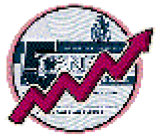
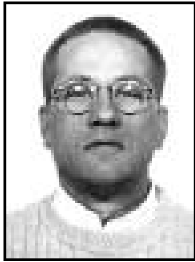


Banking in an era of Reform

New legislation will open doors to increased competition and bank mergers



By Peter Diekmeyer

Banking reform is on the agenda again. After dying an unmerciful death when last fall's federal election was called, Bill C-38 was reintroduced earlier this year with only minor differences from the original version. The bill — whose number at the time of this writing is slated to change to C-8 — is the result of extensive consultations, going back to 1996 with the establishment of the MacKay task force on the future of the financial services sector. After seemingly endless consultations, reports, studies and position papers, a massive bill emerged: an Act to establish the Financial Consumer Agency of Canada, and to amend certain Acts in relation to financial institutions.

The new bill, which includes the key provisions of its predecessor, attempts to set a new policy framework for Canada's financial services sector's four pillars: banks, insurance companies, investment dealers and trust companies. Since extensive hearings have already been held, Finance Department officials hope the new version — all 914 pages of it — will get through the legislative process relatively quickly. Which is just as well, since the reform is long overdue.

Canada's banks are bedevilled by a striking paradox: they are small compared to the giants operating on the international stage. Yet, in Canada, they operate as a quasi-oligarchy, often criticized for a high-handed approach to its clientele. The new legislation — by opening the door to enhanced competition and bank mergers — attempts to address both problems, while at the same time giving the sector the flexibility it needs to operate in today's fast-paced economic environment.

Canada's banks employ more than a half million Canadians, and supply liquidity that make the sector an important engine of the country's economic growth. But to continue to do so, and to grow internationally, the banks need greater access to capital. The bill includes several measures that will make it easier to acquire such financing.

Ownership restrictions — which act as a disincentive to foreign investment — will be relaxed. Banks will now be grouped into three classes. For those with more than $5 billion in capital, investors will now be allowed to own up 20% of any class of voting share, and 30% of non-voting shares. However, these must remain widely held, and control of any large financial institution by one person or group will be prohibited.

Banks with assets of between $1 billion and $5 billion, such as Laurentian Bank and National Bank of Canada, would also be subject to the widely held provision. The finance minister would retain the discretion of changing this status to "closely held" in any re-categorization. In such a case, one person could own up to 65% of the shares. Banks with less than $1 billion in capital could be owned outright by a single shareholder, and the bill reduces the minimum capital required to start a financial institution from $10 million to $5 million.

When implemented, the new legislation will also give the banks greater flexibility to structure their operations by allowing them to form holding companies. This will give them the opportunity to split up heavily regulated activities and those with heavy capital reserve requirements into separate subsidiaries. A bank could, for example, spin its heavily regulated deposit business and less regulated credit card operations into separate subsidiaries. This would make it easier for them to better compete against less-regulated players. The government has pledged to work to allow this asset shifting to occur on a tax neutral basis.

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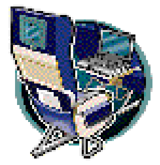
Currently, banks are subject to heavy restrictions on the kinds of businesses they can get involved in beyond banking. The new legislation will relax these restrictions, making it easier for them to get involved in an area such as e-commerce — a crucial step in an era where 85% of basic banking transactions are now done electronically.

The proposed legislation also opens the door to bank mergers such as those Finance Minister Paul Martin rejected with great fanfare in December 1998. However, at the same time, a formal review process will be put in place to allow public input. Banks planning to merge will be asked to submit a Public Interest Impact Assessment to the House of Commons Finance Committee. Any mergers, as well as many of the provisions that heighten industry competition will likely result in



branch closures. When these occur, the bill requires that federal deposit-taking institutions provide four month's notice so customers can reorganize their affairs. In the case of rural communities, the notification period increases to six months.

When bank branches are closed, credit unions are expected to come in and pick up some of the slack — especially in the smaller communities. The bill will allow for the creation of a more national credit union structure that will make it easier for the regional unions to co-ordinate their products and services, and to compete with the big banks.

Insurance companies will also benefit from the legislation. Not only are they protected from acquisitions or mergers with the large banks, they also get access to the payments system. This will give them the ability to provide a broader range of services such as deposit accounts similar to those offered by the banks. At the same time, insurance companies are shielded from competition from the banks, which are still not allowed to offer insurance products at the branch level.

There are several provisions in the bill designed to protect consumers, such as one giving the government the authority to force banks to provide low cost accounts and to cash government checks. However, the nonsensical prohibition on banks providing car lease financing remains.

Small- and medium-sized enterprises will also finally see some relief. This sector has long complained about the big bank's intransigence in providing access to capital and reasonably priced services. To monitor these complaints, a comprehensive program of data collection and analysis will be undertaken. Banks will now be required to report how much money they are lending SMEs.

To regulate and enforce the consumer-oriented protections, a new Financial Consumer Agency of Canada (FCAC) will be created. The agency will monitor the industry's initiatives to protect the interests of consumers and small businesses, promote awareness and respond to inquiries. A Canadian Financial Services Ombudsman (CFSO) would also be established, and would replace the industry-sponsored ombudsman currently in place, whose office is subject to both real and appearance-related conflict-of-interest problems.

Recognizing the fast-changing economic environment, the proposed legislation also sets in place mechanisms for quicker modifications in the future. The act will continue to be reviewed every five years, however, if changes are needed in the meantime, the government is prepared to re-visit the legislation. Many elements will also now be dealt with through regulation-making authorities, obviating the need for legislation.

As with many laws, the devil is in the details, and until the regulations accompanying the bill are finalized, it will be hard to make a final assessment. But according to many parties, things seem to be heading in the right direction.

Peter Diekmeyer is a Montreal-based business writer. He can be reached at peter@peterdiekmeyer.com