Banking and Financial Institutions

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On October 24, 2001, the federal government proclaimed in force the *Financial Consumer Agency of Canada Act* (the "New Act"), which made substantial changes to the ownership, business powers and corporate governance provisions of the federal financial institutions legislation (collectively, the "F.I. Statutes").[1] The New Act is the culmination of a lengthy legislative process dating back to December 19, 1996, when the Minister of Finance (Canada) announced the mandate and composition of the Task Force on the Future of the Canadian Financial Services Sector, which was asked to advise the government on what needed to be done to ensure that the Canadian financial system remains strong and dynamic.

On September 14, 1998, the task force released its report, entitled "Change, Challenge, Opportunity." The federal government agreed with many of the report's recommendations and on June 25, 1999, released a policy paper entitled "Reforming Canada's Financial Services Sector: a Framework for the Future," which outlined four primary initiatives: (i) promoting efficiency and growth among federally regulated financial institutions ("FRFIs"); (ii) fostering domestic competition by facilitating the entry of foreign competitors and removing barriers to entry for new competitors; (iii) strengthening consumer bargaining power through increased access to information; and (iv) improving the regulatory environment.

The New Act implements these policy initiatives. It provides domestic and foreign entities seeking to invest in FRFIs with opportunities to engage in strategic alliances and joint ventures or to acquire particular businesses that were never before available. By doing so, the New Act further blurs the distinction between the types of financial institutions, essentially eroding what is left of the traditional four pillars of the financial services industry.[2]

The following is a brief overview of some of the most significant changes contained in the New Act (which is more than 900 pages in length).

New Ownership Regime

The New Act implements a new ownership regime for banks and insurance companies based on shareholder equity, which generally classifies them as follows:

- large banks and large demutualized insurance companies with equity of $5 billion or more;
- medium-sized banks and medium-sized insurance companies with equity of $1 billion or more, but less than $5 billion; and
- small banks and small insurance companies with equity of less than $1 billion.

Ownership rules that distinguished between widely held Schedule I banks and closely held Schedule II Canadian and foreign-owned banks have disappeared. All Canadian-owned banks are now listed in Schedule I, all foreign-owned banking subsidiaries are now listed in Schedule II, and all foreign bank branches continue to be listed in Schedule III.

Large banks and large demutualized insurance companies are required to be widely held.[3] Previously, the widely held rule restricted any shareholder from having more than a 10% interest in any class of shares. With a view to accommodating significant transactions in the Canadian and cross-border markets, the task force recommended that this rule be relaxed. The task force believed that a relaxed widely held rule would facilitate acquisitions by, and alliances with, these large entities. These transactions could lead to the development of innovative products and delivery channels for the Canadian market, the introduction of platforms from which to offer services to Canadian customers doing business abroad and expansion into foreign markets.

The New Act provides this flexibility. If the Minister is satisfied that an applicant has proper character and integrity (in the case of a natural person) or that an applicant is operated by individuals with suitable reputations (in the case of a body corporate), then the Minister may permit a person or associated group to own up to 20% of any class of voting shares and/or up to 30% of any class of non-voting shares. Above this level of ownership, the person would be considered to be a "major shareholder," which is not permitted for large institutions.

No one may be in a position to exercise control, including "control in fact," over a large bank or large demutualized insurance company. In that regard, the Minister recently released guidelines that describe the policy objectives to be achieved and the factors to be taken into account in determining whether "control in fact" would exist in particular circumstances.

Widely held banks or certain other eligible financial institutions that control a bank that has less than $5 billion in equity are allowed to retain shares in that bank's equity if it later exceeds the $5 billion threshold. Generally, a bank that becomes large through growth or acquisition may meet the widely held requirement through a widely held Canadian or foreign financial institution parent or a widely held bank holding company ("BHC") or insurance holding company ("IHC"). (BHCs and IHCs will be discussed later.) Other widely held entities cannot be major shareholders in such a bank.

Medium-sized banks and medium-sized insurance companies are allowed to be closely held with prior approval from the Minister, although a public float of 35% of their voting shares is required. The public float requirement generally means that 35% of the voting shares must be publicly traded on a Canadian stock exchange. As a result, a shareholder (which can be a commercial enterprise) is allowed to hold up to 65% of the outstanding voting shares and, indeed, 100% of the common shares (if a class of voting preferred shares was issued) of a medium-sized bank or medium-sized insurance company. In addition, the public float requirement may be satisfied upstream by a BHC, IHC or certain other domestic and foreign entities, depending on the particular circumstances.

Small banks and insurance companies are not subject to any ownership restrictions other than being required to receive prior approval from the Minister for any acquisition of more than 10% of their shares.

Although the National Bank of Canada, the Laurentian Bank of Canada and the Canadian Western Bank all have equity of less than $5 billion, the New Act deems

these banks to be entities with equity of more than $5 billion. Consequently, control over these medium-sized and small banks cannot be acquired (since banks with equity of more than $5 billion must be widely held). The Minister has the power to revoke this treatment, however, and recategorize these banks as true medium-sized or small banks. This recategorization can occur only while their equity remains less than $5 billion. According to recategorization guidelines, the Minister will consider regional interests when deciding whether or not to recategorize these entities. Furthermore, a recategorization of a medium-sized bank (namely, the National Bank of Canada) that results in the acquisition of its control is subject to a public review process similar to that for mergers of large banks, which will be discussed later.

BHCs and IHCs

The New Act permits the creation of BHCs and IHCs for the first time. The holding company structure allows banks and insurance companies to engage in activities that they presently conduct in-house, through a subsidiary or through a sister corporation or affiliate. Depending on the particular activity, an affiliate of a bank or an insurance company owned by a BHC or IHC, respectively, may be subject to less regulation and supervision than the bank or insurance company itself. The holding company feature is intended to provide these financial institutions with greater structural flexibility to compete with unregulated and specialized firms. It also facilitates the raising of external capital and creation of alliances with Canadian and foreign business partners.

Ownership restrictions on BHCs and IHCs are essentially the same as those on banks and insurance companies — that is, they are based on shareholder equity. For example, BHCs are divided into the same three categories as banks, depending on their equity, and the same investment restrictions apply to each category. Therefore, as is the case with banks, it is possible for a BHC with equity of less than $5 billion to be owned and controlled by a commercial enterprise. It also remains that a BHC that controls a Schedule I bank with equity of less than $5 billion is deemed to be a large BHC.

Demutualized companies that established nonoperating insurance companies under the *Insurance Companies Act* at the time they demutualized may continue those companies as IHCs.

Differences exist, however, between the widely held rule applicable to BHCs and the widely held rule applicable to IHCs. In particular, an IHC with equity of less than $5 billion is permitted to grow beyond $5 billion in equity without any ownership restrictions other than the 35% public float requirement.

Permitted Activities and Investments: FRFIs, BHCs and IHCs

Permitted activities of BHCs and IHCs include acquiring, holding and administering permitted investments as well as providing management, advisory, financing, accounting and information-processing services to entities in which they have substantial investments. BHCs and IHCs are not permitted to undertake any core financial services functions.

Permitted investments of BHCs and IHCs are the same as for banks and insurance companies and include investments in entities defined as financial services entities formed and regulated under federal or provincial legislatures. These financial services entities include banks, BHCs, insurance companies, IHCs, trust companies, loan companies, investment dealers and foreign entities primarily engaged outside of Canada in a business that, if carried on in Canada, would be the business of one of the entities referred to above.

FRFIs, BHCs and IHCs are permitted to invest in any entity that provides a service that an FRFI itself can provide. This policy is reflected in three new categories of investments.

The first category includes entities that limit their activities to providing financial services that an FRFI is permitted to provide under the New Act, other than deposit taking, fiduciary services, certain leasing activities, high-ratio mortgages on residential properties, underwriting insurance and certain securities-dealing activities. This enables FRFIs to establish, for the first time, separate legal entities to engage in consumer or commercial lending activities that are not directly subject to any licensing or capital requirements under the F.I. Statutes.

The second new category includes entities that engage in activities related to the promotion, sale, delivery or distribution of a financial product or service of the FRFI or a member of its group of companies, but that do not themselves provide a financial service. This type of entity may provide services to other financial services entities outside the group if a significant portion of its business is provided to the FRFI and/or a member of the FRFI's group of companies. This ability to invest in entities that offer services to customers outside the FRFI's group represents a relaxation of the permitted investment regime.

The third category of investments includes service entities. An FRFI, BHC or an IHC may invest in an entity that provides services exclusively to financial institutions and other financial service providers and certain of their affiliates, provided that the entity also provides services to the FRFI, BHC, IHC or its affiliate. This category is more flexible than the previous "service corporations" categorization, as it no longer requires the receiver of services to also be an investor in the services entity.

In addition to these three categories of investments, the legislation continues to permit FRFIs, BHCs and IHCs to invest in mutual funds and their related distribution corporations, real property brokerage entities, downstream holding entities, specialized financing entities and information services entities. Permitted information services activities have also been clarified, if not expanded, to include the operation of data transmission systems, information sites, communication devices and information platforms or portals.

These new investment categories are subject to limitations, since FRFIs, BHCs and IHCs must control certain of their investments. These investments include those in other financial institutions and entities that engage in financial intermediary activities that expose the entity to material market or credit risk. The minority investment regulations made under each of the F.I. Statutes continue to apply, however, and now apply to BHCs and IHCs. Subject to certain terms and conditions, these regulations permit FRFIs, BHCs or IHCs to make minority investments in entities that FRFIs, BHCs or IHCs would otherwise be required to control. However, certain investments must be approved by the Minister or the Superintendent of Financial Institutions before they can be made.

Merger Review Process

One of the goals of the New Act is to allow Canadian financial institutions to become large enough to compete internationally while maintaining a reasonable degree of domestic competition. Large banks and large BHCs are now permitted to merge with other federally incorporated banks or institutions (including BHCs, insurance companies, IHCs, trust or loan companies and nonregulated business corporations) and continue as one bank or BHC. According to ministerial policy, however, large banks are not permitted to merge with large demutualized insurance companies, and vice versa. This policy also applies to large BHCs and large IHCs.

The new ownership restrictions also apply in the context of bank mergers. If a large bank or large BHC were to merge with another institution, the new merged entity would be required to be widely held.

Guidelines governing these mergers require the review of competition issues by the Competition Bureau and the review of prudential issues by the Office of the Superintendent of Financial Institutions ("OSFI"). The guidelines also require the parties to the proposed merger to prepare a public interest impact assessment ("PIIS").

The PIIS must outline the costs and benefits of the proposed merger. This outline can include external considerations, such as the proposed merger's impact on sources of financing for individuals and for small to medium-sized businesses, and regional impacts of branch closures. It can also include internal considerations, such as the proposed merger's impact on employment and impact on the ability to develop and adopt new technologies.

The House of Commons Standing Committee on Finance and the Standing Senate Committee on Banking, Trade and Commerce (collectively, the "Committees") will be asked to review the PIIS and conduct public hearings into the public interest issues related to the proposed merger. The Competition Bureau, OSFI and the Committees will then report to the Minister. The decision on whether or not to approve the merger, and on what terms, is ultimately up to the Minister, who will consider prudential, competition and public interest concerns in arriving at a decision. If the concerns cannot be addressed, the Minister will not allow the proposed merger. If the concerns can be addressed, then the Competition Bureau and OSFI will negotiate competition and prudential remedies, as the case may be, and will assist the Department of Finance in negotiating public interest remedies. Following the successful negotiation of remedies, the Minister will approve the proposed merger with undertakings that reflect the remedies.

Foreign Banks

The New Act amendments to Part XII of the *Bank Act* bring changes with respect to the manner in which foreign banks may operate in Canada, but without substantially changing Canada's foreign bank policy. The aim of these changes is to clarify the complex rules concerning the role and permitted activities of foreign banks in Canada.

Under the new rules, foreign banks fall broadly into three categories: (i) regulated foreign banks that have a financial establishment in Canada ("Financial Foreign Banks"); (ii) regulated foreign banks that do not have a financial establishment in Canada ("Nonfinancial Foreign Banks"); and (iii) entities that fall within the definition of a foreign bank but that are not considered to be regulated foreign banks ("Near Banks"). Different rules apply to each of these types of foreign banks.

The first two categories of foreign banks are considered to be regulated because they meet the designation criteria under the New Act, which distinguishes them from Near Banks. A foreign bank may be so designated[4] if it (or entities it controls or holds a substantial investment in) carries on business in Canada, and:

- it is a real foreign bank according to non-Canadian laws;
- it is regulated as a real foreign bank outside Canada;
- it uses the word *bank* or *banking* or its equivalent in its corporate name; or
- its corporate group derives 35% or more of its consolidated total assets or revenues from the activities of such real foreign banks in the corporate group.

The New Act imposes a general prohibition on all foreign banks carrying on business or making investments in Canada. Neither a foreign bank nor an entity associated with it may carry on business or make investments in Canada unless authorized or otherwise permitted to do so.

Under the New Act, Financial Foreign Banks are generally permitted to carry on the same financial activities as do Canadian banks. The investments permitted of Financial Foreign Banks are designed to place them on a level playing field with Canadian banks. In recognition of the fact that many countries allow banks to own commercial enterprises, the New Act grants the Minister the power to allow a Financial Foreign Bank to invest in certain limited commercial businesses in Canada. The businesses must be the same as, similar to, related to or incidental to the businesses outside of Canada of the Financial Foreign Bank or an entity associated with it. No Financial Foreign Bank or any entity associated with it may carry on or invest in automobile leasing activities, however, which are also prohibited to Canadian banks.

Nonfinancial Foreign Banks are essentially permitted only to engage in commercial activities and have unlimited commercial holdings in Canada. They or their associated entities may not be major shareholders of an FRFI, a BHC, an IHC or a financial services provider. They may, however, acquire any other Canadian entity.

Near Banks may apply for an order from the Minister that exempts them from most of the Part XII requirements, including the general prohibition on foreign banks carrying on business in Canada.[5] With proper exemption orders, Near Banks may therefore carry on unregulated activities in Canada, including asset-based lending, wholesale financing and automobile leasing.

If foreign banks or entities associated with them contravene a particular section of the New Act or fail to comply with any terms and conditions of an order, then the Minister may require them to divest their Canadian investment.

The New Act establishes a number of transitional or grandfathering provisions that focus on investments that are no

longer permitted to designated foreign banks or entities associated with them. Designated foreign banks with existing Ministerial orders may continue to hold investments as long as they disclose to the Minister the nature of the entities' businesses, and as long as those activities do not change.

Measures to Empower and Protect Consumers

The New Act establishes the Financial Consumer Agency of Canada ("FCAC") to enforce the consumer-oriented provisions of the F.I. Statutes and to monitor the industry's self-regulatory initiatives. The FCAC is designed to protect the interests of consumers and small businesses, promote consumer awareness and respond to general consumer inquiries.

Subject to regulations made by the Governor in Council, banks, federal trust and loan companies and federal cooperative credit associations are required to give notice of a branch closure. After notice is given but before the branch is closed, the FCAC's commissioner can, in prescribed situations, require a bank to meet with him or her and interested parties to exchange views about the closing or cessation of activities. This is the extent of the commissioner's powers, however; the commissioner has no power to enforce or prohibit a closure, or to change a closure schedule.

Banks, trust and loan companies, and insurance companies with $1 billion or more in equity must now publish annual statements that describe their contribution and that of their prescribed affiliates to the Canadian economy and society. These statements must be filed with the commissioner and must be disclosed to customers and the public.

Banks are now required to allow individuals to open a retail account without a minimum deposit or the maintenance of a minimum deposit. Eight banks have also signed memoranda of understanding with the federal government, in which they agree to offer low-cost accounts to their customers. In addition, the *Bank Act* restrictions on coercive tied selling are broadened to cover the purchase of any financial product, rather than loans only, as a condition of obtaining another product.

Measures to Improve the Regulatory Environment

The New Act changes the mandate of the Canadian Payments Association ("CPA") to better define its role in the payment system and clarify its objectives. The New Act also increases the size of the CPA board, allowing for the appointment of three independent directors by the Minister.

In support of initiatives to further competition in the financial services sector, the New Act provides the Superintendent of Financial Institutions with increased supervisory powers to deal with the possibility of additional risk in the system.

To reduce regulatory compliance obligations on FRFIs, the New Act first transfers a number of applications formerly requiring Ministerial approval to the Superintendent, thus expediting the approval process. Second, it establishes a new notice-based approval system for many of the applications that require the Superintendent's approval.

Conclusion

The New Act will hopefully provide FRFIs with the latitude to adapt to, and thrive in, an era of change and global competition. In addition to implementing the measures discussed above, the new financial services framework (i) maintains the practice of mandatory five-year review of the F.I. Statutes; (ii) demonstrates the federal government's readiness to revisit the F.I. Statutes prior to the five-year review when necessary to keep up with the changing marketplace; and (iii) increases the federal government's ability to adjust the framework as needed between legislative initiatives. ■

[1] Namely, the *Bank Act* (Canada), as amended; the *Insurance Companies Act* (Canada), as amended; the *Trust and Loan Companies Act* (Canada), as amended; and the *Cooperative Credit Associations Act* (Canada), as amended.
[2] The traditional four pillars of the Canadian financial industry are banks, insurance companies, trust companies and securities dealers.
[3] The Minister, however, may provide by order that the widely held rule does not apply to a large demutualized insurance company.
[4] Foreign banks that are designated under the old rules are deemed to be designated under the new rules.
[5] Near Banks with equivalent exemption orders under the old rules are deemed to have an exemption order under the new rules.

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