Banking Regulation

Second Edition

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CONTENTS

Preface	Peter Hsu & Rashid Bahar, *Bär & Karrer Ltd*	
Albania	Ada Braho, *Frost & Fire Consulting*	1
Angola	Hugo Moredo Santos & Nádia da Costa Ribeiro, *Vieira de Almeida & Associados*	11
Argentina	Javier L. Magnasco & Daniel Levi, *Estudio Beccar Varela*	18
Canada	Blair W. Keefe & Eli Monas, *Torys LLP*	24
Chile	Max Spiess, Juan Pablo Baraona & Ricardo Vásquez, *Baraona Abogados*	33
China	Dongyue Chen & Xingyu Wu, *Zhong Lun Law Firm*	45
Colombia	Luis Humberto Ustáriz González, *Estudio Jurídico Ustáriz & Abogados*	58
Congo D.R.	Angeline Mangana & Gaby Kabue, *MBM-Conseil*	65
Cyprus	Elias Neocleous & George Chrysaphinis, *Andreas Neocleous & Co LLC*	71
Ecuador	Dr Boanerges Rodríguez Freire & Pedro José Izquierdo LL.M., *Coronel & Pérez*	81
Finland	Andrei Aganimov & Niina Nuottimäki, *Borenius Attorneys Ltd*	87
France	Jean L'Homme & Gaël Rousseau, *Fidal*	96
Germany	Dr. Maximilian von Rom & Sebastian Tusch, *Gleiss Lutz*	105
Greece	George Bersis & Smaragda Rigakou, *PotamitisVekris*	113
Japan	Koichi Miyamoto, *Anderson Mōri & Tomotsune*	122
Mozambique	Orlando Vogler Guiné, João Mayer Moreira & Filipe Ravara, *Vieira de Almeida & Associados*	132
Netherlands	Joris van Horzen & Joost Achterberg, *Kennedy Van der Laan N.V.*	140
Portugal	Hugo Moredo Santos & Benedita Aires, *Vieira de Almeida & Associados*	149
Russia	Alexander Linnikov, Sergei Sadovoy & Leonid Karpov, *LEAD Consulting Law Firm*	158
Rwanda	Julien Kavaruganda & Emmanuel Muragijimana, *K-Solutions & Partners*	174
Singapore	Elaine Chan, *WongPartnership LLP*	183
Spain	Fernando Mínguez Hernández, Íñigo de Luisa Maíz & Rafael Mínguez Prieto, *Cuatrecasas, Gonçalves Pereira*	192
Switzerland	Peter Hsu & Rashid Bahar, *Bär & Karrer Ltd*	205
Togo	Martial Akakpo & Sandrine Badjili, *MARTIAL AKAKPO & PARTNERS, LLP*	215
United Kingdom	Ben Hammond, Nicola Higgs & Lorraine Johnston, *Ashurst LLP*	224
USA	Reena Agrawal Sahni & Timothy J. Byrne, *Shearman & Sterling LLP*	235
Uzbekistan	Mels Akhmedov & Irina Tsoy, *Business Attorney Service*	245
Venezuela	Gustavo J. Reyna & Carlos Omaña, *D'Empaire Reyna Abogados*	256

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Introduction

The banking industry in Canada is one of the safest and most efficient banking systems in the world. For seven years in a row, the World Economic Forum has recognised Canada's banking system as the soundest in the world.[1] Canada's banking industry is composed of domestically owned banks, foreign bank subsidiaries, full-service foreign bank branches, foreign bank lending branches (which cannot take deposits and can only fund themselves on the interbank market) and foreign bank representative offices. As of March 2015, the banking industry in Canada comprised 28 domestic banks, 24 foreign bank subsidiaries, 26 full-service foreign bank branches, 3 foreign bank lending branches and 25 foreign bank representatives offices.[2]

Canadian banks are regulated by the Office of the Superintendent of Financial Institutions (OSFI), which is generally regarded as one of the most conservative banking regulators in the world. OSFI is a strong proponent of meeting international best practices and has publicly announced its intention to fully implement Basel III well in advance of 2019. This conservative approach has served the Canadian banking sector well, enabling Canadian banks to weather the financial crisis much better than most of their international competitors (the Canadian government did not have to bail out any financial institutions in Canada).

Regulatory architecture: overview of banking regulators and key regulations

General overview

The *Bank Act*, a federal statute enacted by the Parliament of Canada, is the primary statute governing the banking industry in Canada. The Canadian Constitution gives the federal government exclusive jurisdiction to incorporate banks, establish their business and investment powers, and impose capital and other requirements regulating the business and affairs of banks. While Canadian provincial governments may incorporate and regulate certain deposit-taking institutions, such as credit unions, only institutions incorporated under the *Bank Act* may refer to themselves as banks.

The *Bank Act* has been supplemented by numerous regulations, guidelines, advisories and regulatory rulings that elaborate upon the principles and rules established therein.

Canada believes that there should be a separation between the financial services sector and the commercial sector of the economy. Therefore, government policy is to restrict the ability of banks to engage in or own interests in entities that carry on non-financial services business.

Office of the Superintendent of Financial Institutions

The *Office of the Superintendent of Financial Institutions Act* was enacted by the federal government in order to establish one consolidated regulator for the banking and insurance sectors in Canada. OSFI is the principal agency responsible for overseeing banks and administering the *Bank Act* on behalf of the Minister of Finance. It was created to contribute to the public confidence in the Canadian financial system. As part of its role, OSFI publishes guidelines and advisories in respect of the sector and provides interpretive rulings on a case-by-case basis. Among the key guidelines established by OSFI are those that set out the adequate levels of capital and liquidity to be maintained by banks. The

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Capital Adequacy Requirements Guideline, which was revised in January 2013[3] to incorporate new requirements contained in Basel III, is the key guideline in this regard.

Financial Consumer Agency of Canada

The Financial Consumer Agency of Canada (FCAC) was established in 2001 to administer the consumer provisions of the *Bank Act*, including disclosure requirements regarding borrowing costs and deposit account terms. The FCAC does not have any authority to grant redress to consumers, but can impose penalties on banks for failing to comply with the requirements of the *Bank Act* and the regulations.

Canadian Deposit Insurance Corporation

The Canadian Deposit Insurance Corporation (CDIC) was established to ensure the safety of small deposits and to assist in maintaining the public confidence and stability in the financial system by providing deposit insurance for bank depositors. Although the CDIC relies upon the examination reports of the Superintendent as its vehicle for monitoring the performance of a particular insured bank, it has the authority to request that it be appointed as receiver of a troubled bank in certain circumstances if it perceives that a bank is in danger of becoming insolvent and the CDIC is likely to be called upon to make insurance payments to the depositors of the bank.

Recent regulatory themes and key regulatory developments in Canada

In general, Canadian banks weathered the financial crisis much better than most of their international competitors. However, Canada recognises that remaining stagnant is not an option, and is therefore a strong proponent of continuing to meet international best practices, including with respect to capital and corporate governance.

Capital

Canada announced its intention to fully implement Basel III capital requirements on all Canadian banks well in advance of 2019 (with the majority of the requirements already being imposed by January 2013). In particular, OSFI mandated (i) that all non-common capital instruments issued after January 1, 2013 contain features that require them to automatically convert into common shares of the bank if the bank ever becomes non-viable, and (ii) that all existing non-common capital instruments without such features be amortised over a 10-year period on a straight line basis.

The Financial Stability Board released its October 2011 paper titled "Key Attributes of Effective Resolution Regimes for Financial Institutions", which recommends that all resolution authorities should have the ability to "bail in" senior debt of a failing bank before taxpayers are exposed to losses. On August 1, 2014, the Canadian federal government published a consultation paper outlining a proposed design for a bail-in regime for Canada's domestic systemically important banks (D-SIBs). The proposed regime is aimed at ensuring that (a) taxpayers are protected from having to bail out a D-SIB in the highly unlikely event of such an institution running into difficulty, and (b) Canada's financial system remains strong by clarifying that banks' shareholders and creditors are responsible for bearing losses, thereby giving them stronger incentives to monitor the bank's risk-taking activities. In order to be able to achieve each of the policy objectives set forth in the consultation paper, the bail-in regime would be incorporated into Canada's existing resolution framework for banks. The federal government has undertaken a review of these existing resolution tools to determine how best to integrate the conversion power described in the consultation paper.

In its 2013 Budget Plan, the Canadian federal government introduced plans to impose a higher capital requirement on D-SIBs (as determined by OSFI). OSFI released an advisory in March 2013 describing considerations used to designate D-SIBs and establishing a risk-weighted capital ratio requirement equalling a 1 per cent common equity surcharge for banks so designated. The Canadian banks designated as D-SIBs are Bank of Montreal, The Bank of Nova Scotia, Canadian Imperial Bank of Commerce, National Bank of Canada, Royal Bank of Canada and The Toronto-Dominion Bank. These banks are expected to meet the additional risk capital ratio requirement of 1 per cent by January 1, 2016.

Corporate governance

Another key development in Canada since the financial crisis in 2008 is the renewed focus on corporate governance. In 2010, OSFI created a dedicated corporate governance unit to conduct a cross-sector

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review of governance at larger financial institutions. This information was later used to update OSFI's guideline on corporate governance, which will be discussed in greater detail below under the heading "Bank Governance and Internal Controls". As a result of its review, OSFI has developed a greater focus on risk governance and risk appetite at banks. In particular, banks should have an enterprise-wide, board-approved risk-appetite framework that guides the risk-taking activities of a bank and that is well understood throughout the organisation. The risk-appetite framework should set basic goals, limits and benchmarks pertaining to the amount of risk a bank is willing to accept.

Bank governance and internal controls

The *Bank Act* sets out the required composition of banks' boards of directors and mandates the establishment of certain board committees, including an audit committee and a conduct review committee. Under the *Bank Act*, Canadian banks must consist of, at a minimum, seven directors (at least half of whom must be Canadian residents). In addition, the CEO of a Canadian bank must be a resident of Canada and a director of the bank. Each director and officer of a bank in Canada must discharge his or her duties honestly and in good faith with a view to the best interests of the bank, and is required to exercise the care, diligence and skill set that a reasonably prudent person would exercise in comparable circumstances. While there is currently no law or regulation in Canada on bonus payments to management and employees of banks, OSFI requires Canadian banks to implement the Basel Committee's compensation principles on an annual basis, in addition to other international best practices.

In addition to the *Bank Act* provisions regulating the governance of banks, in January 2013 OSFI issued a best practice guideline (the Guideline), which was updated from a previous guideline that was published in 2003, setting out its expectations regarding corporate governance of banks (as well as of other federally regulated financial institutions, such as trust and loan companies and insurance companies). The Guideline aims to promote industry best practices in corporate governance and address international standards as articulated by organisations such as the Financial Stability Board, the Organisation for Economic Co-operation and Development, the Basel Committee for Banking Supervision and the International Association of Insurance Supervisors. OSFI also articulates its expectations with respect to corporate governance through its *Supervisory Framework* and *Assessment Criteria*, which are available on OSFI's website.

Banks are expected to conduct self-assessments of compliance with the Guideline, which are to be made available to OSFI upon request. In addition to complying with the Guideline, boards and senior management of banks are expected to be proactive and aware of corporate governance best practices that are applicable to their institution and, where appropriate, to adopt these best practices. It is important to note that the Guideline is not intended to apply uniformly to all organisations, but is to be applied flexibly depending on the nature, scope and size of the bank.

OSFI has noted that it will take a number of approaches to assess the effectiveness of a bank's corporate governance processes, including discussions with boards, board committees, senior management and oversight functions, and it will seek evidence that processes exist and are operating effectively.

Board and board responsibilities

The Guideline creates a critical distinction between the responsibilities of a bank's board of directors and the responsibilities of its senior management. While the board is responsible for setting the direction and general oversight of the management and operations of an entire bank, senior management is accountable for implementing the board's decisions and is responsible for directing and overseeing the operations of the bank.

At a minimum, the main focus of the board's attention and activities should be to approve the bank's (i) short-term and long-term enterprise-wide business objectives, strategy and plans, (ii) significant strategic initiatives or transactions, (iii) internal control framework, (iv) appointment, performance review and compensation of the CEO and, where appropriate, other members of senior management, (v) succession plans with respect to the board, CEO and, where appropriate, other members of senior management, (vi) mandate, resources and budgets for the oversight functions, and (vii) external audit plan, including audit fees and scope of engagement.

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Senior management, on the other hand, should be responsible for reviewing and discussing the bank's (i) significant operational and business policies, (ii) business and financial performance in terms of the board-approved strategy, (iii) compensation policy for all human resources, (iv) implementation of internal controls, (v) organisational structure, and (vi) compliance with applicable laws, regulations and guidelines. However, the Guideline also notes that the board has a critical role in providing high-level guidance to senior management through review and discussion of the matters listed above. The board should also seek assurances from senior management that decisions are consistent with the board-approved strategy and risk appetite.

The Guideline identifies a number of attributes of an effective board, including: sound judgement when making decisions (taking into consideration the business objective and risk appetite of the bank); initiative (exercising responsibilities in a proactive manner with a readiness to probe and challenge); responsiveness to issues or deficiencies identified by senior management, regulators or the board itself; and operational excellence (permitting open debate and discussion and advance consideration of important matters). It also suggests that the board of a bank regularly conduct a self-assessment of the effectiveness of the board and board committee practices, occasionally with the assistance of independent external advisers (although the board has discretion in establishing the scope and frequency of such external input).

An effective board should provide objective and thoughtful guidance to, and oversight of, senior management and should collectively bring a balance of expertise, skills, experience, perspectives and competencies. The Guideline suggests that boards and board committees have reasonable representation of individuals with financial industry and risk-management expertise and that boards implement a skills and competency evaluation process that is reviewed annually and updated as appropriate. However, the Guideline does not specifically identify an optimal number of board members.

The Guideline requires that boards be independent from senior management. However, beyond the separation of the chair and CEO, OSFI does not view any single board structure as guaranteeing independence. Further, the board should document and approve an independent-director policy, taking into account the specific ownership structure of the institution and, where appropriate, direct tenure. In keeping with the idea that board independence should be maintained, the Guideline also suggests that the role of the chair be separate from the role of CEO. The chair is expected to have frequent dialogue with, and a high level of influence among, other board members and senior management, in addition to direct and ongoing dialogue with regulators.

For the board to fulfil its duties and role of oversight of the bank's operations, OSFI expects banks to establish oversight functions that are independent from operational management through an appropriate committee, such as an Audit Committee or Risk Committee. The heads of the oversight functions should have unfettered access and a direct reporting line to the board and its relevant committees. Boards should approve the mandate, resources and budgets of the oversight functions and, where appropriate, approve the appointment, performance review and compensation of the heads of these functions. More specifically, boards should review and discuss findings and reports produced by the oversight functions and follow up with concerns or findings that are raised by the oversight functions.

Given the different size and complexity of various banks, the scope and sophistication of such oversight functions may vary among institutions. For example, instead of establishing specific oversight functions, boards and senior management of smaller, less complex banks will ensure that other internal or external functions or processes provide the required level of controls and independent enterprise-wide oversight. In addition, the board should regularly assess the effectiveness of the bank's oversight functions and should occasionally, with the assistance of independent external advisers, conduct a benchmarking analysis of those functions or their processes. The board has discretion to establish the scope and frequency of such external input.

<u>Risk governance</u>

Risk governance is another key area that has been identified by OSFI. As mentioned above, the Guideline states that banks should have an enterprise-wide, board-approved Risk Appetite Framework

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(RAF) that guides the risk-taking activities of the bank and that is tailored to its domestic and international business activities. The RAF should be well-understood throughout the organisation, and all operational, financial and corporate policies, practices and procedures of the bank should support the RAF. The RAF should set basic benchmarks, goals and limits of the amount of risk the bank is willing to accept. The RAF is intended to be forward-looking and should consider the material risks to the bank, in addition to the bank's reputation.

Depending on the size and nature of a bank, the board should establish a dedicated Risk Committee to oversee risk management on an enterprise-wide basis. The Risk Committee should consist of members that are non-executives of the bank, and members of the committee should have sufficient knowledge in risk management of financial institutions. Through assurances from the Chief Risk Officer, the Risk Committee should ensure that risk-management activities are independent from operational management, are adequately resourced and have appropriate visibility throughout the organisation. The Risk Committee should receive reports on significant risks of the bank and exposures relative to the bank's risk appetite (including approved risk limits) and should provide input on the approval of material changes to a bank's strategy and corresponding risk appetite. Banks should also have a senior officer who is responsible for identifying, measuring, monitoring and reporting on the risks of the bank on an enterprise-wide level, and who has unfettered access and a direct reporting line to the board or Risk Committee. This officer should provide regular reports to the board, the Risk Committee and senior management, including reporting on whether the bank is operating within the RAF. In addition, the board and Risk Committee should periodically seek assurances from the Chief Risk Officer that any risk information or analysis provided by business lines is objective. The Guideline also specifies that the Chief Risk Officer and risk-management function should not be directly involved in revenue-generation or in the management and financial performance of any business line or product of the bank, and that the Chief Risk Officer's compensation should not be linked to the performance of specific business lines of the bank.

Audit Committee

Under the *Bank Act*, banks are required to establish an Audit Committee comprising non-employee directors, a majority of whom are "non-affiliated" with the institution. Duties of the Audit Committee include reviewing annual statements and evaluating and approving internal control procedures.

The Guideline stipulates that the Audit Committee, not senior management, should be responsible for recommending to shareholders the appointment, reappointment, removal and remuneration of the external auditor; the Audit Committee should agree to the scope and terms of the audit engagement and approve the engagement letter. The Audit Committee should also establish criteria for the types of non-audit services that the external auditor can and cannot provide to the bank and should be satisfied with the content of the auditor's engagement letter before it is signed. The Audit Committee should also assess whether any change to the external auditor's materiality level and/or proposed scope continues to ensure a quality audit. Annually, the Audit Committee should report to the board on the effectiveness of the external auditor.

OSFI also expects an Audit Committee to discuss the overall results of an audit and any related concerns raised by the external auditor with both senior management and the external auditor, including key areas of risk for material misstatement of financial statements, areas of significant auditor judgment (including accounting policies and estimates), significant unusual transactions, difficult or contentious matters noted during the audit, changes in the audit scope or strategy, internal control deficiencies identified during the course of the audit and areas of financial statement disclosures that could be improved.

Bank capital requirements

Regulatory capital of a bank in Canada consists of Tier 1 capital (which comprises Common Equity Tier 1 capital and Additional Tier 1 capital) and Tier 2 capital.[4] The *Bank Act* requires that banks maintain adequate capital and liquidity, and authorises the Superintendent to establish guidelines on these issues. The Superintendent has issued guidelines for both capital and liquidity.

The current capital adequacy guideline was revised in January 2013 to reflect the changes to capital requirements contained in Basel III.[5] Canada is a strong supporter of the work of the Basel Committee

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and firmly believes that Canadian banks should meet international best practices for capital. The intention is, therefore, for all Canadian banks to fully implement the Basel III requirements well in advance of 2019. In that regard, OSFI has required *all* financial institutions (regardless of the size of the institution or whether it is publicly traded) since the beginning of Q3 2013 to adhere to the new composition of capital public disclosure requirements set forth in the Basel Committee on Banking Supervision Disclosure Rules (the BCBS Disclosure Rules).[6]

Prior to 2015, Canada required that the ratio of a bank's assets to its capital not exceed an assigned leverage ratio (the maximum leverage ratio that could be assigned to an institution by the Superintendent was 23 times total capital, but most institutions would have had a much lower multiple). However, beginning in Q1 2015, Canada adopted the Basel III leverage ratio and disclosure requirements. As such, Canadian banks are now expected to maintain a leverage ratio that meets or exceeds 3% at all times. The Superintendent will also prescribe authorised leverage ratio requirements for individual institutions (and we would expect that many institutions will have been assigned a more restrictive leverage ratio than 3%). The authorised leverage ratio for each institution is confidential and not publicly disclosed. The authorised leverage ratio is assigned by the Superintendent on the basis of a number of factors, including the potential impact of the change in the leverage ratio on the institution's risk-based capital ratios compared to internal targets and OSFI targets, the adequacy of capital and liquidity management processes and procedures and the institution's risk profile and business lines (including diversification of exposures).

One of the principal activities of bank supervisors is to monitor compliance with the capital requirements established under the capital adequacy guideline. Supervisors receive quarterly capital returns from banks, and, when trends begin to develop that suggest that a bank's capital adequacy ratios are reducing, supervisors will require that bank to establish a plan to address these trends. The Superintendent has also published an advisory describing its supervisory intervention programme. Under the advisory, as capital deteriorates, a bank will be assigned escalating stages of intervention. Depending on the stage assigned, additional reporting will be required and other restrictions on the business of the bank may be imposed, including a requirement to cease all dividends paid to shareholders.

If the Superintendent believes that a bank is undercapitalised, it has the authority to direct a bank to increase its capital, and if the Superintendent believes the situation has deteriorated to the point that there is a material risk to depositors and other creditors, it may take control of the assets of the bank to protect them from erosion (or, if that is not sufficient, take control of the bank).

Rules governing banks' relationships with their customers and other third parties

Investment powers

Under the *Bank Act*, banks are prohibited from engaging in or carrying on any business other than the business of banking, except as permitted thereunder. Banks can provide, among other services, any financial services, investment counselling services and portfolio management services; act as a financial agent; and issue and operate payment, credit or charge card plans. Banks may also invest in securities, but are limited in making "substantial investments" or in controlling certain types of entities. A substantial investment will arise through direct or indirect beneficial ownership of voting shares carrying more than 10 per cent of the voting rights attached to all outstanding voting shares of a corporation, shares representing more than 25 per cent of the shareholders' equity in a corporation, or interests representing more than 25 per cent of the ownership interests in any unincorporated entity.

Banks may, however, make controlling and, in certain circumstances, non-controlling substantial investments in Canadian banks, trust or loan companies, insurance companies, cooperative credit societies and entities primarily engaged in dealing in securities; in foreign regulated entities that are primarily engaged outside Canada in a business that if carried on in Canada would be the business of banking, the business of a cooperative credit society, the business of insurance, the business of providing fiduciary services or the business of dealing in securities; and in factoring, finance, financial leasing, specialised financing and financial holding entities. Certain substantial investments may be made only with the prior approval of the Minister of Finance or the Superintendent of Financial Institutions.

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Confidentiality and privacy

All banks in Canada have a common law duty of confidentiality in their dealings with customers and in customer identification. In addition, Canadian banks must comply with Canadian privacy laws, including the federal *Personal Information Protection and Electronics Documents Act* (PIPEDA). PIPEDA applies to all organisations in respect of personal information used, collected or disclosed by an organisation in the context of commercial transactions, and requires that organisations obtain an individual's consent prior to using such personal information. A positive duty to safeguard personal information that has been collected is imposed on organisations, and certain limits on the retention of personal information are also set out in PIPEDA.

Consumer protection

The *Bank Act* contains a number of regulations that focus on consumer protection issues, including requirements for the disclosure of the cost of borrowing and disclosure of interest rates. As mentioned above, the FCAC was established to administer the consumer provisions of the *Bank Act* (in addition to strengthening oversight of consumer issues and expanding consumer education in the financial sector). In particular, the FCAC's mandate, which derives from the *Financial Consumer Agency of Canada Act*, includes the following: (i) to supervise federally regulated financial institutions to ensure that they comply with federal consumer protection measures that apply to them, with undertakings relating to the protection of customers as defined in legislation, and with directions from the Minister of Finance; (ii) to promote the adoption by financial institutions of policies and procedures designed to implement consumer protection measures, voluntary codes of conduct and financial institutions' public commitments designed to protect the interests of customers; (iii) to monitor federally regulated financial institutions to ensure that they comply with voluntary codes of conduct and respect the public commitments they have made to protect the interests of consumers and merchants; (iv) to promote consumer awareness of the obligations of financial institutions to financial consumers and of all matters related to protecting consumers of financial products and services; (v) to foster consumer understanding of financial services and related issues in cooperation with government bodies, financial institutions, consumer groups and other organisations; (vi) to collaborate and coordinate its activities with stakeholders to contribute to and support initiatives to strengthen the financial literacy of Canadians; (vii) to monitor and evaluate trends and emerging issues that may have an impact on consumers of financial products and services; (viii) to supervise payment card network operators to determine whether they are in compliance with the provisions of the *Payment Card Networks Act* and its regulations; (ix) to promote adoption by payment card network operators of policies and procedures designed to implement provisions of the *Payment Card Networks Act* and its regulations; (x) to monitor implementation of voluntary codes of conduct adopted by payment card network operators and any public commitments they make regarding their commercial practices relating to payment card networks; and (xi) to promote public awareness about the obligations of payment card network operators under a voluntary code of conduct or the *Payment Card Networks Act*.

In cases of contravention or non-compliance with legislation, the FCAC will notify a bank of such violation and may also seek a commitment from the bank to remedy the issues within a short time, impose a monetary penalty, impose criminal sanctions or take other actions as are necessary.

With respect to protection of customers' deposits, the CDIC was established to ensure the safety of small deposits and to assist in maintaining stability and public confidence in the financial system by providing deposit insurance for the banks' depositors. CDIC member institutions fund deposit insurance through premiums paid on the insured deposits that they hold. Deposit insurance is automatic for certain eligible Canadian dollar-denominated deposits (including savings accounts, chequing accounts and term deposits with an original term to maturity of five years or less)[7] up to $100,000 per depositor per institution.

* * *

Endnotes

1. World Economic Forum, Global Competitiveness Report, 2008, 2009, 2010, 2011, 2012, 2013 and 2014.

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2. http://www.osfi-bsif.gc.ca.
3. The Capital Adequacy Requirements Guideline has most recently been further updated effective January 2015.
4. Common Equity Tier 1 capital includes common shares. Additional Tier 1 capital includes preferred shares. Tier 2 capital includes subordinated debentures.
5. The Capital Adequacy Requirements Guideline has most recently been revised effective January 2015.
6. See the Basel Committee on Banking Supervision's publication titled Composition of Capital Disclosure Requirements: Rules Text, June 26, 2012, for more details on these capital ratios.
7. Products not insured by CDIC include mutual funds, stocks, bonds and term deposits with a date to maturity of more than five years.

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