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in 27 jurisdictions worldwide

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Canada

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Regulatory framework

- 1** What are the principal governmental and regulatory policies that govern the banking sector?

There are several overarching policy objectives that Canada uses as a framework for establishing the rules of the banking sector.

From a capital perspective, Canada strongly believes that Canadian banks should meet international best practice for capital and was an early adopter of the Basel II Capital Accord as the basis for establishing the capital requirements for domestic banks. Canada has also announced its intention to fully implement the Basel III requirements on all Canadian banks and advised banks to maintain prudent retention policies and sound capital management practices in order to meet the new requirements in the interim period (and well in advance of 2019).

Second, Canada believes that large banks that are important to the economy should be free from the influence of any one shareholder. To implement this policy, Canada imposes a widely held requirement in respect of its largest and most important banks.

Finally, 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.

- 2** Please summarise the primary statutes and regulations that govern the banking industry.

The primary statute governing the banking industry is the Bank Act, a federal statute enacted by the parliament of Canada. Under Canada's constitution, the federal government has exclusive jurisdiction to incorporate banks, establish their business and investment powers and impose capital and other requirements regulating the business and affairs of banks.

The Bank Act has been supplemented by numerous regulations made under its authority that elaborate upon the principles and rules established by the Act.

The Canadian provincial governments also incorporate and regulate certain deposit-taking institutions, such as credit unions; however, only institutions incorporated under the Bank Act may refer to themselves as banks.

The federal government has also enacted the Office of the Superintendent of Financial Institutions Act to establish one consolidated regulator for the banking and insurance sectors. The office is the principal agency responsible for administering the Bank Act on behalf of the Minister of Finance. As part of its role, the office has published guidelines and advisories respecting the sector and provides interpretive rulings on a case-by-case basis. Among the key guidelines established by the office are guidelines addressing the maintenance by banks of adequate capital and liquidity. Guideline A-1, entitled Capital Adequacy Requirements, is the key guideline in this regard.

- 3** Which regulatory authorities are primarily responsible for overseeing banks?

The Office of the Superintendent (the Superintendent) of Financial Institutions (OSFI) has primary responsibility for overseeing banks. The office administers the Bank Act and examines banks to determine that they are in sound financial condition and complying with the requirements of the act and regulations.

The Financial Consumer Agency of Canada has been established to administer the consumer provisions of the Bank Act. These provisions include disclosure requirements respecting borrowing costs and deposit account terms. The agency does not have any authority to grant redress to consumers. Rather, it can impose penalties on banks for failing to comply with the requirements of the act and the regulations.

The Canada Deposit Insurance Corporation (CDIC) provides deposit insurance for the banks' 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 it is likely that it will be called upon to make insurance payments to the depositors of the bank.

- 4** Describe the extent to which deposits are insured by the government. Describe the extent to which the government has taken an ownership interest in the banking sector and intends to maintain, increase or decrease that interest.

The Canada Deposit Insurance Corporation insures the first C\$100,000 deposits held by a depositor in a particular bank. The insurance applies only to funds denominated in Canadian dollars. The Canadian government has not taken an ownership interest in any participants within the banking sector.

- 5** Which legal and regulatory limitations apply to transactions between a bank and its affiliates? What constitutes an 'affiliate' for this purpose? Briefly describe the range of permissible and prohibited activities for financial institutions and whether there have been any changes to how those activities are classified.

Banks are restricted from entering into transactions with related parties. Related parties include a bank's directors and senior officers, persons that have a significant interest in the bank and the entities in which such persons or their spouses or minor children have a substantial investment.

A limited number of specified related-party transactions are permitted under the Bank Act, provided that they are on market terms and conditions.

Subject to certain exceptions, a bank is only permitted to engage in or carry on the business of banking and such business generally as appertains thereto. The Bank Act clarifies activities included within

the ‘business of banking’ and also sets out certain additional activities that banks may conduct, such as dealing with real property and undertaking various information services and data-processing activities. Notably, there are restrictions on banks undertaking fiduciary activities, providing unlimited guarantees, dealing in securities, undertaking insurance activities and undertaking personal property leasing activities. With respect to investments, generally banks are only allowed to acquire control of, or acquire or increase a substantial investment in, a ‘permitted entity’, and part IX of the Bank Act sets out a list of permitted investments. In certain cases, ministerial or superintendent approval is required in order to acquire control of or make a substantial investment in an entity.

The range of permissible and prohibited activities for banks has not changed recently. For the most part, such provisions of the Bank Act have been the same since about 2001.

- 6** What are the principal regulatory challenges facing the banking industry?

In general, Canadian banks weathered the financial crisis much better than most of their international competitors. The main challenge facing the banking sector in Canada is the potential for onerous changes in regulation, including with respect to capital requirements, which are being imposed in some jurisdictions internationally being adopted in Canada, particularly if they are not adopted uniformly on an international level. In particular, Canada has announced its intention to fully implement the Basel III requirements on all Canadian banks and advised banks to maintain prudent retention policies and sound capital management practices in order to meet the new requirements in the interim period (and well in advance of 2019).

- 7** How has regulation changed in response to the recent crisis in the banking industry?

Canada’s banking system did not suffer the same level of erosion of confidence that has been experienced in some other countries. Generally, Canadian banks did not have the same level of exposure to toxic assets as many of their international competitors. Further, the major banks entered the crisis well capitalised and have been able to raise additional capital in the market. Consequently, the government has not been required to inject capital into any Canadian bank.

Nonetheless, the government has amended the Bank Act to give it the authority to make capital investments in the banking industry should they become necessary and to impose restrictions on the business of any bank that receives such investments, including restrictions on compensation paid to directors and officers. Resolution techniques for dealing with troubled banks have also been enhanced through the flexibility to create ‘bridge’ banks.

- 8** In what ways do you anticipate the legal and regulatory policy changing over the next few years?

In 1992, Canada adopted a policy of reviewing and revising the Bank Act every five years. The last such revision was completed in 2007 and the next review is not scheduled to take place until 2012. The minister of finance launched the scheduled review of banking legislation in September 2010, requesting comments to be submitted last year by financial sector participants regarding suggested changes to banking legislation. Very few changes to the legislation are expected.

Canada will probably continue to be an active participant in any discussions that take place at the Basel Committee for Banking Supervision that are directed towards further refining and adopting the Basel III rules or other supervisory directions and in other international discussions, particularly those of the Financial Stability Forum.

Supervision

- 9** How are banks supervised by their regulatory authorities? How often do these examinations occur and how extensive are they?

Supervision takes two forms. Under the Bank Act, the Superintendent is instructed to conduct an examination of every bank at least annually to determine if it is in sound financial condition and complying with the requirements of the Bank Act and Regulations.

Banks are also required to submit detailed financial statements quarterly and annually that are reviewed by the OSFI in an attempt to detect any undue risk before it creates a solvency issue.

The office also relies upon the work of external auditors as an important source of information respecting the financial condition of banks.

- 10** How do the regulatory authorities enforce banking laws and regulations?

While the Bank Act contains penalty provisions and sanctions to address violations of its terms, generally the Superintendent uses other tools to ensure that banks comply with banking laws and regulations. For example, the Superintendent has the authority to enter into binding compliance agreements to ensure that violations are not repeated. The Superintendent may also remove directors and officers who are found to be unfit to hold their positions.

The Superintendent has also been given the power to issue administrative monetary penalties in respect of violations of certain provisions of the Bank Act. These monetary penalties may be imposed if the Superintendent believes, on the balance of probabilities, that a violation has taken place. In practice, the OSFI uses ‘moral suasion’, including the threat of using its formal powers, to effectively regulate banks to make any changes that the OSFI feels are necessary or appropriate.

- 11** What are the most common enforcement issues and how have they been addressed by the regulators and the banks?

Because Canada does not have a history of initiating enforcement actions, there is very little public disclosure of the actions taken by regulators to encourage compliance with the requirements of the Bank Act and Regulations. The one exception is the Financial Consumer Agency of Canada, which publishes the results of its investigations including any sanction that was imposed.

There is no evidence that there are any widespread or recurring compliance issues at this time.

- 12** How has bank supervision changed in response to the recent crisis?

As Canadian banks have not been severely affected by the global financial crisis, there has not been a need to significantly revise the existing supervision of Canadian banks. Regulators have encouraged the banks to shore up their capital to the extent that it is possible. Canada has also announced its intention to fully implement the Basel III requirements on all Canadian banks and advised banks to maintain prudent retention policies and sound capital management practices in order to meet the new requirements in the interim period (and well in advance of 2019).

Capital requirements

- 13** Describe the legal and regulatory capital adequacy requirements for banks. Must banks make contingent capital arrangements?

The Bank Act requires that banks maintain adequate capital and liquidity and authorises the government to make regulations respecting adequate capital and liquidity and for the Superintendent

to establish guidelines in this regard. Although no regulations have been made, the Superintendent has issued guidelines respecting both capital and liquidity.

The current capital adequacy guideline implements the Basel II Capital Accord. Similarly, the liquidity guideline is consistent with the principles laid down by the Basel Committee on Banking Supervision. Canada is a strong supporter of the work of the Basel Committee and Canada has also announced its intention to fully implement the Basel III requirements on all Canadian banks and advised banks to maintain prudent retention policies and sound capital management practices in order to meet the new requirements in the interim period (and well in advance of 2019).

In addition to adopting Basel II, the Superintendent has retained a requirement that the ratio of a bank's assets to its capital does not exceed an assigned leverage ratio. The leverage ratio is assigned based on a number of factors, including the overall size of the bank, its perceived level of risk and the length of time that it has been in existence. Currently, the maximum leverage ratio that may be assigned is 23 times.

14 How are the capital adequacy guidelines enforced?

Monitoring compliance with the capital requirements established under the capital adequacy guidelines is one of the principal activities of bank supervisors. Supervisors receive quarterly capital returns from the banks. As soon as a trend is detected that suggests that a bank's capital adequacy ratios are reducing, supervisors require that the bank establish a plan for addressing the trend.

The Superintendent has published an advisory describing its supervisory intervention programme. Under the advisory, as capital deteriorates a bank will be assigned an escalating stage 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.

15 What happens in the event that a bank becomes undercapitalised?

The Superintendent has the authority to direct a bank to increase its capital if the Superintendent believes that it is undercapitalised. Of course, this may not be possible and further action to protect depositors and creditors may be required. If the Superintendent believes that the situation has deteriorated to the point that there is a material risk to depositors and other creditors, the Superintendent may take control of the assets of the bank to protect them from erosion and, if that is not sufficient, to take control of the bank. Bridge banks may not be as necessary as under circumstances described in question 16.

Recently, the Bank Act was amended to enable the minister of finance to make an investment in the shares of a bank if the minister believes that it is necessary to promote stability in the financial sector. The decision to invest in the shares of a bank must also be confirmed by the governor in council (a committee of cabinet ministers).

If it is not possible to rehabilitate a troubled bank, the Superintendent has the authority to request that the attorney general bring an application to wind up the bank under the Winding-up and Restructuring Act.

16 What are the legal and regulatory processes in the event that a bank becomes insolvent?

If the Superintendent believes that a bank is insolvent or if any other situation exists that may be materially prejudicial to the interests of depositors and creditors (for example, if the Superintendent believes that the bank is no longer viable and will likely become insolvent), the Superintendent may take control of the assets of a bank for an interim period. The Superintendent must report such action to the

minister of finance, and the minister may overrule such action if the minister believes that it is not in the public interest. If the minister does not so order, the Superintendent may continue to exercise control over the assets of the bank or may move to take control of the bank itself. The bank has the right to make representations to the Superintendent if the bank believes that there was no basis for the Superintendent's action.

Once the Superintendent is in control of a bank, the Superintendent may request that the attorney general apply to the federal court for a winding-up order under the Winding-up and Restructuring Act. The court, in making a winding-up order, may appoint one or more liquidators. In the case of banks, the liquidator must be a trustee licensed under the Bankruptcy and Insolvency Act (Canada) or the CDIC.

In addition to the powers given to the Superintendent, the Canada Deposit Insurance Corporation Act gives the CDIC the power to take extraordinary measures in respect of the insolvency of a bank that it insures. For example, the CDIC may be appointed as the receiver of a bank and, if the CDIC believes that a going-concern resolution is available through a sale of the bank to a third party, the CDIC may request an order vesting the shares of the bank in it so that it may force the sale of the shares of the bank to the new shareholder.

The CDIC also has the power to request that the minister of finance establish a bridge bank to acquire the good assets and businesses of the troubled bank. Ultimately, the objective is for the government to sell the bridge bank to a third party and to liquidate the remainder of the troubled bank.

17 Have capital adequacy guidelines changed, or are they expected to change in the near future?

The only changes that have been made since the global financial crisis arose have been to improve the guidance on liquidity management and on the capital treatment of securitisations, counterparty credit risk exposures, the trading book, and to request that banks that have shares listed on a stock exchange to temporarily cease any standing share buy-back programmes.

Canada has also announced its intention to fully implement the Basel III requirements on all Canadian banks and advised banks to maintain prudent retention policies and sound capital management practices in order to meet the new requirements in the interim period (and well in advance of 2019).

Ownership restrictions and implications

18 Describe the legal and regulatory limitations regarding the types of entities and individuals that may own a controlling interest in a bank. What constitutes 'control' for this purpose?

The government believes that large banks that are important to the economy should be widely held. Therefore, the Bank Act provides that banks that have more than C\$8 billion of equity may not have a major shareholder. A major shareholder is defined as a person, or group of persons under common control or acting jointly or in concert, that beneficially owns more than 20 per cent of any class of voting shares or more than 30 per cent of any class of non-voting shares. This rule also applies to a limited number of banks that were under the dollar threshold when the size-based regime was originally applied but were widely held at that time.

In addition to the prohibition against major shareholders, a large bank may not be controlled by any person. The definition of control includes having sufficient influence that, if exercised, would result in the person having 'control in fact' over the bank. A guideline has been published describing the matters that will be considered in determining whether a person has 'control in fact' of a bank. However, the guideline does not provide any bright line test, and identifying when control exists remains largely an exercise of judgement.

In addition to the widely held requirement, no person may acquire more than 10 per cent of any class of shares of a bank or control of a bank without the approval of the minister of finance. The decision to grant an approval is fully the discretion of the minister; however, the Bank Act includes a list of matters that the minister may consider in respect of an application for approval. The list includes the reputation of the applicant for being operated in a manner consistent with the standards of good character and integrity.

There is also a prohibition on a government or an agent of the government being issued shares of a bank.

19 Are there any restrictions on foreign ownership of banks?

There are no foreign ownership restrictions imposed under the Bank Act. However, if the applicant is a national of a country that is not a member of the World Trade Organization, prior to granting an approval for the applicant to acquire more than 10 per cent of the shares of a bank the minister of finance is instructed to consider whether reciprocal treatment is available for Canadians under the laws of that jurisdiction. There is also a restriction on a foreign government or agent of a foreign government being issued shares of a bank.

20 What are the legal and regulatory implications for entities that control banks?

The Bank Act requires that persons that control a bank provide the Superintendent with such information as the Superintendent may require to determine whether the bank is in sound financial condition and complying with the requirements of the Bank Act. In addition, the Superintendent has a policy of requiring that controlling shareholders provide an acknowledgement of the shareholders' intent to provide financial and other support for the bank. However, the acknowledgement letter states that it is not intended to create any legally binding obligations.

21 What are the legal and regulatory duties and responsibilities of an entity or individual that controls a bank?

There are none other than those described under question 20.

22 What are the implications for a controlling entity or individual in the event that a bank becomes insolvent?

In such circumstances, a winding-up order should be issued under the Winding-up and Restructuring Act. The court, in making a winding-up order, may appoint one or more liquidators. In the case of banks, the liquidators must be a trustee licensed under the Bankruptcy and Insolvency Act (Canada) or the CDIC. In such a liquidation, depositors and all other creditors rank prior to shareholders in respect of distributions from the liquidation.

Under the Bank Act, the shares of a bank are required to be issued as fully paid and non-assessable, meaning that a shareholder cannot be called upon to invest additional capital upon the insolvency of a bank. Therefore, a shareholder's liability is limited to the amount of the shareholder's original investment in the bank.

As a result of the powers granted to the CDIC under the Canada Deposit Insurance Corporation Act, the shares held by a shareholder may be sold by the CDIC in order to effect a going-concern solution. In such a case, the shareholder would only receive the amount of money in respect of the shareholder's shares that is derived from the sale organised by the CDIC. Further, the CDIC has the authority to transfer assets of a bank to a bridge bank. In such case, the transferring bank would only receive a payment for the assets in an amount determined by the CDIC in accordance with the Bank Act. The transferring bank would be liquidated and the shareholder would only be entitled to a distribution based on the remaining assets of the bank and the proceeds of the asset sale organised by the CDIC.

Changes in control

23 Describe the regulatory approvals needed to acquire control of a bank. How is 'control' defined for this purpose?

The approval of the minister of finance is required for a person to acquire more than 10 per cent of any class of shares of a bank. An additional approval is required if a person proposes to acquire shares to which are attached more than 50 per cent of the votes that may be cast to elect directors of the bank (in the case of a bank that has less than C\$8 billion of equity) or if the person would otherwise have control in fact of the bank.

For this purpose, control is defined as having influence sufficient that, if exercised, it would give the person control in fact of the bank. The minister has published a guideline describing the factors that will be considered in determining whether a person has control in fact of a bank. However, the guideline does not indicate the weighting that will be assigned to any particular factor and determining when a person has control in fact remains largely a matter of judgement.

The minister has complete discretion to grant an approval, although the Bank Act does specify certain matters that the minister may take into consideration, including the character of the applicant, the applicant's business plans for the bank and the best interests of the financial system in Canada.

24 Are the regulatory authorities receptive to foreign acquirers? How is the regulatory process different for a foreign acquirer?

If the acquirer is resident in a country that is not a member of the World Trade Organization, the minister of finance is required to consider the extent to which Canadians have the ability to invest in banks established under the laws of that jurisdiction.

In addition, if the acquirer is a regulated financial institution, the quality of the regulatory regime in the home jurisdiction of the acquirer will also be an important consideration.

25 What factors are considered by the relevant regulatory authorities in considering an acquisition of control of a bank?

First, an attempt will be made to determine whether the acquirer is suitable to own a bank. In this regard, regulators will look at the reputation of the acquirer to determine whether the acquirer is of good character, likely to respect the rules and regulations respecting banks and unlikely to expose the bank to any undue risk. The financial resources of the acquirer will be an important consideration as controlling shareholders are expected to be an ongoing source of strength for the bank. The acquirer's expertise in running a bank will be another consideration. Further, if the acquirer is a regulated financial institution, consideration will also be given to whether the acquirer is subject to robust regulation in its home jurisdiction.

The acquirer's business plans for the bank will also be an important consideration. An assessment will be made to determine whether the plan is reasonable and not likely to affect the future viability of the bank.

26 Describe the required filings for an acquisition of control of a bank.

The Superintendent administers the application process on behalf of the minister of finance, who must ultimately grant the approval. The Superintendent has published a transaction guide describing the information that must be submitted with the application. Essentially, this information must include a business plan for the bank and information on the financial strength of the applicant, including historic financial statements and a trend analysis showing any trends in respect of its financial performance.

The application must also identify the key individuals that will be responsible for managing the bank together with the back-

Update and trends

One of the hot topics within Canada's banking sector relates to Canada's announcement of its intention to fully implement the Basel III requirements on all Canadian banks and the related advisory by the Office of the Superintendent of Financial Institutions (OSFI) to the banks to maintain prudent retention policies and sound capital management practices in order to meet the new requirements in the interim period (and well in advance of 2019).

The OSFI also recently released an updated version of its 'supervisory framework', which contains the principles, concepts and core processes used by the OSFI to guide its supervision of federally regulated financial institutions, including banks. The updated framework indicates that the OSFI is placing increased importance and focus on sound risk management, effective corporate governance and heightened requirements for liquidity within banks.

ground information necessary for a security background check to be performed on those individuals.

If the application is approved, the controlling shareholder will be required to acknowledge an intention to act as a source of ongoing financial and management support for the bank.

from a non-WTO country that has not previously been analysed by the Canadian regulators, it is not unusual for the process to take considerably longer as an assessment of the regulatory regime in that country will be conducted in addition to the assessment of the applicant.

27 What is the typical time frame for regulatory approval for both a domestic and a foreign acquirer?

The time frame is highly dependent on the identity of the acquirer. That said, a typical time frame for an approval would normally be from two to five months. However, in cases where the applicant is

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