer Agency of Canada (FCAC), which was created for the purposes of educating consumers on their rights and overseeing compliance by institutions with federal consumer-protection measures, is also consistent with the Task Force objective of empowering consumers. The 2001 financial sector legislation addressed the Task Force proposal regarding the provision of access to low-cost accounts to low-income individuals. In implementing this initiative, the government is relying on banks to use a self-regulatory approach (the government has also retained the option of imposing regulations), rather than adopting the Task Force's suggestions such as having the government enter into indemnity agreements with financial institutions regarding regular payments to low-income individuals, which would eliminate the need for holds on government cheques.

1. As noted in this article, the CPA, the Department of Finance, and the Bank of Canada have agreed to study the impact of the elimination of the institutional restrictions and the volume requirement for direct participation in the Automated Clearing Settlement System.