



June 30, 2016

Law Society of Upper Canada

Response to *Technology-led Innovation and Emerging Services in the Canadian Financial Services Sector*

Competition Bureau of Canada Market Study Notice (Spring 2016)

1. Overview

1.1 The Law Society of Upper Canada (“LSUC”) is interested in this Market Study given developments in the financial services sector that put Ontarians in residential real estate transactions, an important sector for the Canadian economy, at risk. Competition concerns arise from at least three sources. First, the LSUC is concerned about relationships between mortgage originators/lenders, up to this point largely deposit-taking institutions, and other parties to the transactions, which may jeopardize the interests of consumers/borrowers. Second, LSUC members, acting on behalf of sellers and buyers, encounter barriers and gaps to the efficient completion of transactions through existing payments systems. Third, the regulatory system for financial services is siloed and compartmentalized, creating gaps and uncertainty for consumers and entities with a consumer protection role, such as the LSUC.

1.2 The Market Study refers to the “Canadian financial services sector”, “FinTech” and “consumers”. These umbrella terms shade the reality that there is considerable diversity in the characteristics of these broad groups. The Market Study appropriately recognizes that the nature and pace of change in the marketplace can disadvantage consumers, leaving them without tools or information, or rendering the advice systems to which they must or do have access, such as lawyers, unable to fulfil their responsibilities to both client and professional regulator. From the LSUC’s perspective, Canadian oversight bodies with responsibility for both policy formulation and regulatory design and delivery



should have regard for the range of consumers implicated in the financial services sector and FinTech. Typically, “retail payments” are smaller payments that do not include residential real estate transactions by virtue of dollar value and transaction complexity. There is room for the broad brush, but there is also need for a finer level of detail in analysis, options and decision. The LSUC urges the Competition Bureau to have particular regard for how digital innovation will affect small and medium-sized users, as directed by its statutory purpose¹, including the types of transactions that are the subject of this submission.

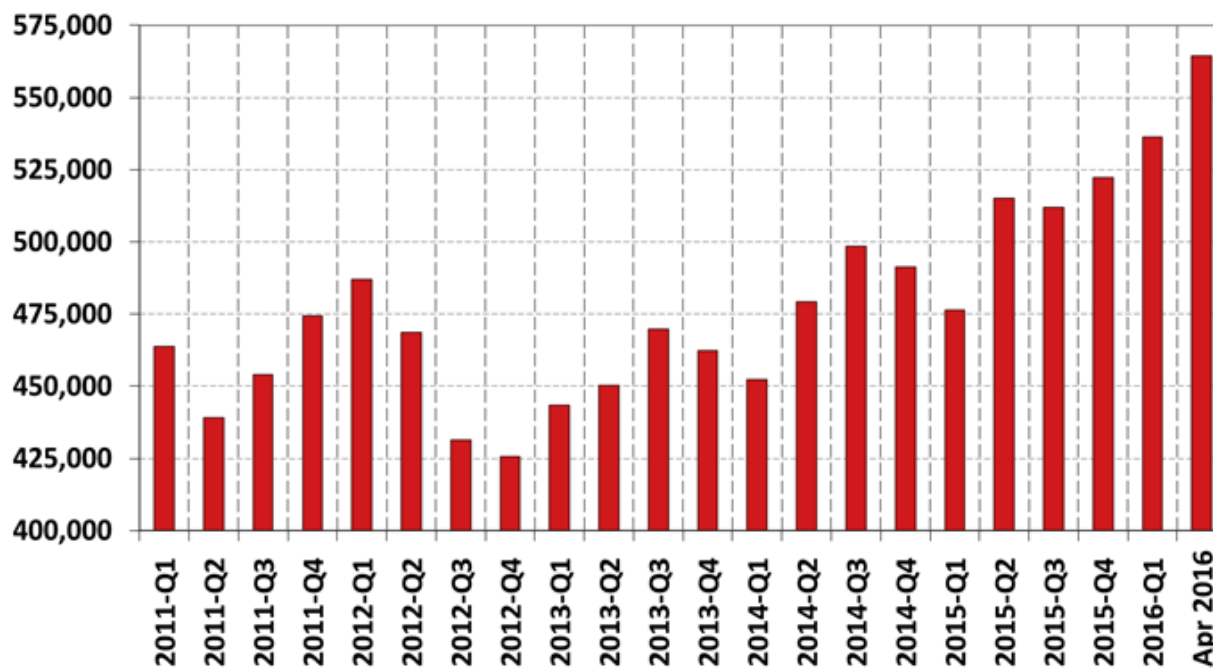
1.3 Real estate transactions have different components that may be affected in different ways by the direction and pace of digital innovation, which by definition will not be a monolithic, consistent or predictable evolution. Most residential real estate transactions involve mortgages, a form of lending. Almost all involve the transfer of funds between or among parties, and most involve mortgages. The McKinsey & Company study cited in the Market Study makes clear that although currently the lowest participation of digital innovation is in lending and finance, and highest in payments², mortgage origination has already started to change and mortgages are one of the types of core business most likely to change³. There has been, and will remain, prudential issues in these transactions, for all of the parties and systemically.

2. Importance of Residential Real Estate Sales and Mortgages in Canada

2.1 The residential home market is important to Canada economically, and to many professional and institutional groups involved in this significant sector. Looking at 2015, the most recent full year, more than 2 million homes were bought and sold in Canada.⁴ Using a rough “rule of thumb” based on population, 1.2 million of those sales occurred in Ontario.



Residential sales activity* Canada



*Seasonally adjusted data at annualized rates

2.2 Figures from the National Household Survey⁵, drawn from the last census in 2011, show that 69% of Canadians own homes (9.2 million out of 13.3 million). Almost 59% of these owner households had a mortgage. Indeed, for homes bought between 2006 and 2011, 80% had a mortgage. Home ownership, and related mortgages, have increased between 1991 and 2006, stabilizing somewhat between 2006 and 2011 (which period included a significant economic downturn).

2.3 Canadian banks hold approximately 75% of the value of outstanding mortgages in Canada (the five largest banks account for 65% of the value).⁶ Credit unions and caisses populaires are significant lenders in some regional markets.⁷ Most -95% - of the residential mortgages in Canada are issued by regulated lenders.⁸ Generally this mortgage lending is funded by retail deposits.



3. Law Society of Upper Canada Regulatory Role

3.1 The LSUC's regulates 49,000 Ontario lawyers and nearly 8000 paralegal licensees in the public interest. It ensures that these individuals are licensed and insured; are qualified to help a person through the legal process; and, meet standards of learning, competence and professional conduct.⁹

3.2 As part of its core mandate, the LSUC is authorized to set standards for the provision of a particular legal service in a particular area of law, and to apply those standards to those who practise law and provide legal services in Ontario.¹⁰ Many lawyers in Ontario are engaged in the provision of services in residential (and commercial) real estate transactions. The LSUC has numerous specific standards applicable to lawyers' fiduciary obligations, trust accounts, title insurance and other matters relating to residential real estate transactions.

3.3 The LSUC has duties to protect the public interest, and to act in a timely, open and efficient manner.¹¹ What happens in residential real estate transactions directly affects the parties to those transactions, ordinary Canadians who are buying and selling homes.

4. Competition Concern #1 – Relationships Amongst Parties to a Transaction

4.1 The role of a lawyer in a residential real estate transaction is to provide independent legal advice which protects the interests of his or her client every step of the way. Usually buyer(s) and seller(s) will be separately represented. In most residential real estate transactions, there will be a mortgage lender, who will be represented. If the mortgage lender is an institutional lender, the mortgage lender will usually be represented by the same lawyer as the purchaser with the purchaser's consent because of the



commonality of interests. In residential transactions, there will usually be a title insurer involved.

4.2 Law Society regulations for prudential reasons provide that funds received by a lawyer in respect of a residential real estate transaction may only be moved in and out of a trust account held in the name of the lawyer or the lawyer's firm at a regulated, deposit-taking financial institution (By-Law 9).¹² In other words, these funds can only be held and transferred (including electronic funds transfers) with members of the Canadian Payments Association.¹³

4.3 Historically, the goal was to have all the parties to the related transactions involved in the purchase or sale of a home be independent and their activities subject to prudential regulation, reducing the risks inherent in undisclosed relationships, non-arm's length arrangements, conflicts of interest and fraud.

4.4 The way business is conducted is changing. Relationships amongst service providers, and how prudential regulation overlays on these relationships, may not be transparent to the consumer, and they may be difficult to discern even with effort. Unregulated activity by entities that are regulated in other respects, let alone activity by new and unregulated entities, may generate higher levels of risk that are not apparent to the consumer, or on which the consumer is not fully advised. This is so whether the lender is a conventional lender, a new form of lender, or a combination.

4.5 In the case of the conventional lender, McKinsey identifies one option for adaptation as "the ecosystem owner":

By ecosystem, we mean a set of linked businesses with a single company at the center. A bank's ecosystem might include dozens of businesses. In its mortgage business, for example, a bank might also offer a property sales



app, an estate agent, a mortgage loan provider, a moving company, a home repair firm, and so on.¹⁴

It is not clear how legal advice, critical to the assessment of title and contractual obligations fits within this ecosystem. It is not clear whether the businesses in the ecosystem are arm's length, or non- arm's length. It is not clear from the example whether access to the mortgage would be tied in some way, or how these services would be related in terms of costs and other risk to the borrower. In addition, other traditional players in the real estate transaction such as title insurers and technology companies could seek to set up the ecosystem.

4.6 Another option identified by McKinsey is for banks to allow the commoditization of their balance sheets.¹⁵ Products designed, packaged and sold by other entities would be based on, or wrapped around a banking function, so that the primary relationship would be not between the bank and the consumer, but between a third party and the consumer. The banking function might be disclosed, and indeed part of the marketing proposition, or implied. To some degree, we have already seen that with virtual banks, or alternative payments systems that route money, at some point, through regulated deposit-takers.

4.7 For most Canadians, buying a home presents both the greatest financial benefit, and the greatest financial risk, they will experience. Undisclosed or under-disclosed relationships and conflicts of interest are a consumer trap with respect to up-front costs and longer-term risks.

Disclosure of all risk elements and the capacity to actually determine both value and risk are critical to all lending and payments. Every transaction presents risk: the key questions are how clearly is that risk described, and on whom does it fall? Digital innovation, in and of itself, does not address nor eliminate risk. In the view of the LSUC, any "relaxation" of existing regulations with respect to disclosure and management of conflict of interest is not an option in residential real estate transactions. Indeed, enhancing such protections may be particularly important for digitally-based transactions as the value of the transactions increase. Additionally, the disclosure of conflicts and risks to the consumer does not always work because of the time pressure and high stress involved in the residential real



estate transaction process. One of the challenges in residential real estate transactions is that consumers are seeking to minimize cost and expedite the home purchase process. Given that most people will only purchase one or two homes in their lifetime, the transaction process tends to be a high pressure process with significant time constraints. These conditions are usually not optimal for consumers to be advised of their choices and for them to realistically seek options in the course of the transaction. This is even more so at the commencement of the transaction before the consumer has met with a lawyer.

5. Competition Concern #2 – Gaps in Payments Clearing and Settlement

5.1 The LSUC, in principle, welcomes digital innovation in the payments system. The concern, however, is that a primary, critical digital innovation must be a real-time payments system which is accessible provides good value and is affordable for all Canadians. The current system is vulnerable and digital innovation itself may undermine the development and implementation of a universal system by cherry-picking parts of the payment spectrum (either by existing or new entities). This will make it even harder going forward to move to a national, accessible, affordable real-time payments system as deposit-takers feel the pressure by innovation at the same time they must invest in change.¹⁶

5.2 The LSUC, drawing upon the long experience of lawyers acting for clients in residential real estate transactions, made submissions to the Task Force for the Payments System Review (“Task Force”), which reported in December 2011. Its submission concluded:

The practical reality is that there is now no certain means by which funds can be moved on a timely basis as between different parties, whether they do their banking with different financial institutions who are members of the Canadian Payments Association or with the same financial institution. Whether one is attempting to verify the authenticity of certified cheques or bank drafts or attempting the use the [Large Value Transfer System] it appears that there are real barriers to effective transfer of closing funds for transactions and therefore a real impediment to completing transactions on a timely



basis. Consumers and businesses find these weaknesses in the system at best inconvenient and at worst an impediment to commerce.

5.3 It is clear from the Report and Policy Papers of the Task Force Payments System Review that the barriers described by the LSUC are not unique to lawyers, nor to real estate transactions, but indeed are widely experienced across types of businesses and types of transactions. The Task Force observed that “we still rely largely on old-fashioned methods of payment such as paper-based processing, and cash and cheques.”¹⁷ It called for “alternative electronic payments methods that deliver greater benefits than our existing cheque-based infrastructure.”¹⁸ One of its principal recommendations called upon the Government of Canada to “partner with the private sector to create a mobile ecosystem.”

5.4 Historically, residential real estate transactions have been completed within Canada’s core clearing and settlement systems, operated by the Canadian Payments Association. When completing real estate transactions, funds need to be available for use within very short timeframes. This is particularly so when the transaction is part of a chain of transactions of buying and selling, all closing on the same day. It is typical for clients to sell their house on the same day that they are buying a new house, and it is typical that funds received from the sale are immediately applied toward the purchase, all in the same day. When funds moved through the paper-based Automated Clearing and Settlement (ACSS) are not available for closing on a timely basis, closings are delayed and this creates additional risk that there will be a breakdown in the transactions, with consequences to the parties that can be dire.¹⁹ For some years, the LSUC has encouraged lawyers that whenever possible they should transfer funds to complete transactions using the electronic wire-based Large Transfer Value System (LVTS). Bank rules, access, training, cost and competition, however, make LVTS inconsistently available on inconsistent terms.²⁰

5.5 For a variety of reasons both prudential and practical, residential real estate transactions are not processed through any of the other electronic payment methods that the Department of Finance Canada has described as



“national retail payment systems.”²¹ The Bank of Canada designated the ACSS as a “prominent system” effective May 2, 2016. The LVTS is also a “prominent system”. As such, they are required to have same-day settlement. It is unclear whether the ACSS will be modified in the shorter term. Neither the ACSS nor the LVTS meet the needs of modern consumers undertaking significant transactions.

5.6 Canada’s payments system is a critical piece of national infrastructure and it must deliver near real-time availability of funds with good value. It is foundational to the economy, to the day-to-day needs of Canadians, and indeed to efficient technology –led innovation and emerging financial services. An example of innovation is what Australia has done with its payment, clearing and settlement systems. Individual transactions involving different banks are settled in real time across accounts at the Reserve Bank of Australia.²²

It should be noted that competition was an element in the reform of the Australian payments system, and that the Reserve Bank of Australia and the Australian Competition and Consumer Commission have a Memorandum of Understanding to ensure a coordinated policy approach.²³

6.0 Competition Concern #3 – Collaboration in Policy and Regulation

6.1 Four major players in the future of the financial services sector in Canada are contemporaneously posing questions that have relate to key aspects of digital innovation in the financial services sector:

- Department of Finance Canada, *Balancing Oversight and Innovation in the Ways We Pay: A Consultation Paper*, 2015
- Canadian Payments Association, *Developing a vision for the Canadian payment ecosystem, Draft for Consultation*, April 20, 2016
- Competition Bureau, Market Study Notice: *Technology-led Innovation and Emerging Services in the Canadian Financial Services Sector*, Spring 2016



- Bank of Canada designation of ACSS under the Payment Clearing and Settlement Act, May 2, 2016

These touch upon questions of systemic importance. They overlap on some matters, and not on others. Taken together, they raise a fundamental question about Canada’s willingness and readiness to consider, and make, fundamental choices about public policy changes in a world of possibilities and pressures driven by digital innovation. There is the question of the ““perimeter of oversight”²⁴, but there is equally the question of the design and effectiveness of the oversight. As noted earlier in the paper, Canadians are diverse in their needs, and this must be taken into account in what policy, regulation and service decisions are taken.

6.2 The LSUC notes that the Competition Bureau Market Study initially is concerned with “consumer-facing activities”. The Law Society hopes that this means that the Competition Bureau will not look only at the “retail” type of transaction, but more broadly at what services are needed for the range of transactions of importance to consumers, including residential real estate transactions. Further, the LSUC urges the Competition Bureau, in an environment where providers and products are changing rapidly, to pay particular regard to the tool box of disclosure, conflict of interest and arm’s length requirements to adequately protect consumers.

6.3 In considering the optimal structure, Canada needs a payments system that delivers accessible, affordable, good value and real-time delivery of funds. This is the foundation to competitive markets serving Canadians.

¹ *Competition Act*, RSC 1985, c. C-34, s. 1.1

² McKinsey & Company, *McKinsey Global Banking Annual Review 2015: The Fight for the Customer*, Exhibit 8, p. 21

³ *Ibid*, Exhibit 9, p. 22 and Exhibit 10, p. 25



⁴ Canadian Real Estate Association, “Canadian home record sales set record in April”, [National Statistics](#), (May 16, 2016, Ottawa)

⁵ Statistics Canada, [Home Ownership and Shelter Costs in Canada](#), 99-014-XIE2011002

⁶ Allan Crawford, Césaire Meh and Jie Zhou, “The Residential Mortgage Market in Canada: A Primer,” *Financial System Review*, Bank of Canada, December 2013, p. 53

⁷ *Ibid*, p. 53

⁸ *Ibid*, p. 54

⁹ [Law Society Act](#), RSO 1990, c. L8, s. 4.1(a)

¹⁰ *Ibid*, s. 4.1 (b)

¹¹ *Ibid*, s. 4.2

¹² Law Society of Upper Canada, [By-Law 9](#)

¹³ [Canadian Payments Act](#), s. 4

¹⁴ McKinsey, p. 29

¹⁵ McKinsey, p. 31

¹⁶ McKinsey, pp.21-23

¹⁷ Task Force for the Payments System Review, [Moving Canada into the Digital Age](#), December 2011, p. 4

¹⁸ *Ibid*, p. 6

¹⁹ For very good commercial reasons, the exchange of funds is usually the last event in the closing of a transaction. In most cases funds will arrive at the lawyer’s office as close to the time of closing as possible.

Barriers to Verification. Upon receipt of the bank draft or certified cheque, prudent lawyers as part of their due diligence may need to contact the issuing bank or the bank that certified the cheque to verify that the instrument was in fact issued or certified at that bank. However, today, many banks refuse to provide this information arguing that they are not allowed to do it, they do not have the staff to do it, or, they are fearful of incorrectly confirming or denying the authenticity of the instrument. Without verification, the vendor’s lawyer must implicitly choose between: 1) personally accepting the financial consequences of closing the transaction without good funds; 2) closing the transaction in escrow (if permitted by the agreement of purchase and sale to do so) until the cheques or drafts clear the trust account (which could take 8 to 15 days or more); or, 3) obtaining the consent of the clients to closing the transaction without knowing that they will receive payment for transferring the title.

Barriers to Access to Funds. Some banks have developed policies whereby they will place a hold on certified cheques and/or bank drafts deposited into business accounts for a period of time pending clearing of the instrument. Some banks do this on a transaction basis, while others have developed policies whereby they place a hold on all transactions over specific amounts. The length of the hold period depends on the individual bank and the transaction. Usually when a hold is placed on the money of the closing date, the funds are not accessible and



the transaction cannot be closed in accordance with the contract. Not having funds available on the closing date is very problematic from a legal perspective. Lawyers advise that they sometimes deal with this problem by negotiating an extension of the closing date with the other side. For example, a vendor who no longer wishes to close the transaction will not agree to an extension and may use this as a basis for terminating the deal. Clients are inconvenienced by the delay, sometimes with follow-on consequences.

²⁰ The following are specific examples of the barriers being encountered when lawyers attempt to use LVTS.

1. Unavailability

Local bank branches often do not know what LVTS is. Some banks advise that LVTS is reserved for very large transactions. Some banks refuse to tell the lawyer how the money was wired or will be wired. Bank staff may indicate that the bank, not the customer, determines what system will be used to wire monies. The payee in these circumstances cannot determine whether the funds received are final and irrevocable, which is the benefit of the LVTS.

2. Level of service differs depending on the bank or branch.

The practice for LVTS transfers differs from bank to bank, and the level of service varies significantly from branch to branch. For example, in some branches only one employee is familiar with the system and delays occur if that employee is not available. Also, some branches require the lawyer to attend personally to initiate the LVTS transfer, whereas all other banking is undertaken by law firm staff.

3. Time lag regarding the sending and receipt of funds

Lawyers have indicated that there is a significant time lag between the time that the money is sent and the time that it is posted to the lawyer's account. Money sent is not received until the next day or later. This is more pronounced in Northern Ontario.

4. Bank fees prohibitive

Lawyers have indicated that, in their view, the fees charged by their banks are prohibitive, and can vary depending on the bank used by the other lawyer. The LVTS charge is typically considerably more than the charge for a bank draft or certified cheque, adding cost to the consumer's transaction. In addition, if the law firm wishes to use an on-line system for the LVTS transfer, there may be a monthly subscription or access fee charged to the firm which in turn increases costs for clients.

²¹ Department of Finance Canada, [Balancing Oversight and Innovation in the Ways We Pay: A Consultation Paper](#), 2015

²² Committee on Payment and Settlement Systems, Bank for International Settlements, [Payment, clearing and settlement systems in the CSSS countries](#), Vol. 1, p. 15 (September 2011)

²³ *Ibid*, p. 14

²⁴ [Balancing Oversight and Innovation in the Ways We Pay: A Consultation Paper](#)