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The 2006 Federal Financial Institutions Legislative Review: What's In It and What's Not

By Robert W. McDowell, James H. Lisson, Robert E. Elliott, Donald E. Milner, Stephen B. Kerr, Koker K. Christensen, Scott Mitchell, and Kathleen E. Yoa

Introduction

On June 14, 2006, the federal Minister of Finance released a consultation paper entitled *2006 Financial Institutions Legislation Review: Proposals for an Effective and Efficient Financial Services Framework* (the “**White Paper**”), which details the Government’s proposed federal financial institutions legislative reforms marking a five-year statutory review. Stakeholders are encouraged to comment on the proposals by July 21, 2006. Following that consultation, the Government will proceed to finalize draft legislation for the parliamentary agenda. The current legislation’s sunset date has been extended from October 24, 2006 to April 24, 2007.

The White Paper notes that globalization, competition and technological innovation have created a very complex business environment for financial institutions and for consumers of the products and services they offer. The stated key objectives of the White Paper’s proposals are to enhance the interests of consumers and businesses, increase legislative and

regulatory efficiency, and adapt the financial institutions framework to new developments. In response to these challenges, the White Paper addresses consumer issues, but the contentious financial sector business powers and sector consolidation issues go without mention.

While the Government’s objectives are laudable (as far as they go), the White Paper steers clear of the politically contentious recommendations received from the industry arising from concerns about the efficiency and global competitiveness of Canadian financial institutions. Some stakeholders undoubtedly will be of the view that the White Paper’s largely technical recommendations are unresponsive to the dynamic environment in which Canadian financial institutions operate, particularly when the primary opportunity to provide new policy direction occurs only with five-year legislative reviews.

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What Is In the White Paper

The White Paper recommendations offer no new policy direction for the financial sector. The Government states that the legislative review is “an opportunity to refine the legislative framework” while maintaining the business powers and ownership status quo between the banking and insurance industries. Although the status quo will be warmly embraced by the insurance industry, it will be perceived as another disappointment by the banking industry.

Enhancing Consumer Interests

While technological innovation often serves to benefit financial consumers, it has also made it more difficult for consumers to make informed choices about the products and services offered by financial institutions. The White Paper suggests that the best ways to ensure that the interests of consumers are protected are competition among financial institutions and increased, more effective disclosure to consumers.

Disclosure Regime for Investment-type Deposits Products

The White Paper indicates that a new disclosure regime will be developed for investment-type deposit instruments, such as guaranteed income certificates and other forms of term deposits, including disclosure of the product’s term, return and penalties for early withdrawal. The White Paper does not mention whether it intends to strengthen disclosure of risks related to principal-protected deposit notes issued in the capital markets, which are treated as deposits from a securities law perspective but are traded like securities.

Disclosure of Administration Fees for Deposit-based Registered Plans

Fees for deposit-based registered plans including fees to open a registered plan or transfer the plan to another institution will have to be disclosed.

Disclosure of Complaint-handling Procedures

Financial institutions are required to have procedures in place to deal with complaints from consumers. The White Paper notes that the current guidelines relating to complaint-handling procedures are lacking somewhat in that consumers may not have access to information relating to these procedures on an ongoing basis. In addition, consumers that do not open an account with a financial institution often do not receive any information about complaint-handling procedures. The White Paper proposes to require financial institutions to make complaint-handling procedures accessible to the public at all times, both in branches and on-line.

The Government does not propose to change the existing independent ombudservice system for the financial sector, despite a recent recommendation from a Senate committee that the federal and provincial governments cooperate to create a single ombudservice for financial institutions.

Disclosure in the Cost of Borrowing Regulations

The White Paper proposes two changes to the *Cost of Borrowing Regulations*. First, at present, the *Cost of Borrowing Regulations* do not specify clearly the way in which disclosure documentation is to be provided to consumers where there are co-borrowers (i.e. more than one signatory to a credit agreement). This has resulted in inconsistencies in the disclosure given to co-borrowers. The White Paper indicates that proposed amendments to the *Cost of Borrowing Regulations* would require lenders to provide the required disclosure to each co-borrower unless all

co-borrowers expressly consent to receiving only a single set of disclosure documents.

Second, the existing *Cost of Borrowing Regulations* do not specify the format that disclosure is to take if a lender chooses to include it in a credit agreement. This has, at times, led to some consumers being unable to locate the required information. The White Paper indicates that the *Cost of Borrowing Regulations* would be amended to require lenders that choose to include the disclosure statement in a credit agreement to do so in such a way that the disclosure statement is easily identifiable by consumers in a consolidated manner or by providing an accurate summary of the required information.

Electronic Transactions

Building on the existing voluntary industry code of practice for consumer debit cards, the Government will encourage the financial sector to develop a voluntary consumer protection regime to cover a range of electronic transactions, such as internet and telephone banking, stored value cards and on-line payment options. Undoubtedly, a voluntary code is proposed because many service providers are not federally regulated or are unregulated. This is an area where cooperation between federal and provincial governments will be necessary to ensure a level of regulatory consistency.

Cheque Hold Periods

The Government proposes to amend the *Bank Act* to provide regulation-making authority to limit cheque hold periods. In light of proposed amendments to the *Bills of Exchange Act* to facilitate electronic cheque imaging, the Government has accepted the banking industry's commitment to reduce the maximum cheque hold period from ten to seven days and eventually to four days. Regulations will not be introduced so long as the industry commitments are observed. It is interesting that the proposal does not

appear to extend to the federal trust and loan and co-operative sectors as well.

Unclaimed Balances

The Government proposes to set the time period for Bank of Canada's liability for unclaimed deposit balances at 40 years for balances of \$1,000 or less and the time period for balances of more than \$1,000 at 100 years, rather than in perpetuity.

Increasing Legislative and Regulatory Efficiency

The White Paper identifies the following key areas in which legislative efficiency could be improved:

Credit Unions and Caisses Populaires

Currently, the *Cooperative Credit Associations Act* requires a minimum of ten credit union members to form a cooperative credit association, which is a high threshold for entry. In addition, there is a need to provide a deposit insurance opt-out regime for retail associations similar to the regime applicable to banks. Accordingly, the Government proposes to decrease the number of credit unions required to incorporate a cooperative credit association to two and to introduce a deposit insurance opt-out regime for retail associations that do not accept retail deposits (i.e., deposits of less than \$150,000).

This is an opportunity for the Government to consider a process so that all new deposit-taking institutions that do not propose to take retail deposits do not need to apply to the Canada Deposit Insurance Corporation to be exempt from membership.

These changes alone, however, are unlikely to significantly improve the attractiveness of retail cooperative credit associations as operational vehicles because of other restrictions, including restrictions on control of associations and the overlay of provincial regulatory restrictions on their

operations. This is an area where federal and provincial governments should cooperate to assist the cooperative financial services industry to become more efficient and competitive.

Residential Mortgages Exceeding 75% of the Property Value

The mandatory insurance regime for high loan-to-value (“LTV”) ratio mortgages was originally introduced as a prudential measure to protect lenders from fluctuations in property value and associated borrower defaults. The current statutory regime sets the requirement for mortgage insurance for loans of more than 75% of the value of residential property. With changes in the marketplace, this requirement means that some consumers are paying more for their mortgage than is justifiable on a prudential basis. As the complete and immediate elimination of this restriction may have undesirable effects on both lenders and borrowers, the Government proposes to raise the LTV ratio for mandatory insurance to 80% of the value of residential property and to consider further increases to the threshold in future legislative reviews.

Foreign Bank Entry

The White Paper indicates that, while there is a general satisfaction with the core principles that govern the foreign bank entry framework in Canada, some aspects of the regime have been criticized as complex and burdensome. One such area is the application of ministerial approval requirements for “near banks”, foreign entities that are not regulated as banks in their home jurisdiction but provide bank-type services in Canada. The Government proposes to narrow the current framework to apply to “real” foreign banks and to remove near banks. Presumably this means that near banks would not require a ministerial exemption order to engage in financial services-related activities in Canada.

Improvements to the Regulatory Approval Regime

Currently, some routine transactions that do not raise significant policy issues require ministerial approval. The Government wishes to streamline the regime to ensure that transactions are dealt with expeditiously and identifies the following areas for streamlining: liquidation, discontinuance, amalgamation, investments, name changes, transfers of business within corporate groups, reinsurance agreements and declarations of large dividends. In addition, the Government proposes to introduce deemed approvals for transactions involving information technology and other ancillary services for which ministerial approval is required and to remove certain Superintendent of Financial Institutions (Canada) (“**Superintendent**”) approval requirements.

Reinsurance Approvals, Transfers and Purchases of Policies

Since the Office of the Superintendent of Financial Institutions has introduced risk-based capital rules and other prudential tools, ministerial approvals for “out of the ordinary course of business” indemnity reinsurance transactions, and other transfers and purchases of policies will be removed. For assumption reinsurance transactions, the requirement for ministerial approval will be removed for companies assuming policies and Superintendent approval will be required for all assumption reinsurance transactions, except for transactions where a Canadian company cedes all or substantially all of its policies.

Reducing Compliance Costs for Reinsurers

Currently, reinsurers are subject to the complaint-handling procedures and third-party dispute resolution systems required by the Financial Consumer Agency of Canada (the “**FCAC**”). This requirement is essential for consumers of primary insurance, but is a needless compliance burden on

reinsurers that deal only with other insurers. Accordingly, the Government proposes to exempt reinsurers from FCAC oversight, including from FCAC cost assessments and dispute handling requirements. Arguably, wholesale financial institutions and foreign bank branches should benefit from this proposed exemption since they also do not deal with retail consumers.

Penalties

It is proposed to make it an offence for individuals or institutions to knowingly provide the Superintendent with false or misleading information.

The maximum penalty for a violation by a financial institution of a consumer provision under federal financial institutions legislation will increase from \$100,000 to \$200,000.

Adapting the Framework to New Developments

The White Paper observes that financial institutions have to respond to trends such as globalization, convergence, consolidation and technological innovation. Recognizing this, the White Paper proposes several legislative amendments:

Ownership Regime Thresholds

The current size-based ownership regime, which was introduced in 2001, provides that:

- banks with equity of \$5 billion or more are required to be widely held;
- banks with equity of \$1 billion or more, but less than \$5 billion can be closely held but are subject to a 35 per cent public float requirement (unless ministerial exemption is obtained); and
- banks with equity of less than \$1 billion can be wholly owned by a single shareholder.

In light of the growth in the financial services sector, the White Paper proposes to increase the large bank equity threshold from \$5 to \$8 billion and to increase the \$1 billion equity threshold for small banks, trust and loan companies and insurance companies to \$2 billion. Interestingly, the White Paper does not mention any ownership threshold change for life insurance companies with equity of \$5 million or more.

Canadian Payments Systems and Electronic Cheque Imaging

Currently, the cheque clearing process involves physical delivery of a cheque to the paying or issuing financial institution. The White Paper proposes to amend the *Bills of Exchange Act* to allow financial institutions to transmit cheque images electronically, which is far more efficient. A paper cheque would be retained for a period of time after an image of the cheque is taken. The consumer impact of this amendment - shortened cheque hold periods - is discussed above.

Special Security Regime

The White Paper does not propose to alter the current *Bank Act* special security regime. The Government concludes that removing or significantly limiting this regime would deprive banks of the benefit of a national regime and could affect the availability and cost of credit to borrowers. Certain technical amendments to the regime are proposed to improve its efficiency, including updating provisions referring to provincial agencies/offices, allowing electronic communications and updating the applicable fee schedule.

What's Not In the White Paper

Most notably absent from the White Paper are the larger issues affecting business powers, sector consolidation and corporate governance for

international institutions. The regulated financial services industry, with its skilled and well-paid employees, is a vital and dynamic component of the Canadian economy, and the industry's larger players compete in global markets. A significant proportion of financial institutions in Canada are federally regulated. Despite this, federal financial institutions legislation last received a thorough overhaul fifteen years ago. Although there have been several legislative reviews since then, the 2006 White Paper proposes only some relatively minor adjustments to the existing legislative framework.

That this White Paper does not tackle the hard issues is not surprising. The current minority Conservative government will not win significant political support by addressing controversial policy issues, and may risk losing support by altering the status quo. Thus, the White Paper

- as the Conservative Party election platform promised - to the delight of the insurance industry and the disappointment of the banks - maintains the current restrictions on deposit-takers selling insurance in branches and does not adopt the Canadian Bankers Association's "compromise" proposal to allow deposit-takers to refer customers to insurance agents and brokers outside the branch;
- offers no timeframe for the release of the long-awaited guidelines that will detail the public interest test for ministerial approval of bank mergers;
- does not discuss the current policy against common ownership of large banks and large life insurance companies;
- does not discuss the current requirement that two-thirds of the directors of Canadian-owned financial institutions must be resident Canadians, whereas only 25% of the directors of a federal business corporation must be resident

Canadians, a requirement that chafes financial institutions with a significant international focus;

- despite its objectives of increasing efficiency, and competition, offers no federal leadership or "national" solutions for a range of financial services issues where jurisdiction is shared with the provincial governments, such as harmonized rules for cooperative financial institutions across Canada; and
- does not address many of the impacts of technological change in the delivery of financial services, including the use of electronic systems to provide financial services to Canadians from outside Canada.

Conclusion

The White Paper recommendations are uncontroversial - as far as they go - and, despite the uncertainties of a minority Government, are designed to ensure that the impending federal financial institutions legislation receives the necessary support to be enacted before the next federal election. Debate and decision-making on important policy issues have been postponed yet again. Uncertainty in this significant Canadian industry is an opportunity lost.

Interestingly, the White Paper recommends greater flexibility in the sunset provisions for federal financial institutions legislation so as to avoid the current risk that an inconveniently timed snap election could jeopardize the continuity of federal financial institutions.

For further information on the subject of this article, please contact Robert McDowell or Robert Elliott. Their contact information is on the following page.

FINANCIAL INSTITUTIONS AND SERVICES GROUP

Vancouver

Donald M. Dalik 604 631 4739
ddalik@van.fasken.com

Robert W. Quon 604 631 4962
rquon@van.fasken.com

Donald J. Weaver 604 631 4924
dweaver@van.fasken.com

Calgary

Cory S. Exner 403 261 5366
cexner@cg.fasken.com

David H. Field, Q.C. 403 261 5360
dfield@cg.fasken.com

Toronto

Robert W. McDowell 416 865 4408
rmcdowell@tor.fasken.com

Donald E. Milner 416 865 4411
dmilner@tor.fasken.com

Robert E. Elliott 416 865 4382
relliott@tor.fasken.com

Stephen B. Kerr 416 865 5141
skerr@tor.fasken.com

Koker K. Christensen 416 868 3495
kchristensen@tor.fasken.com

C. Scott Mitchell 416 865 4516
csmitchell@tor.fasken.com

Kathleen E. Yoa 416 865 5451
kyoa@tor.fasken.com

Montréal

Bruno Arnould 514 397 5210
barnould@mtl.fasken.com

Sylvie Bourdeau 514 397 4388
sbourdeau@mtl.fasken.com

Maurice Forget 514 397 7441
mforget@mtl.fasken.com

Yvon Martineau 514 397 7575
ymartineau@mtl.fasken.com

Daniel Picotte 514 397 7527
dpicotte@mtl.fasken.com

Québec City

Jacques Croteau 418 640 2080
jcroteau@qc.fasken.com

Yves Lacroix 418 640 2072
ylacroix@qc.fasken.com

Jean Morency 418 640 2002
jmorency@qc.fasken.com

New York

Philippe David 212 935 3203
pdavid@nyc.fasken.com

London

James H. Lisson 011 44 20 7382 6050
jlisson@lon.fasken.com

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Vancouver

604 631 3131
info@van.fasken.com

Québec City

418 640 2000
info@qc.fasken.com

Calgary

403 261 5350
info@cgyc.fasken.com

New York

212 935 3203
info@nyc.fasken.com

Toronto

416 366 8381
info@tor.fasken.com

London

44 20 7382 6020
info@lon.fasken.com

Montréal

514 397 7400
info@mtl.fasken.com

Johannesburg

27 11 685 0800
info@jnb.fasken.com