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CANADIAN FINANCIAL MARKETS: THE GOVERNMENT'S PROPOSAL FOR REFORM

by

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Abstract

This paper discusses Canada's financial sector, recent institutional changes, and the Government's recent (April 1985) proposal for financial market reform and its likely impact. Canada's financial markets have been dominated by traditional financial institutions known as the "four pillars". Although traditions and regulations have contributed to the evolution of Canadian financial markets, economic conditions and customer-provided incentives have recently created the major impetus for change. Structural changes have ocurred along three separate but related tracks: product and service innovation by banks and near-banks; less market segmentation; and conglomeration. Political pressures have led the federal and provincial governments involved to accommodate the changes that occurred and to encourage changes that were clearly inevitable. The Government of Canada is currently proposing sweeping regulatory reform of financial institutions to encourage more competition for the dominant chartered banks, to establish more effective safeguards to protect consumers, to ban self-dealing, and to insure the stability of the financial system. If implemented, the proposal may alter the traditional roles of financial institutions and their relationship with the federal government.

Canadian Financial Markets:

The Government's Proposal for Reform

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The views expressed in this paper are solely those of the author and should not be interpreted as the views of the Board of Governors of Federal Reserve System or its staff.

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Introduction and Summary

Structural changes have taken place in Canadian financial markets, which blurr the distinctions between traditional institutions and challenge the authority of regulations and supervisory controls. The Government of Canada has proposed sweeping regulatory reform of financial institutions to encourage more competition for the traditionally dominant[1] chartered banks, establish better safeguards to protect consumers, to ban self-dealing, and insure the stability of the financial system. If implemented, the proposal may alter the traditional roles of financial institutions and the relationship between them and the government.

The proposal breaks with tradition in two fundamental ways: first, it re-affirms and further encourages the erosion of traditional market segmentation and specialization; and second, by creating a new class of chartered bank, it eliminates the traditional requirement that Canadian banks be "widely-held" (i.e. owned by many agents rather than one or a few). The proposal encourages a relatively new form of organization in Canada, a financial holding company (FHC), which brings together non-bank financial

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[1] Although this point about dominance is debated, in 1984 chartered banks issued 66 percent of all deposit liabilities, held 45 percent of total business financing, and extended 73 percent of commercial credit, 67 percent of consumer credit, and 25.3 percent of mortgage credit. Trust and Mortgage loan companies, whose principal business has been mortgage financing, extended 25.9 percent of all mortgages in 1984, only .6 percentage points more than chartered banks. There is considerable competition, however, among the top five or six chartered banks.

entities and a new class of federally chartered bank yet to be established. Taken at face value, the introduction of FHCs paves the way to a financial structure in which relatively large, highly-integrated, financial conglomerates offer a full range of financial services. And the elimination of the "widely-held" requirement -- now perceived in Canada as a self-regulating mechanism for avoiding concentration of power and fiduciary problems, such as self-dealing -- would imply an extensive revamping of regulatory power and supervisory control, including a more active role by the federal government.

This paper discusses Canada's traditional financial sector, recent institutional changes, and the Government of Canada's proposal and its likely impact if implemented. Canada's financial markets are dominated by traditional financial institutions (often called the "four pillars"), which are dominated by chartered banks. Although traditions and regulations have contributed to the evolution of Canadian financial markets, economic conditions and customer-provided incentives have created the major impetus for change. Most notable among the economic conditions were the high and volatile Canadian (and U.S.) interest rates of the late 1970's and early 1980's.

Structural changes have occurred along three separate but related tracks: product and service innovation by banks and near-banks; integration of all types of institutions into the larger financial marketplace (i.e., less specialization); and conglomeration. Political pressures have led the federal and provincial governments involved to accommodate the changes that occurred and to encourage changes that were clearly inevitable.

I. The Traditional Framework of Canadian Financial Markets

The Canadian financial system has traditionally been composed of four pillars representing banking, insurance, trust, and securities industries. Each provided a distinct set of products and services to a well defined segment of financial markets, with commercial lending by banks, fiduciary services by trusts, insurance underwriting by insurance companies, and underwriting and full brokerage services by securities firms. This traditional structure evolved, partly because of market forces and partly because of boundaries imposed by regulation, perhaps reflecting that specialization of function was the most efficient way to provide financial services.

Along with the separation of functions, the Government of Canada has traditionally required chartered banks to be "widely-held".[2] In the past the government has relied on widespread ownership of financial institutions to prevent concentration of power and safeguard against conflicts of interest and self-dealing which are harmful to customers and threaten solvency and liquidity. It is perceived that when ownership of large financial institutions is placed in one or a few hands, the temptation

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[2] A shareholder or group of associated shareholders (resident or nonresident) cannot own more than a 10 percent share in a Schedule-A chartered bank. Foreign ownership and participation has been traditionally limited. The combined ownership of nonresidents cannot exceed 25 percent of any one Schedule-A bank and can be 100 percent of a Schedule-B bank. And until last year, total nonresident ownership of chartered banks could not exceed 8 percent of total bank domestic assets; the limit was increased to 16 percent in June 1984.

is on ocassion, "overwhelming" to take improper advantage of access to funds from the financial institution.[3] Limited ownership of financial institutions has thus played a central role in Canadian tradition and thinking on the prudential and fiduciary aspects of financial intermediation.

Within the traditional framework, the predominant players in the Canadian financial system have been the five or six largest federally chartered banks. They have a far greater share of total assets and have enjoyed greater regulatory flexibility[4] than their counterparts in the United States (the big city banks) and their competitors in Canada (the near-banks which include trust companies, mortgage loan companies, credit unions, and cooperatives). But traditional boundaries have been crossed.[5] The existing structure of financial markets has emerged from the confluence of strongly held traditions, regulatory constraints, and the exercise of comparative advantage in a fast changing economic environment.

II. Pressures for change in Canadian Financial Market

Canadian financial institutions, particularly the intermediaries, have come under increasing economic and political pressure to change. These institutions have attempted to diversify their portfolios of assets and

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[3]See Bouey (1985).

[4]The chartered bank statute outlines what banks cannot do and says little about what they can do while the statute for Trust and Mortgage loan companies clearly specifies that they can provide certain services only.

[5]The Bank Act of 1967 allowed chartered banks to issue mortgages. Near-banks were allowed to participate in the deposit insurance system in a separate piece of legislation. The Bank Act of 1980 made further changes that attempted to increase competition. This will be discussed in more detail.

liabilities, offer a wider array of maturities particularly on the liability side, and more closely match the maturities of their assets and liabilities. The changes that have taken place have occurred on three separate but related tracks: product innovation by near-banks; integration by financial intermediaries into the larger financial marketplace, often circumventing regulatory barriers to diversification; and the conglomeration of different types of financial intermediaries under a single corporate group.[6]

The impetus for change in Canada's financial markets during the 1970s originated predominantly in economic conditions and technological advances in information processing industries. Change did not originate in deregulation or regulatory reform, although changes in the regulatory structure did support and encourage changes that were already in progress. This is in contrast to the recent experience in the United States, where <u>some</u> changes could not have occurred without deregulation, and economic conditions accentuated the difficulties in the transition to the new unregulated environment.

The most important economic factors leading to product and service innovations by near-banks and expansion of services by all financial intermediaries were the high and volatile interest rates and inflation

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[6]Despite these moves towards integration and conglomeration, however, the traditional "four pillars" nevertheless have been kept distinct. This is the result of overlapping jurisdictions between Federal and Provincial authority, the clear delineation of the services provided by chartered banks (and near-banks), and the dominant role played by chartered banks in the Canadian financial structure. The federal government has jurisdiction over chartered banks and other institutions that choose to be federally chartered, excluding securities dealers. Provincial governments have sole jurisdiction over securities dealers and local credit unions and like the federal government can have jurisdiction over other nonbank institutions that choose provincial charters. Jurisdictions will often overlap.

rates during the 1970's and early 1980's and narrowing profit margins on existing products. Other economic factors contributed as well. The large trade imbalances and associated capital flows that resulted from the oil crises created greater demand for international financial services. In addition, because of increased internationalization, and Canada's proximity to the United States, Canadian financial institutions were influenced by foreign developments and foreign competition.

The major change has been the attempt by each type of intermediary to become more fully integrated into financial markets and thus compete on once traditionally separate territory. The major incentive to innovate and diversify was provided by the desires of corporate and personal clients to economize on cash balances held in low (or no) interest paying accounts and long-term fixed rate deposits. Once customers demonstrated a preference for higher returns and cash management techniques the market responded. Chartered banks issued a larger volume of shorter loans in mortgage markets (including floating rate mortgages) and near-banks created newer shorter term interest paying accounts (such as daily interest savings accounts and daily interest checking accounts). Trust and mortgage loan companies issued a larger share of shorter maturity deposits and shorter maturity mortgage loans both issued since the late sixties and early seventies as well as adjustable rate and shorter-term mortgages first introduced during the late seventies and early eighties. Life insurance companies issued short term deferred annuities that are close substitutes to relatively short-term or medium-term deposits. And over the last eighteen months, securities dealers have paid interest and provided check writing privileges on idle customer balances that were awaiting a good trading opportunity.

The transition to the new cash conscious economic environment was relatively easy for chartered banks whose traditional business was matching short to medium-term commercial loans with short-term liabilities in the form of checking accounts and short-term deposits. But it was more difficult for near-banks and insurance companies that either dealt in medium to long-term maturities or never issued deposits but carried long-term liabilities. As the near-banks competed for market shares they were creative in responding to market pressures and adept in escaping traditional habits in the new higher and more volatile interest rate environment.

Traditional distinctions in the services offered by financial institutions have become blurred. Chartered banks have issued consumer loans since the late 1950s, government insured mortgage loans since 1954, and non-government insured mortgages since 1967 as well as traditional commercial loans. They also take deposits of varying maturities and offer access to discount brokerage services. Brokerage houses now offer interest bearing checking accounts on client cash balances. Insurance companies offer short term deferred annuities that are close substitutes to time deposit accounts of different maturities. Trust and mortgage companies offer a wide range of "banking" services. And new institutions, conglomerates, have surfaced providing the marketplace with combinations of the above services.[7] Table 1 compares the services currently provided by each of the four pillars with the services they provided under their original charters.

In summary, none of these changes would have occurred were it not for changes in economic conditions, economic incentives, and the relaxation of key restrictions on chartered bank and near-bank activities. But the pressures for change were primarily economic conditions.

III. The Structure of the Canadian Financial Sector

The Composition of the Financial Sector

The financial sector in Canada is composed of a diverse group of highly competitive financial institutions (particularly the five or six largest chartered banks) offering a large number of financial goods and services. Nevertheless, the Canadian financial sector is a highly concentrated one, in which chartered banks dominate both the asset and liability side of an aggregate financial industry balance sheet. At the close of 1984, chartered banks (twelve domestic and fifty-eight foreign) as a group accounted for about 54 percent of the total assets held by all financial institutions in Canada (see Table 2). The second largest financial institution was life insurance companies, accounting for 11.9 percent of total assets, followed by trust companies with 8.7 percent, credit unions with 7.4 percent, and mortgage loan companies with 6.6 percent.

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[7]Credit unions in British Columbia can provide virtually all banking, fiduciary, insurance brokerage, and brokerage services under one roof. And in Quebec, the Insurance Act permits insurance companies to own other financial intermediaries and to own up to 50 percent of their assets in subsidiaries.

Table 1

Institution	Traditional Role	Current Role
Chartered Banks	- take demand and short-term deposits - issue demand and short-term loans to businesses - underwrite and distribute government and corporate securities	- take deposits of all types - issue demand, term and mortgage loans to individuals and companies - invest in securities with limits on equity holdings[1/] - underwrite and distribute government bonds - engage in types of financial leasing and venture capital investments, through wholly owned subsidiaries
Trust and Mortgage[2/] Loan Companies	- administration of trusts and estates[3/] - mortgages matched by longer-term deposits	- administration of trusts and estates[3/] - issue demand deposits and short-term deposits - issue consumer and business loans - MLC's confine activities to taking deposits and issuing loans secured by mortgages; usually affiliated with banks or trusts
Life Insurance Companies	- issue life insurance	- underwriting insurance - sell annuities including deferred annuities that are close substitutes for term deposits[4/] - manage funds (including pension funds) on behalf of customers via segregated funds[5/] - investments permitted parallel those of trust and mortgage loan companies[6/]
Investment Banks	- securities brokerage and underwriting	- securities brokerage and underwriting[7/] - customer accounts treated as deposits with interest paid on cash balances - check writing privileges have been offered recently

1/ Until the Bank Act of 1980 chartered banks were allowed to deal in securities; that is, underwrite broker, or distribute government and corporate securities. Now their activities are limited to participating in selling groups that distribute securities and buy and sell securities through brokers on behalf of clients.

Table 1 (cont.)

Notes Continued:

Banks are specifically prohibited from offering discretionary fiduciary or trust services and are generally prohibited from insurance brokerage, portfolio management, or investment counselling.

2/ Trusts and Mortgage Loan Companies are subject to capital leverage requirements. There is no maximum ratiostated in law but no company has borrowings exceeding 25 times capital. If the desired ratio is less than 20 percent, these companies can invest in mortgages, government securities, corporate securities either secured or meeting certain earnings tests, and corporate equity also subject to some tests. The total of unsecured lending or lending that does not meet tests are limited to 7 percent of total assets. If the desired ratio exceeds 20 percent, then these companies must comply with additional portfolio, earnings, cashflow, and liquidity requirements although the range of assets it can issue are essentially the same. Two thirds of the assets must be held in government securities, residential mortgages, insured commercial mortgages or commercial mortgages meeting quality tests, and commercial paper meeting certain quality tests.

3/ Trusts are the only institution in Canada allowed to provide these services.

4/ They are not permitted to take deposits.

5/ These funds essentially offer fiduciary services.

6/ See footnote 2.

7/ Prohibited from underwriting insurance and fiduciary services.

Table 2

Financial Sector Assets[1]: 1984-Q4

	C$Billion	Percent of Total: Excluding Pension Funds	Percent of Total: Including Pension Funds
Chartered Banks[2]	405.6	59.1	52.7
Life Insurance	81.8	11.9	10.6
Trust and Mortgage Loan Companies	69.7	10.2	9.1
Local & Central Credit Unions	50.7	7.4	6.6
Property & Casualty Insurance	16.4	2.4	2.1
Financial Corporations	14.2	2.1	1.8
Investment Dealers[3]	10.2	1.5	1.3
Segregated Funds	10.2	1.5	1.3
Investment Funds	9.5	1.4	1.2
Other[4]	17.6	2.6	2.3
Total	685.9	100.0	89.1
Pension Funds	83.8		10.9
New Total	769.7		100.0
Memo Item: Four Pillars	567.3	82.7	73.7

1/ Source is Financial Institutions, Statistics Canada, except where noted.
2/ Includes subsidiaries that are mortgage loan companies as reported in Statistics Canada: total excluding these subsidiaries is C$370 billion, from Bank of Canada Review, July 1985.
3/ The primary business of Dealers involves high turnover of their inventory; their actual inventory at any time understates their participation.
4/ Includes Financial leasing corporate loans (C$2.7 billion), Business Financing Corporations (C$7.2 billion), REITS (C$.5 billion), Closed-end Funds (C$1.9 billion), Accident and Sickness Branches of Life Insurance Companies (C$4.7 billion), and Trust Company Retirement Funds (C$.6 billion).

Chartered banks held in excess of 65 percent of deposits issued by deposit-taking intermediaries, and accounted for 45 percent of total business financing in Canada in 1984. In addition, chartered banks issued over 70 percent of commercial credit and over 60 percent of consumer credit issued by financial institutions in 1984.

Not only is there a great degree of concentration in financial markets as a whole but there is also a large degree of concentration among chartered banks. In 1984, the top five chartered banks owned 80 percent of all chartered bank assets, thus giving these five banks roughly a 40 percent share among all assets held by financial institutions in Canada.

As a group the four pillars continued to play a dominant role in 1984. By the end of 1984, the four pillars held 83 percent of all assets owned by financial institutions in Canada; chartered banks accounted for 65 percent of the assets of the four pillars.

The Regulatory Environment

The large market share of chartered banks can be traced to the relative freedom from restrictive regulations. Unlike their counterparts in the United States (commercial banks) chartered banks in Canada were not generally subject to deposit rate ceilings (except for a short period under the Winnipeg Agreement effective 1972-74), were never restricted from paying interest on any type of accounts, until recently had few if any restrictions on assets, and were not geographically restricted.

The legislative review of the Bank Act in 1967 provided a significant boost to chartered banks (see Table 3). The review removed the ceiling on bank loan rates, reduced reserve requirements on term deposits

Table 3

Chronology of Recent Legislative Changes

1954	- CB's can create consumer loans backed by chattel mortgages. - CB's can issue government issued mortgages.
1967	- CB's can issue mortgages. - removed CB's ceiling on rates on bank loans and reduced reserve requirements on deposits. - created deposit insurance for near-banks (Trusts and Mortgages Loan Companies). - CB's required to divest holdings of trusts and loan companies.
1980	- CB's can lease via subsidiaries. - CB's powers in security dealing restricted. - near-banks granted participation in Canadian Payments Association. - non-Canadian banks can become full service banks to increase competition. - lowered reserve requirements.

CB's = Chartered Banks

and changed their structure, and permitted banks to issue conventional mortgage loans.[8] Banks, however, were forced to divest their holdings of trust and loan companies. Although not part of the Bank Act, trust and mortgage loan companies were also allowed to participate in the Canadian deposit insurance system which allowed them to compete more effectively with chartered banks for deposits.

The 1980 review of the Bank Act altered the possibilities for chartered banks and near-banks. Relaxation of portfolio restrictions of near-banks and contractual savings institutions permitted them to increase their commercial and business financing. In addition, near-banks were granted participation in the Canadian Payments System which was previously controlled by the chartered banks. In principle, this made it easier for them to compete for deposits. The review allowed the incorporation of foreign banks, albeit on a limited scale, permitted banks to engage in leasing through subsidiaries, and restricted banks' powers to engage in securities dealings.

IV. The Government of Canada's proposal for regulatory reform in Canadian banking

Reasons for Financial Market Reform

It is in the financial market environment described in previous sections of this paper that the Government of Canada has proposed sweeping regulatory reform of financial markets and institutions in Canada. It is an environment in which major structural changes have occurred over time.

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[8] Only chartered banks are subject to reserve requirements.

These changes have stirred concern by participants in financial markets and the Government of Canada about several key issues.

First is the move toward conglomeration of financial institutions (not including chartered banks) under one corporate umbrella. Some of these conglomerates, which have access to large flows of deposits, are owned by families or small groups of individuals, and some of them combine financial and nonfinancial entities under one board of directors. The existence of conglomerates has raised questions about the increased potential for self-dealing, as in the case of closely-held ownership, and conflicts of interest, as in the case of nonfinancial and various financial entities operating together under one decision making unit.[9]

Second are the recent failures of several relatively large trust companies.[10] These failures have renewed concerns about self-dealing and therefore the stability of the financial market structure and the relevance of existing regulations and supervision in detecting and eliminating problems of liquidity and solvency in Canadian financial institutions.

Third is the blurring of the lines of distinction between types of financial institutions. This has raised concerns on the part of these institutions and the government about fairness and equity in the federal regulation of institutions that offer like services.

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[9]For a detailed discussion of the "separateness" issue see Cornyn, et. al.

[10]More recently, two chartered banks, Canadian Commercial Bank and Northland Bank, have been liquidated. Their combined assets were about 1 percent of total bank assets. Mercantile Bank has experienced liquidity problems, and is seeking a merger partner.

Fourth is the continued dominance of Canadian financial markets by the federally chartered banks. Even though the Green Paper takes the view that concentration is not necessarily inefficient, the Government has been under increasing political pressure to redress the degree of concentration in segregated and aggregate financial markets, and the dominance of chartered banks in Canadian financial markets. Near-banks have pressured the government to allow them to more actively participate in markets that have been the traditional markets of chartered banks. Many of these near-banks are not widely-held corporate entities, and thus cannot be federally chartered as banks. The government would however like to see more competition in Canadian financial markets and would like to encourage diversification by owners of financial institutions.

In summary, the Government of Canada has several motives for proposing financial market reform: (1) address recent system stability and institutional solvency problems; (2) deal with the problems of equity in regulation, conflict of interest, and self-dealing -- prudential and fiduciary problems that have surfaced as a result of recent failures and gradual structural change in financial markets; (3) meet the desire of financial institutions to be competitive and to diversify while satisfying the objectives in (1) and (2).

Overview of the Government's Proposal

The proposal addresses three main areas: (1) the organizational structure of financial institutions and the services offered by any one institution; (2) prudential and stability related concerns; and (3) modernization and simplification.

The central feature of the proposal is the introduction of a new organizational possibility for Canada's financial institutions: a federally chartered financial holding company (FHC) that would allow the combination within one corporate grouping of a wide range of financial institutions, offering a variety of products on both the asset and liability side. This range of institutions includes a new form of chartered bank -- a Schedule-C bank--that differs from existing chartered banks in that it need not be widely-held.

Complementing the introduction of FHCs are the prudential and stability aspects of the proposal, that introduce new initiatives to enhance consumer protection, to ensure the soundness of institutions, and ensure the stability of the financial system. Regulators will play a larger role under the government's proposal. Specific initiatives include a strict ban on self-dealing with few exceptions, measures to control the abuse of conflicts of interest, and enhanced powers for supervisors to allow them properly to discharge their legislated duties. In addition, the proposal aims to modernize and simplify where necessary, the legislation and regulations which define and guide the various financial institutions. It is the government's view that the establishment of FHC's under the government's proposal would at once support previous desirable changes and satisfy the government's objectives.

In summary, the import of the current proposal is twofold: (1) it allows the formation of FHCs that can wholly own a chartered bank as well as other types of financial institutions; and (2) it explicitly places existing chartered banks in a glass-cage until their regular legislative review scheduled for 1990. Existing chartered banks (Schedule-A and Schedule-B) are forbidden from either forming FHCs or becoming part of one.[11] In doing so, the proposal allows the remaining participants in financial markets to gain a competitive edge with the chartered banks.

The Creation of Schedule-C Banks:

Under the new proposal a FHC could wholly own a chartered bank -- a Schedule-C bank. This new class of bank would have the same powers and would be subject to the same reserve requirements as currently existing Schedule-A (widely-held) and Schedule B (closely-held) banks.[12] Schedule-C banks would however be permitted to be closely held by a FHC. The purpose of the Schedule-C bank would be to provide FHCs access to a wider range of markets. There are currently 10 domestic federally chartered banks (Schedule-A) banks.[13] No individual including nonresidents can own more than 10 percent of the shares of a Schedule A bank and total nonresident ownership cannot exceed 25 percent. As stated earlier, this class of bank currently owns 50 percent of all assets of all financial institutions in Canada, and the top five chartered banks in this class own 80 percent of all chartered bank assets. All but one Schedule-B banks are foreign owned. There are currently 58 foreign owned banks. As an aggregate, foreign owned Schedule-B banks are limited to only a 16 percent share of total domestic bank assets (just increased from 8 percent in the

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[11]Smaller Schedule-A banks may be allowed to do so.

[12]All Schedule-A banks are domestically owned and all, except one, Schedule-B bank are foreign owned. The domestically owned Schedule-B must become widely-held within 10 years of incorporation.

[13]As of October 1985.

summer of 1984). This class of banks owns only 3.6 percent of total assets of financial institutions in Canada.

Major Features of the Proposal Regarding FHCs

The major features of the proposal regarding FHCs are listed on the following pages:

Federal Incorporation:

(a) a FHC must be federally incorporated if it owns two or more regulated financial institutions one of which is federally incorporated[14]; each institution is subject to legislation and regulation applying to its own type; and the federal government is responsible for supervision of Schedule-C banks and the FHC; and

(b) each part of a FHC must maintain a separate corporate identity making its own decisions, having its own directors, financial reports, etc., although they can share certain services, such as computing facilities.

Regulation and Supervision:

(a) provisions for avoiding double counting of capital; a strict ban on self-dealing; strict controls on all transactions within a FHC group and between the group and affiliated businesses; common distribution arrangements, or networking, would be allowed, but tied or conditional selling would be prohibited; and

(b) directors of FHCs will be held to higher standards than currently required under the Business Corporations Act.

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[14]This is the language used in the proposal. Discussion with Department of Finance staff suggests the government intended "federally regulated" rather than "incorporated".

Ownership:

(a) if a FHC is financial, then it can own a majority interest in the Schedule C chartered bank;

(b) foreign ownership requirements of chartered banks, insurance companies, and trust and mortgage companies are unchanged (currently, transfers of ownership of Schedule-A banks, existing life insurance companies, and existing trust and mortgage loan companies to nonresident restricted to maximum ownership of 10 percent and total foreign ownership of 25 percent; and there are no restrictions on foreign ownership of newly created insurance and trust and mortgage loan companies):

-- foreign interests in FHCs must be independent of institutions and investors that own a Schedule-B bank; and

-- foreigners can set up their own FHC but it cannot include a Schedule-C bank.

Jurisdictions: federal government will not supersede provincial governments' traditional role (such as in providing its own deposit insurance, as in Quebec, and in regulating securities firms).

Enhanced Regulatory and Supervisory Role by the Federal Government

Because the "widely-held" requirement does not apply to the newly formed Schedule-C banks, there is a greater potential for abuse of consumers. The government's proposal calls for a revamping of the regulatory and supervisory environment. The proposal specifically calls for the following:

(a) consideration of a possible consolidation of the federal government's regulatory agencies responsible for banks and for trust and mortgage companies, and insurance companies (Office of Inspector General and the Department of Insurance);

(b) creation of new office to deal with conflicts of interest;

(c) enhanced regulatory powers to obtain information and data and to intervene in the operations of financial institutions such as cease and desist orders, forced divestitures, seizeure of assets, and generally intervene.

V. Analysis and Conclusion

The government's proposal breaks with tradition in two fundamental ways. First, it further encourages the erosion of traditional market segmentation and traditional specialization of function by financial institutions in Canada. Secondly, it proposes eliminating the traditional requirement that Canadian banks be "widely-held."

The major change proposed is the introduction of federally incorporated financial holding companies (FHC) that can wholly (i.e., solely) own any number of different types of financial institutions including a new form of chartered bank -- a "Schedule-C" bank. The regulatory and supervisory proposals complement the establishment of federally incorporated FHCs and address the increased potential for conflicts of interest and self-dealing.

Establishing FHCs potentially accomplishes several objectives. First, it makes it easier for non-bank institutions to enter markets that were traditionally the domain of chartered banks. This satisfies the government's desire to encourage increased competition in Canadian financial markets and satisfies the demands of near-banks to be able to compete with federally chartered banks. Trust companies, for example, that are not widely-held can now either form their own FHC and establish a chartered bank, or can join a FHC and become a wholly-owned Schedule-C bank.[15]

Second, it brings existing federally unregulated conglomerates under the purview of the federal government. Existing conglomerates that own more than two types of regulated financial institutions, one of which is federally regulated, must become federally incorporated under this proposal, and all financial institutions belonging to a FHC will be subject to supervision with respect to self-dealing and perhaps conflicts of interest.

If a strong demand for the new services develops, and if conglomeration continues to be profitable, then the government's proposal opens the way for a financial structure in which relatively large highly-integrated financial entities could offer a full range of financial products. Existing types of institutions may then disappear under a corporate umbrella. Chartered banks, awaiting their scheduled legislative review in 1990, may lose their market share. This of course depends on the evolution of the new concept of FHCs and the outcome of the legislative review in 1990.

Although chartered banks oppose several key aspects of the proposal, the business community in general supports the government's objectives of enhanced competition and less concentration as well as its

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[15]They must then give up their estate, trust, and agency business.

goals regarding soundness, stability, and consumer protection.[16] Trusts and other near-banks, although supporting the FHC concept, are opposed to separateness qualifications and dislike the Schedule-C bank concept. Existing conglomerates, now faced with the possibility of openly competing with chartered banks on the one hand, and being federally regulated on the other, have been relatively silent; it is generally believed that they see these changes as a political and economic triumph. Regulators, although generally supportive of the overall proposal, have reservations about the ability of supervisors to execute the difficult tasks delegated to them under the proposal, particularly in the area of self-dealing.

Major questions remain over the actual changes that would occur if the proposals are implemented. Even if FHCs were perceived as a viable and profitable way of doing business in Canadian financial markets, the threat of heavy regulation and supervision may discourage their formation. Why should a profitable trust company or mortgage loan company now offering bank-like services become federally incorporated as a Schedule-C bank, or join an existing or new FHC, when it entails further supervision of their activities? On the other hand, if FHCs become widespread, the large, complex, and highly integrated financial conglomerates will pose seemingly endless and impossible supervisory problems and demands for regulatory bodies. How will regulators detect and then prevent conflicts of interest? How will self-dealing be recognized within an endless web of financial transactions of large numbers of entities belonging to one corporate group?

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[16]Since they cannot participate, chartered banks support diversification and the FHC concept.

If regulators are completely successful in accomplishing their regulatory and supervisory goals regarding the new FHCs, then the new form of financial institution will probably be unattractive, and few will be formed. Few if any of the government's objectives regarding competition and concentration will be achieved.

If regulators are unsuccessful, then the potential for self-dealing, conflicts of interest, and therefore financial instability will increase greatly. In that case, the government's objectives of sound and stable financial markets and consumer protection will not be met.

The most likely outcome will lie somewhere between these two extremes: more competition and integration; more regulation and supervision; and hopefully a more stable financial environment in which conflicts of interest and self-dealing are carefully guarded if not eliminated.

The Government of Canada hopes to bring legislation to Parliament by the end of 1985. Insiders suggest, however, that this is overly optimistic. The Minister of State (Finance) for Monetary Affairs has stated clearly and emphatically that although the details of the proposal are negotiable, the general principles are not. When legislation is brought before Parliament, probably early in 1986, it is expected to carry the basic principles of the government's current proposal.

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