



Department of Finance
Canada

Ministère des Finances
Canada



SECOND CONSULTATION PAPER

Potential Policy Measures to Support a Strong and Growing Economy: Positioning Canada's Financial Sector for the Future

Review of the Federal Financial Sector Framework

August 11, 2017

Preface

This paper launches the second stage of the renewal of Canada's federal financial institutions statutes.¹ The Department of Finance Canada is consulting on potential policy measures that could lead to consideration of legislation in Parliament prior to the statutory sunset date of March 29, 2019, or inform the Department's longer-term approaches to the financial sector.²

The Department began the first stage of the renewal process with the release of a consultation paper on August 26, 2016. The first paper set out the landscape of Canada's financial sector and identified key trends that may influence future directions. It sought input on these trends and related implications, as well as how best to position the federal financial sector framework for the future. The paper asked stakeholders to consider in their comments three policy objectives that help to assess whether Canada's financial sector is functioning effectively:

- stability: the sector is safe, sound, and resilient in the face of stress;
- efficiency: the sector provides competitively priced products and services and passes efficiency gains to customers, accommodates innovation, and effectively contributes to economic growth; and
- utility: the sector meets the financial needs of an array of consumers, including businesses, individuals, and families, and the interests of consumers are protected.

The Department heard from a diverse range of stakeholders. This second consultation paper takes into account their comments and recommendations. It reflects Canadians' high expectations for the sector and responds to trends and emerging issues that are actively reshaping the sector and the needs of its users.

This paper seeks views on whether and how to implement potential policy measures, as well as on policy directions for future work.

In addition, the Department will undertake targeted stakeholder consultations on separate technical and consequential changes that could be made to the federal financial institutions statutes to ensure they remain up to date and sound.

¹ The *Bank Act*, the *Cooperative Credit Associations Act*, the *Insurance Companies Act*, and the *Trust and Loan Companies Act*.

² Sunset provisions in Canada's federal financial institutions statutes provide the opportunity to conduct the regular renewal of Canada's federal financial sector framework.

Process

The consultation period will close on September 29, 2017.

Written comments should be sent to:

Director
Financial Institutions Division
Financial Sector Policy Branch
Department of Finance Canada
James Michael Flaherty Building
90 Elgin Street
Ottawa ON K1A 0G5
Email: fin.legislativereview-examenlegislatif.fin@canada.ca
Telephone: 613-369-9347

The Department may make public some or all of the comments received or may provide summaries in its public documents. Stakeholders providing comments are asked to clearly indicate the name of the individual or the organization that should be identified as having made the submission.

In order to respect privacy and confidentiality, please advise when providing your comments whether you:

- consent to the disclosure of your comments in whole or in part;
- request that your identity and any personal identifiers be removed prior to publication; or
- wish that any portions of your comments be kept confidential (if so, clearly identify the confidential portions).

Information received through this comment process is subject to the *Access to Information Act* and the *Privacy Act*. Should you express an intention that your comments, or any portions thereof, be considered confidential, the Department will make all reasonable efforts to protect this information.

Table of Contents

Introduction 4

Supporting a Competitive and Innovative Sector 6

Improving the Protection of Bank Consumers 12

Modernizing the Framework 13

Safeguarding a Stable and Resilient Sector 20

Annex 24

Introduction

The Government has outlined its focus on an agenda to build long-term, inclusive economic growth to support Canadians. A well-functioning financial sector is core to delivering on this commitment, as it provides the financial services that are used to grow the economy, from credit to small businesses and investment in innovative start-ups.

The regular renewal of the federal financial institutions statutes provides the Department of Finance Canada the opportunity to position the federal financial sector framework for the future and ensure that it continues to meet the changing needs of Canadians.

In the first stage of consultations, the Department received a broad range of comments. Financial institutions, organizations representing consumers and investors, financial technology (fintech) firms, professional and trade associations, academics, financial centres, and individual Canadians, among others, shared their views.

Overall, stakeholders indicated that the framework is well positioned to meet the changing needs of Canadians and the economy. The foundational elements of the framework continue to be supported by stakeholders, including strong and clear mandates for federal financial sector regulatory agencies and a principles-based approach to regulation, a size-based ownership regime for financial institutions, and a separation between banking and insurance activities.

At the same time, stakeholders recommended targeted updates to the framework to ensure that it effectively adapts to new developments and innovations in the sector.

Stakeholders observed that the sector is entering a new period of innovation, with fintechs at the leading edge. Many comments made clear that Canadians benefit through greater access, choice, and competition from the presence of new market entrants and a framework that encourages innovation in financial services.

At the same time, a number of stakeholders emphasized the need for the framework to do more to serve the interests of Canadians. They called for the framework to provide a high level of consumer protection in the context of a rapidly changing landscape of financial products and services.

Stakeholders also noted that the sector is adapting to an evolving business environment, both at home and abroad. They urged the framework to keep pace with changes in the business models of financial institutions, for example, by providing additional flexibility to invest in infrastructure and maintaining high standards to ensure effective governance.

While the Government of Canada has implemented a range of measures since the financial crisis to safeguard a stable and resilient sector, stakeholders highlighted certain risks to the sector that warrant further consideration, namely, the ability of the federally regulated property and casualty insurance sector to cope with a low-probability, high-impact earthquake.

To ensure that the framework continues to meet the needs of all Canadians now and in the future, the Department is considering a series of policy issues set out in this paper under four themes:

- Supporting a competitive and innovative sector;
- Improving the protection of bank consumers;
- Modernizing the framework; and
- Safeguarding a stable and resilient sector.

A number of specific issues are under review for inclusion in the 2019 update to the federal financial institutions statutes. The Department is seeking views on these options for potential legislative inclusion.

In addition, there are issues of a longer-term nature on which the Department will continue to work past the renewal of the statutes. The Department is seeking views from stakeholders to advance the assessment of these issues.

Further potential policy measures of a more targeted nature are included in an annex to this paper.

Supporting a Competitive and Innovative Sector

The Government has clearly defined a growth agenda to build an inclusive economy and support the middle class. A competitive and innovative financial sector has an important role to play in driving this agenda. The sector is a significant contributor to economic growth in its own right, playing a fundamental role in ensuring the efficient deployment of credit and capital among savers and borrowers.

The current financial sector framework has proven to be stable and resilient for Canadians. This is the essential foundation on which Canada's economy grows. At the same time, the global economy is changing rapidly, and Canada's financial sector must be ready to adapt and provide the innovative services that Canadians and businesses need.

In this context of change, the Department will work to ensure that the financial sector is serving and driving inclusive economic growth. The Department is considering a number of measures to enable an innovative and competitive sector, with both near-term and longer-term initiatives.

In the area of competition and innovation, the Department is seeking input on potential policy measures to include in the 2019 update to the federal financial institutions statutes. These near-term measures are:

- Clarifying the fintech business powers of financial institutions;
- Facilitating fintech collaboration; and
- Streamlining the bank entry and exit framework.

Fintechs (i.e., companies that commercialize emerging financial technologies) are at the leading edge of innovation in Canada, often in collaboration with financial institutions. Clarifying the fintech business powers of financial institutions and removing obstacles to collaboration between fintechs and financial institutions can help to accelerate innovation, potentially making the sector more accessible and affordable to Canadians.

Small and mid-size banks are also important contributors to competition and innovation. In the near-term, refining a smooth entry and exit process will contribute to a dynamic and contestable marketplace.

In the longer term, the Department is considering how the legislative and policy framework for the financial sector aligns with a strong focus on economic growth and whether there are possible refinements that would better position Canada's economy for future growth and innovation.

Within this broader assessment, there is a need for further analysis on the important role that small and mid-sized banks play in promoting competition and innovation, and the contribution they can make to increasing capital formation and efficient credit allocation in Canada.

As another forward-looking initiative, the Department also intends to examine the merits of open banking—a framework under which consumers have the right to share their own banking information with other financial service providers—and will seek the views of stakeholders.

Clarifying the Fintech Business Powers of Financial Institutions

Financial institutions depend on technology to operate their information-intensive businesses, and technology creates opportunities for institutions to offer new products and services that meet the changing financial needs of Canadians.

Federally regulated financial institutions identified outdated statutory language as an impediment to their ability to offer expanded fintech services. For example, the federal financial institutions statutes use terms such as “portal” or “platform” to describe additional information processing activities that a bank may undertake in-house with approval. These terms can be difficult to apply to emerging business models.

Federally regulated financial institutions are generally prohibited from commercial activities and investments. This long-standing policy keeps institutions focused on their core area of expertise: financial services. Over time, flexibility has been incorporated into the federal financial sector framework to accommodate technology-driven changes in the business of financial services.

Striking the right balance between a clear focus on financial services and flexibility to adapt to new technologies presents challenges in the context of rapid change. The determination of whether a given technology could fit within the framework therefore requires a case-by-case assessment based on clear and modern rules.

The Department is seeking views on whether to clarify and modernize the type of information and technology activities that federally regulated financial institutions are permitted to undertake in-house, while maintaining the long-standing prohibition on commercial activities. In this context, the Department is seeking views on appropriate statutory language.

Facilitating Fintech Collaboration

Collaboration between firms with different capabilities drives innovation. Fintechs bring technology and speed to market, and incumbent financial institutions bring scale through existing customer relationships and balance sheets.

Facilitating collaboration between fintechs and federally regulated financial institutions encourages the cross-pollination of ideas and contributes to a sector that is more responsive to the financial needs of Canadians. Greater collaboration between fintechs and financial institutions can also contribute to growth and innovation in the sector by providing fintechs with greater funding and business opportunities.

A number of stakeholders noted that they would welcome measures to better facilitate collaboration, through greater flexibility for investments in fintechs by financial institutions, referrals by financial institutions to fintechs, or arrangements where fintechs provide outsourcing services to financial institutions. Facilitating collaboration must be balanced with the policy objective of limiting federally regulated financial institutions from engaging in commercial activities.

The Department is seeking views on whether to provide federally regulated financial institutions with additional flexibility to make non-controlling investments in fintechs and the corresponding authority to make referrals, subject to appropriate consumer protection, prudential, and commercial activities limitations. Views related to the outsourcing framework, which is prudential in nature, should be directed to the Office of the Superintendent of Financial Institutions (OSFI) for consideration.

Improving Regulatory Transparency and Coordination

Fintechs are often smaller firms with fewer resources. They may be less familiar with the federal financial sector framework. Fintechs also interact with federal, provincial, and territorial authorities, with each playing a role in the regulation of financial services in Canada. Fintechs have identified greater coordination between federal, provincial, and territorial authorities as a means to advance innovation in financial services.

To support greater financial innovation, the Government and federal regulatory agencies are committed to working with provincial and territorial regulatory authorities to better coordinate and share information. The Government will also continue to work to provide fintechs with more detailed information on the framework, such as better regulatory contact information. These efforts will improve federal regulatory transparency and better position fintechs to grow and succeed.

Streamlining the Bank Entry and Exit Framework

Ease of entry and orderly exit are key features of a dynamic and contestable financial services marketplace. Ease of entry allows financial sector entrepreneurs, including fintechs, to enter the financial sector efficiently to target underserved niches and offer new products and services to Canadians. Orderly exit allows firms to voluntarily leave the sector smoothly should their business plans change. Stakeholders identified

a number of targeted refinements related to streamlining the entry and exit framework.

The Department is seeking views on whether to undertake a series of targeted refinements to streamline and promote a smooth entry and exit process. For example:

- The number of officers a newly incorporated federally regulated financial institution may remunerate could be increased to better meet OSFI's prudential expectations around designated officers; and
- The Superintendent could be provided with the authority to extend the period to issue an Order to Commence and Carry on Business in exceptional circumstances.

Positioning a Competitive and Innovative Sector to Support Long-Term Economic Growth

Competition in the financial sector can be a tool to promote long-term economic growth. A competitive sector can deliver more affordable and innovative financial services to consumers and can provide credit to dynamic, cutting-edge areas of the economy. The level of competition in the sector needs to be carefully calibrated against a well-managed regulatory and legislative framework for oversight and risk. Over the longer term, the Department will consider the current balance of economic growth and risk management and whether refinements are needed to better position the sector to be competitive and innovative.

Small and mid-sized banks can contribute to long-term economic growth, as they often target different areas and market segments, such as small businesses. Over the last few decades, the Government has undertaken a number of legislative reforms to promote the entry of small and mid-sized banks. Bank ownership rules have been broadened to allow small and mid-sized banks to be owned by foreign banks, non-bank financial institutions, and commercial firms. Flexible banking structures have been permitted, such as lending branches, cooperative banks, and the ability for banks that do not accept retail deposits to opt out of deposit insurance. The statutory minimum initial capital requirement for banks has also been reduced, from \$10 million to \$5 million.

Small and mid-sized banks are regulated in a manner proportionate to their size, risk, and complexity. OSFI plays a strong role in engaging with small and mid-sized banks through its small bank advisor mechanism. OSFI holds regular meetings with executives of small and mid-sized banks to discuss current and emerging issues on balancing risks, controls, and small and mid-sized banks' ability to compete. Each of the federal financial sector agencies—the Canada Deposit Insurance Corporation

(CDIC), the Financial Consumer Agency of Canada (FCAC), and the Bank of Canada—also regularly consult with small and mid-sized banks on agency policy initiatives.

The Government will continue to apply proportionality in the development of policy and regulation going forward. However, despite this approach, small and mid-sized banks note that they face challenges due to proportionately higher regulatory burden and capital expectations relative to their larger counterparts, and are of the view that these requirements are not reflective of the overall stability risk posed by small and mid-sized banks.

With this context in mind, the Department will analyze the contribution that small and mid-sized banks can make to increasing capital formation and efficient credit allocation, which are important financial functions that can grow the Canadian economy.

Competition in the financial sector can be a tool to deliver economic growth. In this context, the Department is seeking views on how best to ensure that the financial sector supports long-term economic growth, while balancing the need for a well-functioning and stable sector and, in particular, the role that small and mid-sized banks can play in enhancing the innovative and competitive potential of the Canadian economy.

Examining the Merits of Open Banking

New technologies and business models transform the ways in which Canadians interact with their financial service providers and also contribute to an innovative and competitive financial sector. A number of jurisdictions are considering or actively moving forward with open banking—a framework under which consumers have the right to share their own banking information with other financial service providers.

Open banking holds the potential to make it easier for consumers to interact with financial service providers and increase competition. It is also an area that stakeholders, including fintechs, identified as key to encouraging innovation in the sector. The Department intends to examine the merits of open banking to give Canadians greater access to and control over their banking data, while protecting their security and privacy.

Fintechs have also expressed interest in the federal financial institutions legislation, which is essentially an opt-in framework that is flexible, proportionate, and principles-based. Beyond open banking, opportunities may exist to further support competition and innovation in the financial sector.

The Department intends to examine the merits of open banking. This would include consideration of how other jurisdictions are implementing open banking and the potential benefits and risks for Canadians.

The Department is also seeking views on other specific adjustments to the federal financial sector framework that could further support competition and innovation.

Improving the Protection of Bank Consumers

Canadians expect a robust federal consumer protection framework that protects them in their dealings with banks. The federal consumer protection framework for banks is designed to allow consumers to take advantage of a wide range of choice in financial products and services, provide them with the tools to make informed financial decisions, and help facilitate fair outcomes in their dealings with banks.

Fair treatment of bank customers is central to the federal consumer protection framework and should be an integral part of banks' corporate culture. Banks' boards should oversee consumer protection by ensuring that appropriate policies are in place and that management and staff carry them out.

Canadians also benefit from a dedicated regulator, the FCAC, that supervises banks' compliance with the *Bank Act's* consumer provisions. The FCAC also monitors and evaluates trends and emerging issues, promotes consumer awareness and education, and supports initiatives to strengthen Canadians' financial literacy.

In 2016, the Department proposed measures to strengthen the protection of bank consumers. The measures covered five areas: access to basic banking services, business practices, information disclosure, complaints handling, and governance and public accountability.

Initiatives are underway to assess whether further improvements are warranted:

- The Minister of Finance asked the Commissioner of the FCAC to examine best practices in financial consumer protection across Canada;
- The FCAC is reviewing bank sales practices to assess whether sales targets and incentives are contributing to poor outcomes for consumers. It will investigate any non-compliance and take enforcement action where necessary; and
- OSFI is reviewing domestic retail sales practices at domestic systemically important banks, and is focusing on risk culture, the governance of sales practices, and how banks manage the potential reputational risk inherent in sales activities.

These reviews will help inform potential policy measures to strengthen the framework and improve protections for bank consumers, building upon the measures proposed in 2016.

Modernizing the Framework

A well-functioning federal financial sector framework keeps pace with new developments and best practices to remain up to date and effective for its various users. Stakeholders noted that Canada’s financial sector is adapting to a number of important shifts, including a changing macroeconomic environment and a more uncertain international business climate.

The framework must continue to respond to the changing macroeconomic environment and rising public expectations of corporate governance and transparency that support the safety and soundness of the financial system.

This section sets out potential policy measures to better allow federally regulated life and health insurers to match assets to their liabilities in a changing macroeconomic environment, update the corporate governance framework for all federally regulated financial institutions, and respond to structural changes in the credit union industry.

In addition, the Department intends to undertake targeted technical consultations to ensure that provisions of the federal financial institutions statutes remain clear and current, and that they reflect their underlying policy intent.

Specialized Infrastructure Investment Powers

As described above, federally regulated financial institutions have broad powers to invest in financial services and have limited powers to make commercial investments (i.e., investments should support the core business of providing financial services). To accommodate the changing needs of institutions—and enable them to adapt to an evolving business environment—flexibility has been incrementally incorporated into the federal financial sector framework over time. This has allowed institutions to invest in limited commercial areas (e.g., real property, information technology).

Federally regulated life and health insurers have relied on fixed income investments (e.g., government and corporate bonds, mortgages) to build their asset portfolios to meet their long-term insurance policy obligations. In adapting to a low-yield environment, life and health insurers are increasingly looking to alternative investments such as infrastructure. Life and health insurers are gaining experience in infrastructure investment, having already financed Canadian roads, hospitals, and hydroelectric facilities, primarily through debt. The industry is now seeking to pursue new infrastructure investment opportunities.

The Department is considering whether to permit federally regulated life and health insurers to have additional investment powers in infrastructure. This would enable them to better match their assets and liabilities and to more actively participate in the financing of infrastructure in support of long-term growth that benefits all Canadians.

To protect policyholders and to maintain insurers' focus on the business of life and health insurance (and not commercial investments such as construction), investments should be subject to certain conditions, such as approvals, limits on the total amount of all infrastructure investments that a single insurer could make, equity caps on individual investments, as well as defining the permitted type of infrastructure investments.

The Department is seeking views on whether to provide federally regulated life and health insurers with additional investment powers in infrastructure. The Department is also seeking views on the conditions that should be applied to additional infrastructure investment powers of life and health insurers so as to protect policyholders and maintain the long-standing limitation on commercial investments.

Corporate Governance

The manner in which financial institutions conduct their business is central to public confidence in the financial sector. A strong and modern corporate governance framework ensures that institutions exercise effective risk management and rigorous internal controls.

Federally regulated financial institutions are recognized leaders in establishing and applying strong corporate governance frameworks. OSFI continues to set expectations for federally regulated financial institutions on the prudential aspects of corporate governance, taking into account domestic and international best practices.

Bill C-25, sponsored by the Minister of Innovation, Science and Economic Development, proposes a number of changes to the *Canada Business Corporations Act*, which serves as a foundation for the corporate governance requirements in the federal financial institutions statutes. The Department is considering whether to align the federal statutes—which are tailored to reflect the unique nature of financial institutions—with the proposed changes to the *Canada Business Corporations Act* across the areas discussed below and in the annex to this paper.

The same governance principles generally apply to all federally regulated financial institutions, irrespective of their size. This encourages appropriate oversight and risk management practices. At the same time, the Department recognizes that potential changes under consideration may impact larger publicly listed and smaller unlisted institutions differently. In this context, the Department is seeking views from small institutions, where applicable, on the impacts of these potential changes.

Promoting Diversity on Boards

Diversity is a recognized means to expand the mix of skills, knowledge, and experience of boards of directors. A central aspect of diversity is ensuring that

women are represented on boards and in senior management. The importance of gender balance in governance is not limited to the financial sector. The Government has also introduced a principles-based framework to enhance the representation of women within Governor in Council appointed positions.

For example, Bill C-25 is proposing to promote gender diversity by adopting a “comply or explain” model for publicly listed companies. This model requires a company to disclose to its shareholders information respecting gender diversity policies among directors and senior management (e.g., the proportion of women on the board). If no such policies exist, the company must provide an explanation to its shareholders. In practice, publicly listed institutions already follow this model.

The Department is seeking views on whether to implement a “comply or explain” model to promote the participation of women on boards of directors and in senior management of federally regulated financial institutions.

Strengthening Shareholder Democracy in the Election of Directors

Ensuring that shareholders, members, and policyholders have a strong voice in fundamental corporate matters is critical to the overall functioning of a company. Bill C-25 is proposing key changes to the timing, frequency, and way in which directors are elected to boards. The Department is considering whether to change the federal financial institutions statutes so as to establish annual elections, mandate individual director elections, and introduce majority voting.

Establishing Annual Elections

The opportunity for shareholders, members, and policyholders to express their voice in a consistent, predictable, and frequent manner is a key feature of a healthy governance framework. Bill C-25 is proposing to require annual elections for directors of publicly listed companies.

The federal financial institutions statutes allow for staggered director terms of up to three years, although publicly listed institutions already hold annual elections as a matter of practice. Similar to Bill C-25, the Department is considering whether to eliminate staggered director terms and establish annual elections for federally regulated financial institutions to increase director accountability for corporate performance and allow shareholders to voice their views more frequently.

The Department is seeking views on whether to establish annual elections for directors with fixed, one-year terms for all federally regulated financial institutions. For small institutions, the Department is considering whether to provide a two-year transition period and seeking views on the unique implications for these institutions.

Mandating Individual Director Elections

Individual director elections democratize the voting process by allowing shareholders, members, and policyholders to express their support or opposition for directors on an individualized basis. Bill C-25 is proposing to prohibit slate voting, which occurs where a group of directors is nominated by management for election, and shareholders, members, and policyholders vote for the group (and not the individual directors).

Similar to Bill C-25, the Department is considering whether to prohibit slate voting for federally regulated financial institutions. In practice, publicly listed institutions already hold individual director elections, although smaller institutions may face additional burden in moving to individual director elections.

The Department is seeking views on whether to mandate individual director elections for all federally regulated financial institutions. For small institutions, the Department is considering whether to provide a two-year transition period and is seeking views on the unique implications for these institutions.

Majority Voting for Directors of the Board in Uncontested Elections

Ensuring that directors have the support of shareholders, members, and policyholders strengthens corporate governance. Bill C-25 is proposing that, in an uncontested election, where the number of available director seats equals the number of nominees, candidates would require more votes in favour of their candidacy than against them in order to be elected (or re-elected) to a board.

The federal financial institutions statutes do not require a majority voting standard in uncontested director elections. In considering majority voting, the Department recognizes that it is important to implement a framework that would limit disruptions to the operations of a board and allow for the board to maintain the requisite mix of skills required to ensure the safety and soundness of an institution.

The Department is seeking views on how a majority voting standard could work in an uncontested election for directors of federally regulated financial institutions, while ensuring minimum disruptions to the operations of a board and continued stability in the case of a failed election of a candidate.

Distributing Meeting Materials

Shareholders, members, and policyholders require certain information in order to meaningfully participate in and make decisions at annual meetings. Bill C-25 is proposing to permit the use of the “notice and access” system as established by provincial-territorial securities regulators. This approach allows companies to notify

shareholders of a meeting and the means to gain access to essential material without sending an entire information package at the outset.

The Department is considering the merits of allowing federally regulated financial institutions to choose to adopt the notice and access system. This could minimize the costs associated with sending out by mail extensive meeting materials. However, for smaller institutions, the cost savings may not be as significant.

The Department is seeking views on whether to permit the use of the “notice and access” approach for all federally regulated financial institutions. For small institutions, the Department is seeking views on whether this approach would be beneficial.

Strengthening Corporate Transparency

The Department is committed to implementing strong standards for corporate transparency to safeguard the integrity of federally regulated financial institutions against money laundering and terrorist financing. Bill C-25 is proposing to explicitly prohibit the use of bearer shares and bearer share warrants. These instruments are wholly owned by those holding the physical stock certificate and carry the potential to facilitate money laundering and terrorist financing, given their transferable and untraceable nature.

The Department is seeking views on whether to strengthen corporate transparency by prohibiting bearer shares and bearer share warrants under the federal financial institutions statutes.

Federal Credit Unions and the *Cooperative Credit Associations Act*

Credit unions are a source of competition in financial services and often focus on niche markets, such as rural areas or smaller communities and small business lending. They are primarily regulated and incorporated at the provincial level and operate within provincial borders.

In 2012, a federal credit union (FCU) framework was implemented under the *Bank Act*, responding to a request from the credit union sector to provide provincial credit unions with a federal option to grow regionally or nationally. A credit union’s decision to pursue this option would be made by its board of directors and members based on the merits of the business case and with the approval of its province. It would also need to meet federal prudential standards and receive approval from the Minister of Finance.

Provincial credit unions have expressed interest in the FCU framework. In July 2016, Caisse populaire acadienne ltée³ of New Brunswick became the first FCU. In December 2016, the membership of Coast Capital Savings of British Columbia agreed to put forward an application to become an FCU. Innovation Credit Union of Saskatchewan has also indicated it plans to pursue FCU status by 2020.

The cooperative sector continues to evolve and recently initiated two key structural changes to entities incorporated under the *Cooperative Credit Associations Act*:

- Cooperative owners of the Credit Union Central of Canada (CUCC) decided that its ongoing trade association activities were best housed under a commercial structure. In December 2015, the Canadian Credit Union Association was incorporated under the *Canada Business Corporation Act* to carry on these activities. As a result, the CUCC discontinued; and
- Concentra Financial Services Association, the sole retail association under the *Cooperative Credit Associations Act*, restructured as a bank in January 2017.

There are no active institutions currently subject to the *Cooperative Credit Associations Act*.

The Department is seeking views on the merits of maintaining or repealing the <i>Cooperative Credit Associations Act</i> .
--

Limitations on Using the Terms “Bank,” “Banker” and “Banking”

It is important that consumers know when they are dealing with a bank, rather than another type of financial service provider, as banks are subject to protections and obligations created by the federal banking framework. For this reason, the *Bank Act* limits the use of the terms “bank,” “banker” and “banking” to banks only. The limit applies broadly to all prudentially regulated non-bank deposit-taking institutions (e.g., provincial credit unions and trust and loan companies), securities dealers and brokers, and other financial services providers, such as financial technology companies.

Provincial credit unions, which are not banks, highlight that they are currently using the verb “bank” and the term “banking” to describe their activities and the services they provide to Canadians, such as by having online “banking” websites or using the marketing phrase “come do your banking with us,” rather than using alternative common terms such as “online transaction accounts” or “providing personal financial services.” Credit unions have indicated that they do not want to contravene the *Bank Act*, but they believe they would be competitively disadvantaged unless they are allowed to use banking-related terms to describe their business activities. Credit

³ Caisse populaire acadienne ltée operates under the trade name UNI Financial Cooperation.

institutions recognize that limits on the use of these terms are required so that there is appropriate disclosure to consumers and to mitigate marketplace confusion (e.g., ensuring that a brochure with such terms is accompanied by a prominent and closely proximate declaration that the institution is not a bank).

The Department is seeking views on whether prudentially regulated non-bank deposit-taking institutions should be given flexibility to use the terms “bank” or “banking” to describe their activities and services in appropriate circumstances. Feedback is welcomed on how to refine the limitations on the use of these terms and on how to avoid marketplace confusion and ensure appropriate protection of consumers.

Safeguarding a Stable and Resilient Sector

A stable and resilient financial sector is critical to a healthy Canadian economy. In response to the global financial crisis, the Government endorsed a G20 plan to make the global financial system more resilient to reduce the likelihood and potential severity of future crises.

The Government followed up by implementing a number of key domestic reforms. These include enhanced capital and liquidity standards for banks and supervisory reforms in line with international standards and best practices. Reforms to implement recovery and resolution plans for domestic systemically important banks and a legislated bail-in regime are also underway.

The Government continues to adopt targeted measures to safeguard the stability and resiliency of Canada's financial sector, recognizing that risks and their transmission mechanisms are constantly evolving. For example, the Government recently took action to reinforce Canada's housing finance system to help protect the long-term financial security of borrowers and all Canadians, and undertook a comprehensive review of the deposit insurance framework to ensure it provides adequate protection for the savings of Canadians.

Stakeholders commented that the sector is generally well positioned from a stability perspective, having entered this renewal process from a position of strength. However, stakeholders highlighted certain risks that warrant further consideration by the Department.

This section sets out potential policy measures regarding the ability of Canada's property and casualty insurance sector to cope with a low-probability, high-impact earthquake. It also sets out work being undertaken by the Department in the areas of insurance resolution, cyber risk, and climate risk disclosure.

Earthquake Insurance

Canadians are best served when stable financial institutions offer effective insurance coverage to well-informed consumers. The property and casualty insurance sector is concerned about their ability to cope with low-probability, high-impact earthquakes.

Federally regulated property and casualty insurers are generally able to manage the financial cost of any likely natural disaster and are among the best prepared in the world for earthquake losses. OSFI imposes a stringent prudential standard on federally regulated property and casualty insurers by requiring them to have resources to withstand a 1-in-500-year earthquake. OSFI also requires large banks to

assess their own earthquake exposures, including the potential costs of increases in mortgage defaults.

Recent international experiences underline the high level of uncertainty in predicting damages in extreme earthquakes. Insurers remain exposed to tail risks from such earthquakes, as well as the possibility that insured damages could exceed the financial resources of particular insurers, impacting their solvency.

Licensed insurers are members of the Property and Casualty Insurance Compensation Corporation (PACICC), which provides protection to policyholders in the event of insurer failure. PACICC could face challenges in an extreme earthquake scenario, which could impact the broader property and casualty sector and Canadian consumers.

Effective insurance coverage requires consumers to understand and manage their own risks. However, consumers may not be fully aware of their exposure to earthquake risk. Under-insurance on the part of consumers could leave them vulnerable should they be directly affected by an earthquake. Private sector studies suggest that between 40 and 70 per cent of homeowners in British Columbia have earthquake insurance, while fewer than 5 per cent in the Ottawa–Québec corridor are covered. In this regard, the Canadian Council of Insurance Regulators is actively reviewing issues related to natural catastrophe insurance, in particular its availability and consumers' understanding of risks.

The Department is considering how to limit the system-wide risks an extreme earthquake could pose to federal property and casualty insurers, and will be consulting with provinces, territories, and stakeholders. In addition, the FCAC intends to improve consumer education products related to catastrophic risk and insurance to develop consumer awareness of insurance products and consumer rights and responsibilities, and will seek out opportunities to collaborate with provincial and territorial governments.

Insurance Resolution Framework

In response to the global financial crisis, the Government endorsed a G20 plan to develop effective resolution regimes for systemically important financial institutions—those so important to the functioning of the financial sector that they cannot be wound up under a conventional bankruptcy and liquidation process should they fail without imposing disproportionate costs on the economy.

Canada has made a number of post-crisis reforms to its resolution framework, consistent with international standards. Reforms have largely focused on the banking sector. More recently, *Budget 2017* announced a plan to establish a resolution framework for financial market infrastructures, which are systems that enable

individuals and firms to safely and efficiently purchase goods and services, make financial investments, manage risks, and transfer funds.

As the Financial Stability Board and the International Association of Insurance Supervisors continue to advance standards for the effective resolution of insurers, the Department will review the existing framework to assess whether additional measures should be taken to preserve financial stability in the unlikely event of a major life insurer's failure.

The Department is seeking views on possible enhancements to the life insurance resolution framework.
--

Cyber Risk

Cyber security is a priority for the financial sector and the Government. Public Safety Canada recently undertook a Cyber Security Review to take stock of the evolving threats in cyberspace to understand and explore ways that cyber security is becoming a driver of economic prosperity and to determine the appropriate federal role in this digital age. Public consultations have confirmed that cyber security in Canada is a highly complex issue with multiple challenges and an increasing range of opportunities. The responsibility for addressing these challenges and seizing these opportunities is shared by governments, the private sector, law enforcement, and the public. Throughout the consultation, three ideas were consistently raised as being important and relevant to cyber security in Canada: privacy, collaboration, and using skilled cyber security personnel.

Information gathered is now being used to inform policy and program decisions that will advance cyber security capability, resiliency, and innovation across all sectors of the economy. The goal is to:

- Create a new cyber security strategy that is forward-looking, enduring and responsive to a continually changing cyber security environment; and
- Make Canada a global leader in the provision of cutting-edge cyber security technology and the use of these technologies to promote safe and secure services to the global marketplace.

The Department will work with Public Safety Canada to assess what legislative and regulatory changes might be needed to achieve this.

Concurrently, the Department is pursuing greater international co-operation on cyber security, through the G7 and G20, in order to raise awareness and work towards common initiatives to improve cyber resilience. In line with this engagement, the Government recently endorsed the G7 Fundamental Elements of Cybersecurity in the Financial Sector, which serves to guide public and private financial sector entities in designing and implementing their cyber security strategies and operating frameworks.

Climate Risk Disclosure

There is growing policy focus on climate-related disclosure, both at the international level and in Canada. Stakeholders highlighted issues related to green finance and, in particular, the need for firms to improve disclosure of climate-related risks.

The final recommendations of the Financial Stability Board's industry-led Task Force on Climate-related Financial Disclosures were released on June 29, 2017. Relatedly, the Canadian Securities Administrators have announced a project to review the disclosure of risks and financial impacts associated with climate change. The Department is looking forward to the recommendations from this process and continues to contribute to ongoing work on green finance in international forums, including the G7 and G20.

Annex

This annex sets out for comment potential policy measures of a more targeted nature to the federal financial sector framework.

Modernizing the Framework

Information Publication Requirements

The Office of the Superintendent of Financial Institutions (OSFI) currently publishes basic information (e.g., legal name, chief agent) regarding federally regulated financial institutions. In contrast, the legislation requires OSFI to publish only fairly limited information.

The Department is seeking views on whether to reflect OSFI's current practice to publish on its website basic information on all federally regulated financial institutions in the financial institutions statutes.

Transactions of Public Interest

For certain transactions requiring Ministerial or Superintendent approval, applicants must publish their intention to request approval in the *Canada Gazette*.

The Department is seeking views on whether to broaden the list of approvals that require advance publication in the *Canada Gazette* (e.g., financial establishment in Canada). Notices would call upon objections from the public. This potential change would inform Canadians of transactions that could be of public interest and provide them with an opportunity to object.

Unclaimed Balances

An “unclaimed balance” is a Canadian-dollar account, deposit, or negotiable instrument held or issued by a federally regulated bank or trust company. When there has been no owner activity in relation to the balance for a period of 10 years, and the owner cannot be contacted by the institution holding it, the balance is turned over to the Bank of Canada, which acts as the federal custodian on behalf of the owner. The Bank of Canada does not currently charge administrative fees.

The Department is seeking views on whether to modernize the administration of unclaimed balances, and in particular:

- The unclaimed balances that should be transferred to the federal custodian;
- The information that should be provided to the custodian to ensure that unclaimed balances can be claimed effectively (e.g., dates of birth and social insurance numbers);

-
- The appropriate period of time for unclaimed balances to be held by the custodian, whether holding periods should vary by balance size or instrument type, and what should be done with unclaimed balances after this time; and
 - Considerations for allowing unclaimed balances to be administered on a cost-recovery basis (e.g., administrative fee).

Nuclear Insurance

The *Insurance Companies Act* includes an exemption that was originally intended to address nuclear insurance capacity shortages within Canada by allowing the insurance of nuclear risks located in Canada from abroad by foreign insurers.

Since then, the regime has been modernized to regulate only foreign insurers that carry on business (i.e., insure risks) in Canada and allow foreign insurers to insure risks located in Canada. This makes the specific exemption for nuclear insurance unnecessary.

The Department is seeking views on whether to subject nuclear insurance to the general foreign companies regime and repeal the nuclear insurance exemption contained in Part XIII of the *Insurance Companies Act*. This potential change would not impede the ability of the Minister of Natural Resources to set criteria and approve nuclear liability insurers under the *Nuclear Liability and Compensation Act*.

Place of Records

Foreign federally regulated insurers are presently required to hold records at the chief agency in Canada of the foreign company.

The Department is seeking views on whether to allow foreign insurers to hold records in Canada at a location other than the location of the chief agency of the foreign company. This potential change would align record location requirements for foreign insurers with those of foreign banks, promoting greater consistency across the federal framework.

Structured Settlement Agreements

A three-party structured settlement agreement is a negotiated insurance arrangement whereby a third party (the assignee insurer) assumes the responsibility of a property and casualty insurer or marine insurer (the original insurer) to make a series of payments to a claimant.

This structure can be interpreted as the assignee insurer issuing an annuity, which is prohibited under the *Insurance Companies Act* for federally regulated property and casualty insurers and marine insurers.

The Department is seeking views on whether to allow property and casualty insurers and marine insurers to assume the periodic payment obligations associated with three-party structured settlement agreements. This potential change would provide greater regulatory consistency and would facilitate the reinsurance of three-party structured settlement agreements.

Increases in Significant Interest

Ministerial approval is generally required if an entity wishes to acquire shares of a federally regulated financial institution. An approval is not required where a controlling shareholder is seeking to directly increase its share ownership.

However, Ministerial approval is required where the controlling shareholder of a financial institution is seeking to indirectly increase his or her significant interest in that institution, either by:

- Acquiring control of a third-party entity that already has a significant interest, or;
- Having an entity it controls acquire a significant interest in that financial institution.

The Department is seeking views on whether to exempt persons who already control a federally regulated financial institution from having to seek Ministerial approval for indirect increases in their share ownership.

Electronic Meetings

Shareholders, members, and policyholders can choose to participate in meetings electronically, subject to the by-laws of the institution. As technology becomes more prevalent, broader use of electronic meetings could become the preferred model.

The Department is seeking views on the appropriate conditions for increasing electronic participation in meetings so long as access to a physical meeting in Canada is provided.

Advanced Voting (Electronic or Otherwise)

Shareholder, member, and policyholder participation is important in the decision-making process of an institution, including voting on such things as proposals and members of the board. Some provincial legislation permits members of a credit union to vote in advance electronically, by mail or by ballot at a local branch office. However, stakeholders have submitted that the current federal framework may not clearly permit voting in advance (electronically or otherwise), and this lack of clarity may create uncertainty.

The Department is seeking views on whether to clarify the rules regarding advance voting and how this may impact current practices, including determining record dates and notice of meetings.

Proposals by Members of a Federal Credit Union

“One member, one vote” is a principle among federal credit unions that encourages proactive member engagement with the board. Under the *Bank Act*, any member of a federal credit union may submit a proposal for consideration by the board. However, shareholders may submit a proposal if they meet certain eligibility criteria, including the amount or value of outstanding shares owned.

Some stakeholders have requested the harmonization of bank and federal credit union eligibility requirements. The Department is seeking views on whether a threshold ought to apply before members of a federal credit union can bring forward a proposal, and what type of threshold would be appropriate.

Access to Federal Credit Union Membership Lists

Ensuring transparent and effective communication among members on matters relating to the affairs of a federal credit union is essential to good governance. To facilitate member engagement, the *Bank Act* outlines the way in which members can obtain membership lists.

Stakeholders have indicated these lists may include certain commercially sensitive information and that there should be a limit on their access. The Department is seeking views on whether to continue allowing members automatic access to FCU membership lists in support of transparent communication or whether access should only be provided on request.

Safeguarding a Stable and Resilient Sector

Related-Party Regime

Related-party transactions are permitted, provided that they are authorized by the federal statutes, including being conducted at market terms and conditions. This ensures that a related party’s interest in, or relationship with, a regulated entity does not affect the exercise of its best judgment.

The Department is seeking views on expanding the scope of the definition of “related party” (i.e., persons who are in positions of influence over a federally regulated financial institution). Specifically, the Department is considering potential changes to the financial institutions statutes in order to include, as related parties of a federally regulated financial institution:

-
- A person who holds a non-controlling significant interest in an entity that controls a federally regulated financial institution. This potential change would also apply to spouses, common-law partners, children under 18 years of age of that person, and entities controlled by the person or family members; and
 - An entity controlled by an entity in which a person (including their spouse, common-law partner or child under 18 years of age) who controls a federally regulated financial institution has a substantial investment.

The Department is also considering whether to expand the application of the related-party regime to the following entities under the *Insurance Companies Act*:

- Parents of insurance companies incorporated in Canada that are currently exempted from related-party status because the parent is a foreign company with branch operations in Canada; and
- Subsidiaries and substantial investments of foreign insurance companies.

These potential changes would ensure that transactions between these entities and a company, or foreign company, are subject to the related-parties rules, including providing OSFI with the authority to approve certain transactions for which no approval was previously required.

Permitted Credit Exposures

Directors, officers, and their interests are currently permitted to undertake transactions with a federally regulated financial institution representing up to 50 per cent of regulatory capital of the institution.

The Department is seeking views on whether to reduce this limit from 50 per cent of regulatory capital of the institution to 25 per cent. This potential change would bring the exposures for these related parties in line with OSFI's expectations regarding large exposures for domestic federally regulated financial institutions.

Substantial Investments Regime

Approvals for Substantial Investments

Federally regulated financial institutions that are planning to acquire a permitted entity need to obtain the approval of the Superintendent in certain circumstances. The Department is seeking views on whether to realign the scope of Superintendent approvals to better match the administrative burden to prudential risks through the following potential changes:

- Establishing a materiality threshold for Superintendent approval of the acquisition of unregulated entities, up to 2 per cent of the consolidated assets of the acquirer;

-
- Eliminating Superintendent approval where a federally regulated financial institution acquires control of a limited partnership investment fund (that is not a mutual fund entity or a closed-end fund) only because it controls the general partner of that partnership. This potential change would recognize that limited partners, and not general partners, are exposed to a fund's market or credit risk; and
 - Requiring Superintendent approval for the acquisition of control of a factoring or financial leasing entity, subject to the materiality threshold. This potential change would make the federal framework more consistent, as these entities can pose credit risks similar to those posed by finance entities, where Superintendent approval is currently required.

Mutual Fund Distribution and Real Property Brokerage Entities

In general, the federal framework allows federally regulated financial institutions to invest in only unregulated entities that exclusively engage in authorized activities.

However, the framework allows “mutual fund distribution entities” and “real property brokerage entities” to engage in activities that are not authorized as long as their principal or primary activities (respectively) meet the statutory definition of “mutual fund distribution entities” and “real property brokerage entities.”

The Department is seeking views on the merits of removing the principal and primary tests, and requiring these entities to exclusively engage in authorized activities, consistent with the rules for other unregulated entities.

Reclassification of Investments

The federal framework permits a federally regulated financial institution to reclassify the category under which it holds an investment (e.g., specialized financing, temporary investment), subject to meeting the requirements of the new category.

A reclassification resets the period over which the investment can be held. For example, reclassification into the specialized financing category would allow the investment to be held for an additional 13 years. This allows federally regulated financial institutions to hold investments for longer than the framework intends.

The Department is seeking views on whether to clarify that when a financial institution reclassifies an investment, it would be deemed to be acquiring the investment at the time it originally made the acquisition.

Indeterminate Extensions

The federal statutes allow certain categories of investments (i.e., temporary investments, loan workouts, realization of a security interest) to be held for a

temporary period. The Minister or Superintendent, as the case may be, may authorize these investments to be held for an indeterminate period of time, on request.

In these situations, it would be more appropriate to reclassify the investment under the “permitted entity” category, which would make it subject to the normal statutory framework (e.g., approval or control requirements). As a result, the Department is seeking views on whether to eliminate indeterminate extensions for these investments.

Frequently Traded and Easily Valued Assets

A federally regulated financial institution must seek Superintendent approval when undertaking a large asset transaction (i.e., over 10 per cent of assets).

Certain types of large asset transactions, involving assets considered to be “frequently traded and easily valued” (i.e., government securities, money market instruments, and other widely distributed debt securities), are exempt from this approval.

The Department is seeking views on whether to narrow the scope of the exemptions to ensure that the Superintendent reviews transactions involving significant financial risks, which may not have been contemplated when the exemptions were drafted, such as collateralized debt obligations and credit default swaps.

Canada Deposit Insurance Corporation’s Claims in Liquidation

Under the *Winding-Up and Restructuring Act*, the liquidator of a failed financial institution has the right to apply set-off on claims. This allows the liquidator to reduce the amount of claims of a party by the amount of debt that party owes to the estate of the failed institution.

In a liquidation, the Canada Deposit Insurance Corporation (CDIC) would pay out on insured deposits to depositors and would then submit a claim to the liquidator for the amounts paid. Should the liquidator decide not to recognize CDIC’s full claim, because it applied set-off against a deposit, CDIC’s ability to recoup the full payment of insured deposits could be reduced.

The Department is seeking views on whether to change the *Canada Deposit Insurance Corporation Act* to clarify that the liquidator of a CDIC member institution has no right to apply set-off against a claim related to insured deposits. This potential change would protect CDIC’s ability to recoup the full payment of insured deposits made to depositors.