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Canada

Supporting a Strong and Growing Economy: Positioning Canada's Financial Sector for the Future

A Consultation Document for the Review of the Federal Financial Sector Framework

August 26, 2016

Canada

Invitation for Comments

Closing date: November 15, 2016.

Written comments should be sent to:

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Overview

Sunset provisions in the Bank Act, the Cooperative Credit Associations Act, the Insurance Companies Act and the Trust and Loan Companies Act provide the opportunity to conduct regular reviews of Canada's federal financial sector legislative and regulatory framework.

Reviews allow consideration of whether the framework continues to effectively support the economy and individual Canadians, and whether the framework remains technically sound. A well-functioning financial sector is critical to supporting a strong and growing economy.

Three core policy objectives guide financial sector policy and frame this review:

- **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
- **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 Government of Canada is seeking views to help achieve these policy objectives and position the financial sector framework for the future.

Process

In the Budget Implementation Act, 2016, No. 1, Parliament extended the statutory sunset date in the financial institutions statutes by two years until 2019 to facilitate the review process.

The review will follow a two-stage process. This paper launches the first stage by:

- setting out the current landscape
- identifying key trends that may influence future directions
- seeking input on these trends and related implications and areas for potential action

Responses to the paper are invited from all stakeholders. Submissions will inform the development of a policy paper for further consultation in 2017.

Introduction

The financial sector plays an important role in supporting economic growth. Financial institutions and capital markets allocate savings to investments, support financial needs of consumers and large and small businesses, and enable payments and transactions.

Canada's financial sector is entering this review from a position of strength, after weathering the 2008 financial crisis well relative to international peers. Looking back, the Canadian framework, including its approach to regulation and supervision of financial institutions, was credited globally for the sector's good performance under stress, a reputation that has benefited regulated institutions.

Looking forward, the financial sector will have to adapt to new trends, including emerging financial innovation and technologies that will challenge existing business models, evolving consumer preferences and customer relationships, changing demographics, and continuing globalization.

This review will assess whether the financial sector legislative and regulatory framework effectively supports growth and positions the sector to meet the federal government's policy objectives of stability, efficiency and utility.

Landscape

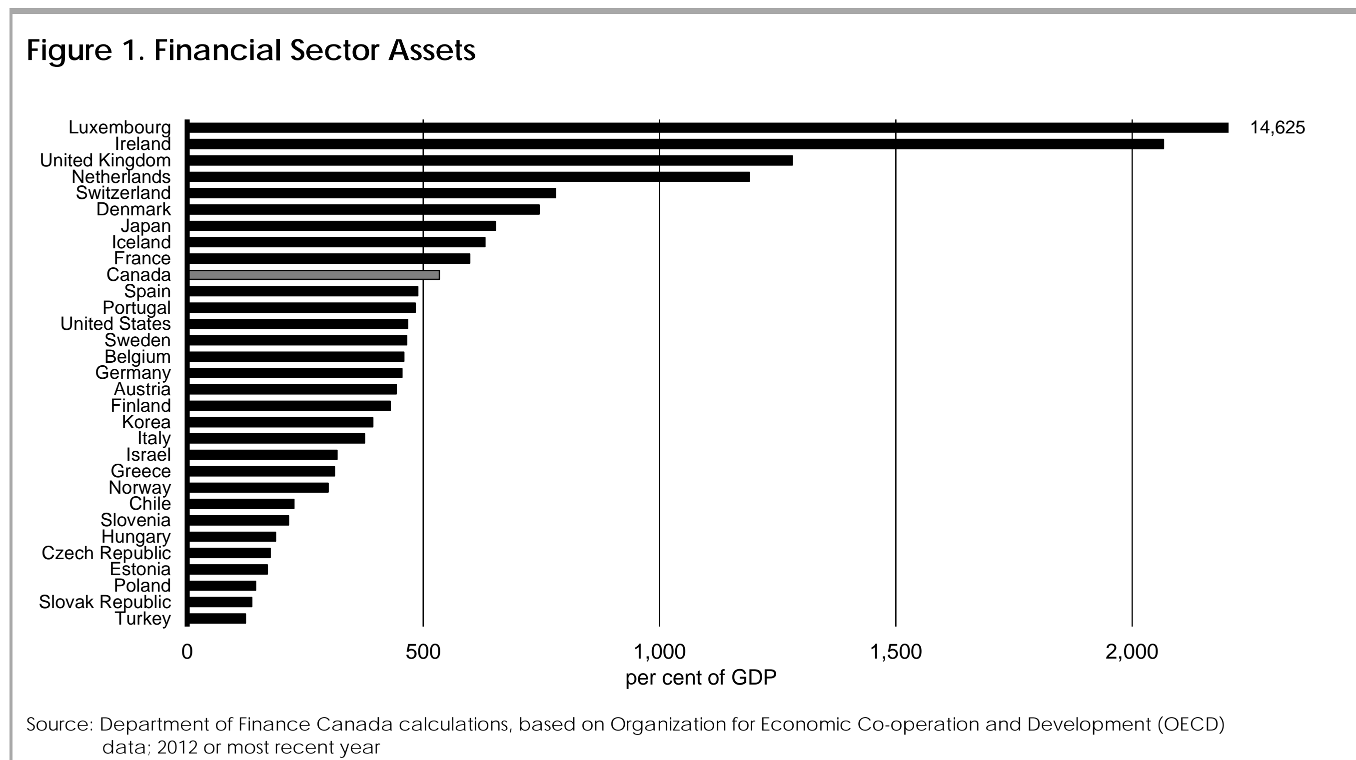
The financial sector comprises many sub-sectors. The federal financial institutions statutes set out rules for banks and for federally incorporated institutions in the trust and loan, life insurance, and property and casualty insurance sub-sectors. Credit unions, caisses populaires and securities dealers and exchanges are important financial services providers that are generally provincially regulated. Financial market infrastructures, including payment clearing and settlement systems, facilitate certain core activities of financial institutions, while payment card network operators facilitate retail payments.

The financial sector is overseen by a number of different regulators, depending on the sub-sector and the type of regulation.

The Size of the Financial Sector in the Canadian Economy

Canada's financial sector manages assets of about $10 trillion, more than five times Canada's gross domestic product (GDP) (see Figure 1).

Figure 1. Financial Sector Assets



Source: Department of Finance Canada calculations, based on Organization for Economic Co-operation and Development (OECD) data; 2012 or most recent year

The financial sector is an important segment of the economy in its own right, outside its enabling role for others. As of 2015, it accounted for 7.0 per cent of GDP, one of the highest proportions in the G7, and over 790,000 jobs, which represented 4.4 per cent of all jobs in Canada.

Several Canadian cities serve as domestic and global financial centres. Toronto is one of the largest financial centres in North America and ranks 10th on the Global Financial Centres Index, while Montréal and Vancouver rank in the top 25. Many other Canadian cities and regions play important roles. For example, Calgary is important for financing energy companies, key insurance companies are based in Winnipeg and Kitchener-Waterloo, and Halifax hosts a number of companies specializing in back office operations.

A key way in which the sector contributes to economic growth is by providing financing, credit and equity to businesses at various stages of development. These services help unlock the potential of growing businesses by providing long-term capital through debt or equity offerings to drive their future success. Growing businesses rely on funding from a number of sources, including financial institutions, other key players in Canada's private equity market (in particular, venture capital fund managers and angel investors), and public sector sources.[1]

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[1] For example, the Business Development Bank of Canada, which is a federal Crown corporation.

The overall composition of lending has shifted over time, as total lending to households has increased relative to total business lending. This may be driven by a number of factors, including weaker business investment and increasing leverage by Canadian households.

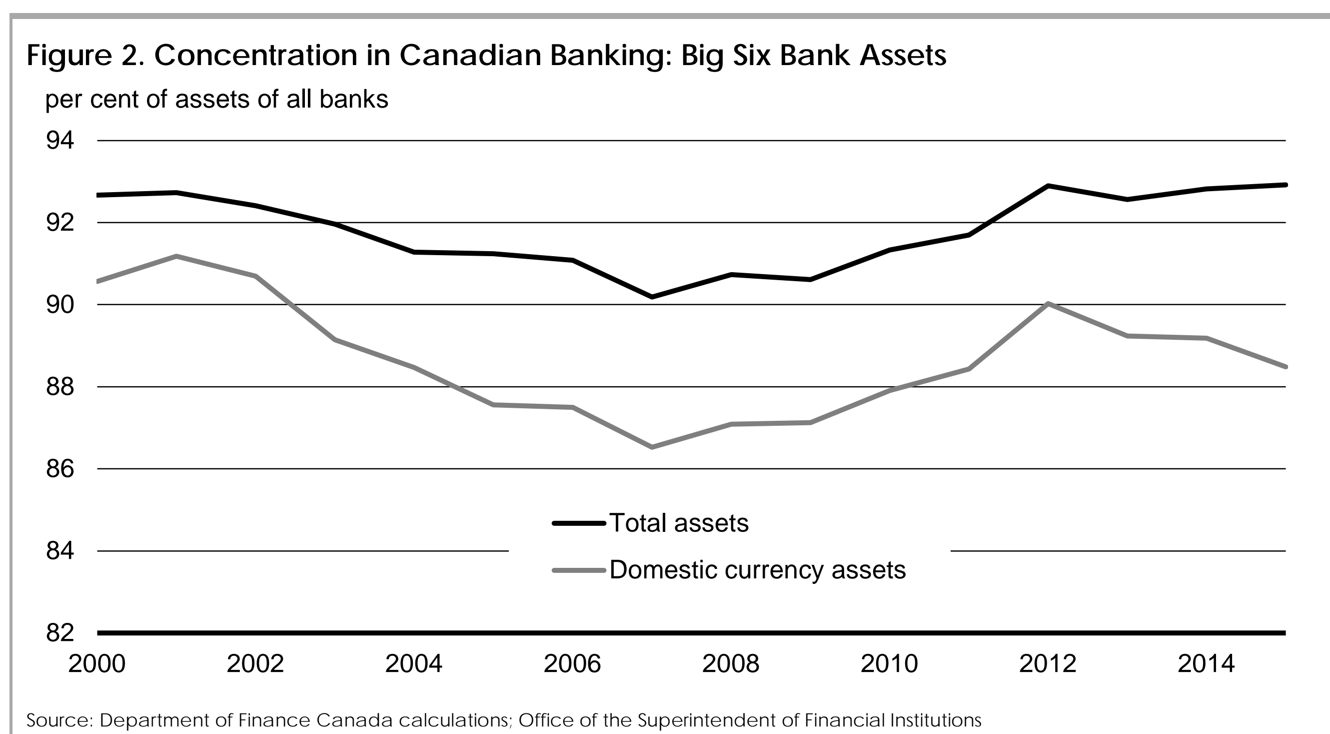
The Canadian financial sector is composed of a number of different types of entities, as outlined below.

Large Banks

Canada's large bank conglomerates provide the full spectrum of financial services, including retail and commercial banking, wealth management services, wholesale banking operations, and insurance services.

The six largest banks[2] continue to hold most of the market share in the banking sub-sector. Together, they hold $4.6 trillion in assets. The large banks' share of all assets in the banking sub-sector has increased since the financial crisis, and they now represent 93 per cent of all banking assets, compared with about 90 per cent in 2007 (see Figure 2). In 2013, Canada's six largest banks (the "big six") were designated as domestic systemically important banks by the Office of the Superintendent of Financial Institutions.

Figure 2. Concentration in Canadian Banking: Big Six Bank Assets



Source: Department of Finance Canada calculations; Office of the Superintendent of Financial Institutions

[2] Bank of Montreal, Bank of Nova Scotia, Canadian Imperial Bank of Commerce, National Bank of Canada, Royal Bank of Canada and Toronto-Dominion Bank.

The large banks have proven profitable through strong and weak economic periods. While there are several ways to measure this profitability, since the financial crisis, the large banks' return on equity exceeds their international peers, smaller Canadian banks and the corporate sector overall (see Figure 3).

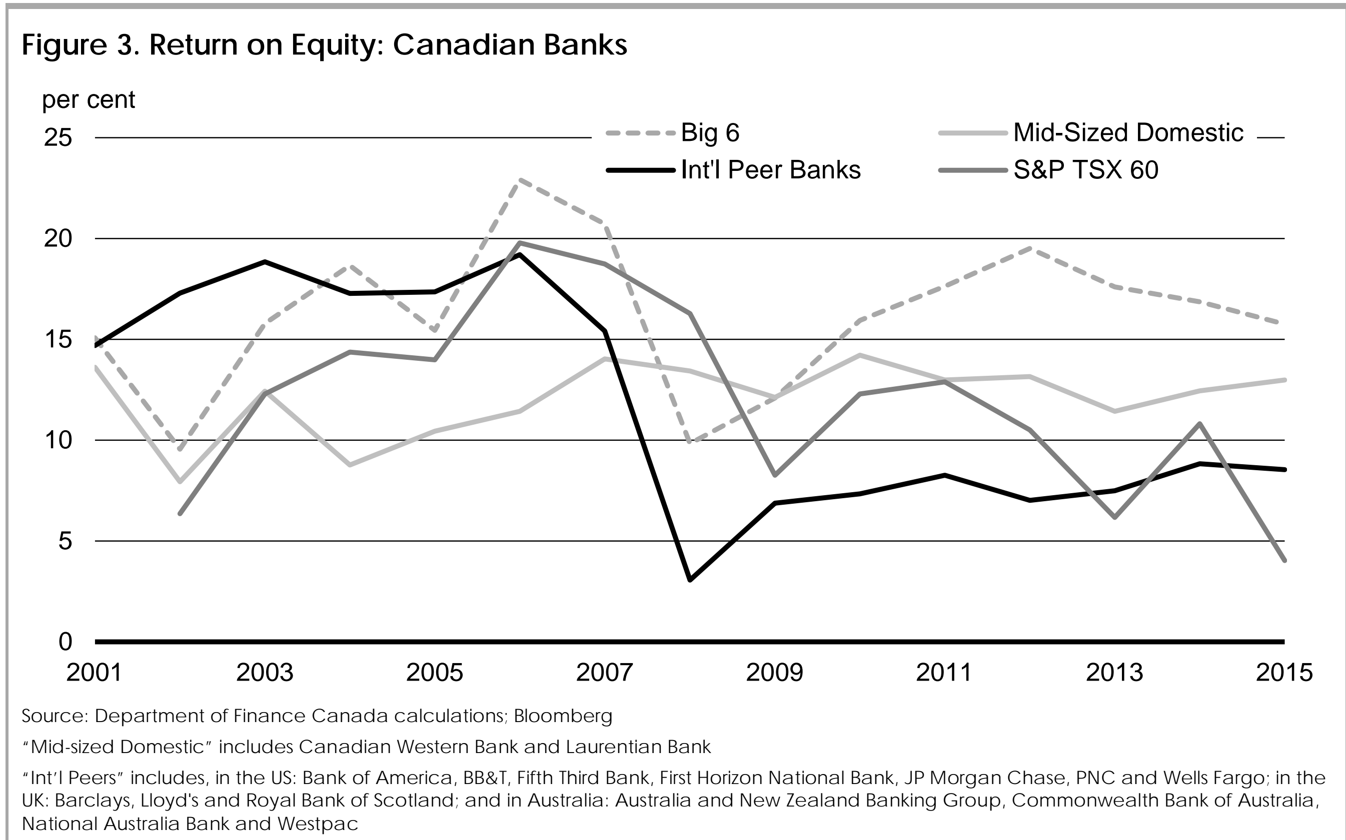


Figure 3. Return on Equity: Canadian Banks

Source: Department of Finance Canada calculations; Bloomberg

"Mid-sized Domestic" includes Canadian Western Bank and Laurentian Bank

"Int'l Peers" includes, in the US: Bank of America, BB&T, Fifth Third Bank, First Horizon National Bank, JP Morgan Chase, PNC and Wells Fargo; in the UK: Barclays, Lloyd's and Royal Bank of Scotland; and in Australia: Australia and New Zealand Banking Group, Commonwealth Bank of Australia, National Australia Bank and Westpac

Over the past few decades, the large banks have undergone significant business expansion in Canada, with new offerings and increased market share. This includes both organic growth and acquisitions across a range of product lines, such as deposits, mortgage lending, wealth management, securities dealing, and, since the financial crisis, auto loans.

Small and Medium-sized Banks

Small and medium-sized banks in Canada offer either full-service banking operations on a small scale or focus on niche business lines, such as credit cards, mortgage loans, prepaid cards, auto loans and reverse mortgages, in order to generate economies of scale necessary to be competitive against larger players in specific markets. Canada has 23 small and medium-sized domestically owned banks that collectively make up about 2 per cent of the assets of all banks in Canada. Together, these banks have assets totalling $119 billion. A significant proportion of funding for small deposit-taking institutions comes from brokered deposits, which are bank deposits collected by third-party brokers. The majority of brokered deposits are sourced by large investment dealers that, as discussed below, are now all owned by large banks.

Foreign banks provide banking services in Canada either by establishing a subsidiary or by operating in Canada as a foreign bank branch. There are 24 foreign bank subsidiaries, with total assets of $136 billion, and 32 foreign bank branches in Canada, with total assets of $99 billion.[3] In order to promote competition, Canada allows small and medium-sized banks to be owned or closely held by commercial entities and non-bank financial institutions. Some commercial companies that own banks, such as retailers, leverage their commercial distribution networks to sell banking products (e.g., credit cards). Other banks are independently owned.[4] Non-bank financial institutions, such as insurance companies and credit unions, can use their banks to diversify their product offerings or operate in other regions of the country. Some small banks provide for access to banking services in remote areas, including Canada's northern communities.

Trust and Loan Companies

Trust and loan companies have business powers that are broadly similar to those of banks. Trust companies also have fiduciary powers and therefore can, for example, act as an executor or a trustee for a trust. There are 63 federally regulated trust and loan companies operating in Canada, with total assets of roughly $335 billion. Of these, about 20 are trust companies that are subsidiaries of large Canadian banks, and most large deposit-taking trust and loan companies are owned by banks. The majority of other trust companies focus on pure fiduciary activities.

Trust and loan companies can be regulated federally or provincially, although certain provinces have ceased incorporating trust companies, encouraging companies that wish to provide fiduciary services nationally to establish a federal trust company.

[3] The largest foreign subsidiaries are HSBC Bank Canada and Citibank Canada, and the largest foreign bank branch is Bank of America, National Association.

[4] Independently owned small and medium-sized banks include Canadian Western Bank, Equitable Bank, First Nations Bank of Canada, General Bank of Canada, HomEquity Bank, Laurentian Bank of Canada, Versa Bank and Wealth One Bank of Canada.

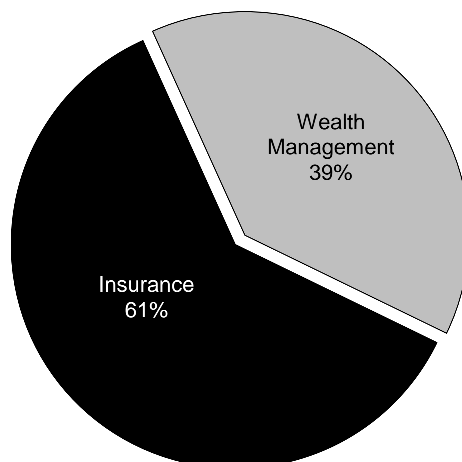
Life Insurers

Life and health insurance companies provide a wide range of products to help manage retirement and the risk of illness and premature death. There are 40 Canadian federally incorporated life insurance companies, some of which are subsidiaries of foreign institutions. Federally incorporated life insurance companies hold total assets of $1.3 trillion, approximately 90 per cent of which are held by the three largest life insurers (the "big three").[5] In addition, there are 31 foreign incorporated life insurance companies operating in Canada, with total assets of $26 billion.

There are also eight federally incorporated fraternal benefit societies in Canada, with total assets of $14 billion, and five foreign incorporated fraternal benefit societies operating in Canada, with total assets of $3.5 billion. Fraternal benefit societies provide similar services as life insurers.

Many life and health insurers have been expanding beyond traditional product lines to become more diversified financial services companies. In the past, they focused on products such as participating and term insurance and group health and life insurance, supplemented by term annuities, as the primary savings product. Today, Canadian insurance companies engage in a broader array of wealth management activities, including mutual funds, segregated funds and universal life insurance (see Figure 4).

Figure 4. Big Three Life Insurers: Composition of Earnings



Sources: Department of Finance Canada calculations; financial statements of the three large life insurers (Q1 2016)
Note: Net earnings attributable to "corporate" and "other" segments are excluded

The sub-sector has also seen increased emphasis on international growth, through insurance business or asset management. The three large life insurers in particular have developed significant international operations, and typically generate over 50 per cent of their net income from outside Canada.

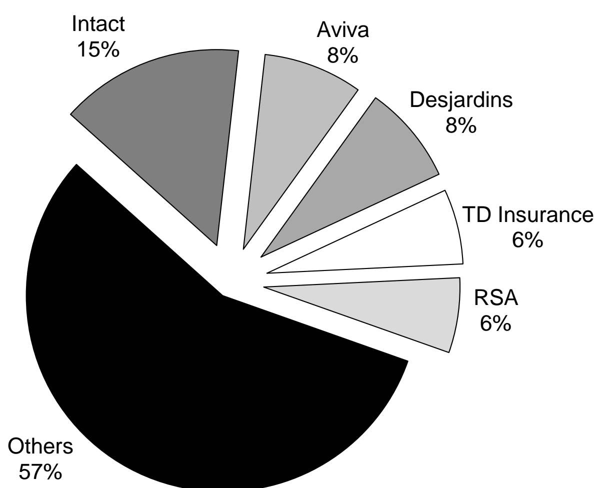
5 The Great-West Life Assurance Company, Manulife Financial Corporation and Sun Life Financial Inc.

Property and Casualty Insurance Companies

Canada's property and casualty (P&C) insurance companies help consumers manage risks related to property, including home and auto, and provide property and business disruption coverage to large and small businesses.

There are 87 federally incorporated P&C companies in Canada, with assets totalling $118 billion, some of which are subsidiaries of foreign firms. In addition, there are 74 foreign incorporated P&C insurance companies operating in Canada, with assets of $35 billion. The sub-sector has undergone consolidation in recent years as the market share of the three largest P&C insurers increased from 25 per cent in 2007 to 31 per cent in 2014. The market share of the largest P&C insurer is 15 per cent (see Figure 5).

Figure 5. Property and Casualty Insurance: Market Share



Sources: Insurance Bureau of Canada; 2014 direct premiums written, consolidated groups

P&C insurers are adapting to advances in financial technology and evolving customer preferences. For instance, the use of advanced analytics technology (the precise anticipation of risks) has become more widespread, and some companies have begun offering insurance products for participants in the growing "sharing economy."

P&C insurers have been impacted by the increasing severity and frequency of catastrophic events (insured losses of $25 million or more), both natural and man-made, over the past 20 years. The Insurance Bureau of Canada reports that the May 2016 northern Alberta wildfire is the costliest insured natural disaster in Canadian history.

Mortgage Lenders and Insurers

Housing finance in Canada is supported by a number of lenders and mortgage insurers. Lenders include banks and other financial institutions, such as mortgage lenders that are not prudentially regulated (i.e., regulated for safety and soundness). The market share of lenders that are not prudentially regulated has grown in recent years. In particular, the share of outstanding residential mortgage credit serviced by mortgage finance companies increased from 6.6 per cent in 2007 to 12.5 per cent in 2015.

Federally regulated lenders are required to obtain mortgage default insurance for homebuyers who make a down payment of less than 20 per cent of the property purchase price. Many other lenders also access mortgage insurance.

Mortgage insurance is currently provided by the Canada Mortgage and Housing Corporation (CMHC), a federal Crown corporation, and two federally regulated private mortgage insurers. In the event that a mortgage insurer is unable to make insurance payouts to lenders, the federal government backs 100 per cent of the mortgage insurance obligations of CMHC, and, subject to a deductible, the obligations of the private mortgage insurers. The proportion of insured mortgage lending has decreased in recent years relative to uninsured lending.

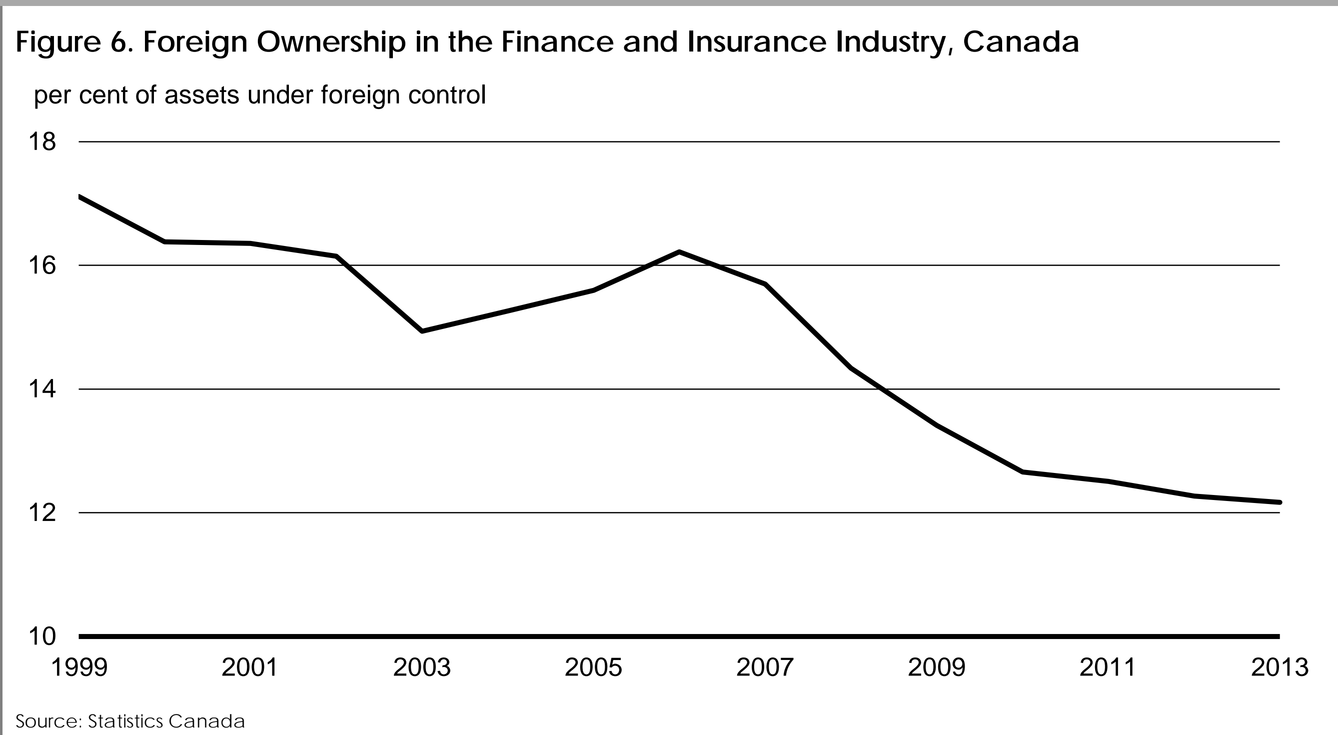
OSFI monitors the mortgage insurers for compliance with the guarantee framework and reports its findings to the Minister of Finance.

Foreign Financial Institutions

Foreign financial institutions have long been an important niche presence, often focusing on serving foreign businesses with operations in Canada. They usually operate as smaller competitors in Canada but frequently have large foreign parents. Foreign insurers also play a significant role in providing reinsurance to the Canadian marketplace.

In recent years, some foreign players have exited the Canadian marketplace, either through withdrawing their presence or limiting cross-border activity. This has reduced the overall market share of foreign players in Canada and is consistent with an overall global trend since the financial crisis, which has seen financial institutions retrenching and refocusing on core markets. Between 2000 and 2006, between 15 and 17 per cent of Canada's financial industry assets were under foreign control. Since then, the proportion of foreign-controlled assets in the financial industry has fallen to about 12 per cent (see Figure 6).

Figure 6. Foreign Ownership in the Finance and Insurance Industry, Canada



Source: Statistics Canada

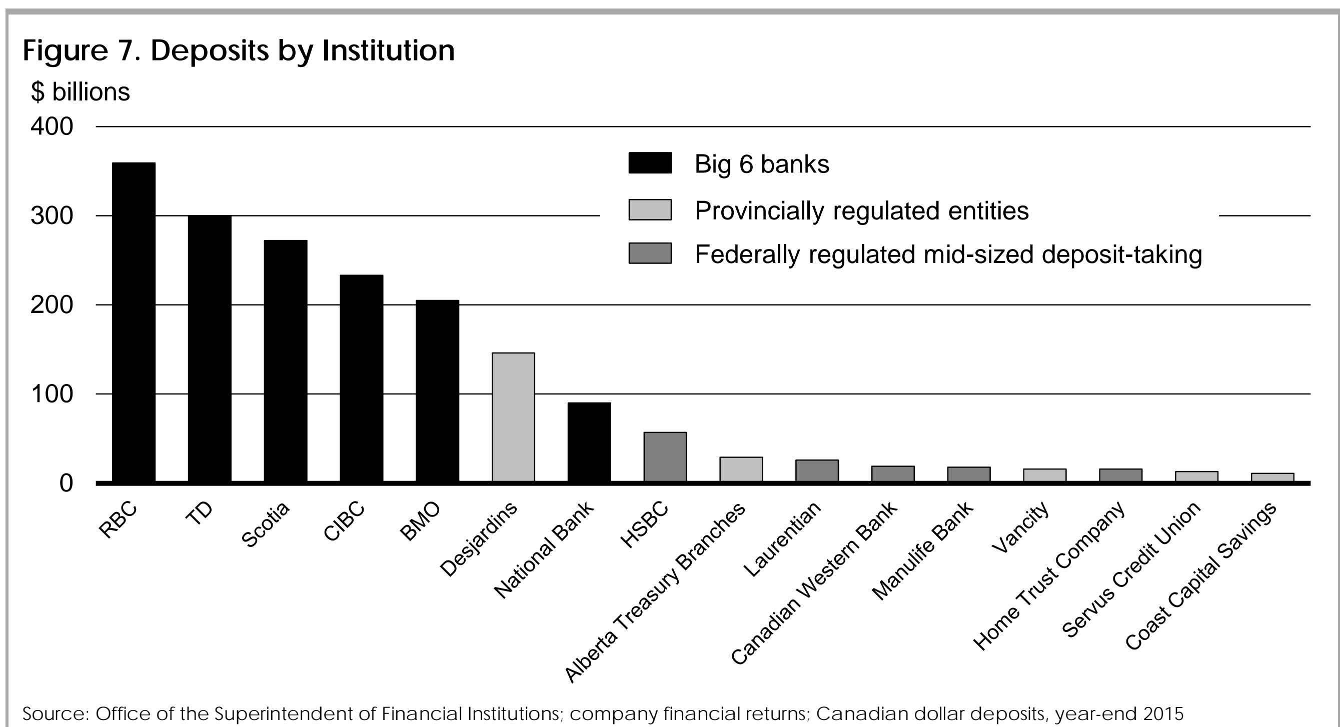
Credit Unions and Caisses Populaires

Financial cooperatives, which are generally regulated at the provincial level, are member-based deposit-taking institutions and important community-focused competitors in Canada. Since 2012, provincial cooperatives have had access to a federal credit union framework, allowing them to become federally regulated and to expand and compete beyond a provincial footprint. On July 1, 2016, Caisse populaire acadienne ltée of New Brunswick became the first federal credit union.

Financial cooperatives provide primary financial services to their members, such as consumer and small business lending and deposit-taking, under cooperative principles and are largely regulated by the province in which they operate. Provincial credit union centrals[6] provide liquidity, payment and trade services to their members (predominantly individual credit unions and caisses populaires).[7] Cooperative retail associations can be organized federally to carry on business according to cooperative principles but are permitted to offer financial services to non-members and operate nationally.

Today, there are over 600 credit unions and caisses populaires in Canada, with almost 3,000 branches in both rural and urban centres. They hold combined assets of $350 billion and serve over 10 million members. Their market share is high in certain product lines and in certain regions, particularly in Quebec, British Columbia and Saskatchewan. These entities vary in size, as illustrated in Figure 7.

Figure 7. Deposits by Institution



Source: Office of the Superintendent of Financial Institutions; company financial returns; Canadian dollar deposits, year-end 2015

The Desjardins Group is the largest cooperative financial institution in Canada, representing about half of the system and operating over 300 individual caisses in Quebec and Ontario.

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6 Atlantic Central, Central 1 Credit Union, Credit Union Central of Alberta Limited, Credit Union Central of Manitoba Limited, and Credit Union Central of Saskatchewan.

7 A separate system for cooperatives operates in Quebec, primarily through the Desjardins Group.

Canadian credit unions and caisses populaires have also been steadily consolidating in order to grow and adapt to shifting local and rural economic situations. This has allowed them to reap efficiencies of scale and form partnerships while maintaining their local and community-focused business models. The number of separate institutions has declined from a peak of 3,200 in the 1960s. As they grow larger, these entities have begun to engage in more complex activities, such as lease financing and securitization of mortgages.

Securities Dealers and Exchanges

Securities dealers and exchanges are important intermediaries in raising funds on capital markets. Capital markets allow the Canadian public and private sectors to raise funding in Canada and abroad through either equity or debt instruments.

Securities dealers' primary roles are to help arrange financing and provide advisory services; exchanges primarily help execute transactions. The Investment Industry Regulatory Organization of Canada regulates 177 investment dealers and several exchanges.[8]

The six largest securities dealers are owned by the large Canadian banks. In 2015, these bank-owned dealers led 61 per cent of all deals underwritten, accounting for 64 per cent of the value of securities issued. Their share of the value of corporate equities issued was higher, at 71 per cent, although they accounted for slightly less than one half the value of all corporate debt issued.

The largest exchanges (the Toronto Stock Exchange, the Montréal Exchange and the Canadian Securities Exchange) are owned by different groups of financial institutions, including banks, insurers and pension funds. Canada's equity market capitalization ranks ninth globally, with USD $1.9 trillion of the USD $66.6 trillion global total. Canada's debt market amounts to USD $2.2 trillion, out of a total global bond market, worth USD $77.4 trillion.

Recognizing that sound capital markets in Canada are essential to creating conditions for economic growth, the federal government has released proposed legislation for consultation that would provide new tools to manage systemic risk so that well-functioning capital markets can continue to achieve these goals.

Financial Market Infrastructures

Financial market infrastructures play a critical role in the financial system and the broader economy. These infrastructures facilitate the clearing, settlement and recording of monetary and other financial transactions, such as payments, securities and derivatives contracts (including derivatives contracts for commodities). There are currently three financial market infrastructures headquartered in Canada that are designated as systemically important.[9]

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8 Examples include the Toronto Stock Exchange (TSX), the TSX Venture Exchange, the Montréal Exchange, the Canadian Securities Exchange, the Aequitas NEO Exchange, the Natural Gas Exchange, ICE Futures Canada and 12 alternative trading systems.

9 The Large Value Transfer System, which clears and settles large-value Canadian dollar payments; CDSX, which clears and settles securities transactions; and the Canadian Derivatives Clearing Service, which centrally clears fixed-income and derivatives contracts.

Payment Card Network Operators

Payment card network operators play an important role in enabling credit, debit and prepaid card payments throughout Canada by facilitating electronic transfers of information among their network participants.

The use of credit and debit card payments has risen in recent years. Visa, Interac, MasterCard and American Express, the four major payment card network operators in Canada, had a combined purchase volume of $665 billion in 2015, a growth of 5.5 per cent over the previous year.

Other Financial Sector Entities

The Canadian financial sector also consists of a number of other entities that perform important functions and foster competition and are not prudentially regulated. These entities include companies that focus on single product lines or services, such as leasing companies, payday loan providers and money services businesses. In addition, newer financial technology companies offer innovative financial services products, either independently or through partnerships with incumbent financial institutions (discussed in further detail below). Market-based financing entities, including investment management firms, financing companies and broker dealers, provide a wide range of financing and investment options.

Other entities provide regulated financial sector firms with essential services, such as technology, back office services and accounting. Pension funds and asset managers play an important role as sources of long-term capital.

Financial Sector Regulators

The regulated entities in the financial sector are overseen by a number of authorities, depending on the institution and the type of regulation.

Banks are regulated at the federal level, and securities dealers and exchanges are regulated at the provincial-territorial level. Entities in other sub-sectors, such as insurance, trust and loan, and credit unions, can be established and regulated at either level.

Federally, the Minister of Finance has overarching authority over federal financial sector legislation, supported by the Department of Finance Canada. This includes the governing legislation setting out clear independent mandates for each of the four federal financial sector oversight bodies:

- The Bank of Canada provides liquidity to the financial system; oversees payment, clearing and settlement systems; and assesses risks to financial system stability.
- The Canada Deposit Insurance Corporation is the federal deposit insurer and resolution authority for federally regulated deposit-taking institutions.

- The Financial Consumer Agency of Canada supervises federal financial entities to ensure they comply with their consumer-related obligations, and works toward strengthening the financial literacy of Canadians.
- The Office of the Superintendent of Financial Institutions undertakes prudential regulation and supervision of federally regulated financial institutions.

Federal agencies have well-established mechanisms to ensure collaboration, information sharing and cooperation.

Each province and territory also has its own regulatory architecture governing, for example, securities firms, insurers, payday lenders and credit unions. Mechanisms exist for collaboration among federal and provincial-territorial regulatory agencies and ministries responsible for financial sector policy. The federal government has also clarified regulatory accountability and responsibility between the federal and provincial governments to clearly delineate that federal and provincial authorities are responsible for the prudential oversight and management of stability risks arising in institutions under their own jurisdictions.

Policy Context

Canada's financial sector performed well during the 2008 financial crisis compared with its peers, and the sector has adapted well to the post-crisis environment. The sector's strength has been recognized by the international community, including the International Monetary Fund. The World Economic Forum has ranked Canada's banks as the soundest in the world for eight consecutive years.

Following the financial crisis, measures were implemented to further strengthen the framework in response to changing economic and competitive conditions and, in collaboration with other jurisdictions, to bolster the strength and stability of the financial sector globally. The federal government has continued to proactively respond to emerging issues, risks and developments, and has a number of targeted initiatives now underway. A brief summary of post-crisis measures and targeted initiatives underway follows.

Stability-Focused Reforms

The main focus of the post-crisis reform agenda has been financial stability, including implementing reforms that emerged out of the G20, the Financial Stability Board and international standard-setting bodies.

Canada participated actively in developing these standards, and has led in implementing certain key stability-focused reforms, such as Basel III capital and liquidity standards for banks. Adjustments to Basel III to promote a level playing field are still in progress. Canada has also pursued a number of other supervisory reforms in line with international standards and best practices, including with respect to stress testing, financial disclosures and corporate governance. Other examples include the development of recovery plans setting out how domestic systemically important banks would recover from severe stress, and resolution plans setting out how they could be resolved in the unlikely event that recovery actions fail.

Most recently, the Budget Implementation Act, 2016, No. 1 introduced a legislative framework for a bail-in regime for Canada's domestic systemically important banks. This regime will protect Canadian taxpayers in the unlikely event of a large bank failure by reinforcing that bank shareholders and creditors are responsible for the bank's risks.[10] Regulations and guidelines setting out further features of the bail-in regime are being developed for consultation.

Other Policy Reforms

The Government of Canada has also advanced other policy reforms since the financial crisis (see Appendix for more detail). These include measures to:

- establish a federal credit union framework and improve the ability of new entrants and smaller banks to compete with larger players
- strengthen Canada's anti-money-laundering and anti-terrorist financing regime
- maintain a healthy, competitive and stable housing market
- improve financial literacy and consumer protection
- support international financial services trade and investment
- ensure that national payment systems are safe, efficient and responsive to users' needs

Work and consultations on a number of other ongoing policy initiatives will continue on separate tracks from this consultation on the financial sector review, for example:

- a review of Canada's deposit insurance framework to ensure that it provides adequate savings protection for Canadians
- an assessment of options to amend the housing finance framework to reduce taxpayer exposure and enhance efficiency, while continuing to support long-term stability of the financial system
- measures aimed at balancing oversight and innovation in national retail payments systems so that end users are at the same time protected and have access to innovative products and services
- development of a resolution regime for financial market infrastructures in line with international standards, to mitigate the impact of the disorderly failure of systemically important financial market infrastructures on core financial markets

[10] Deposits will not be subject to the bail-in regime.

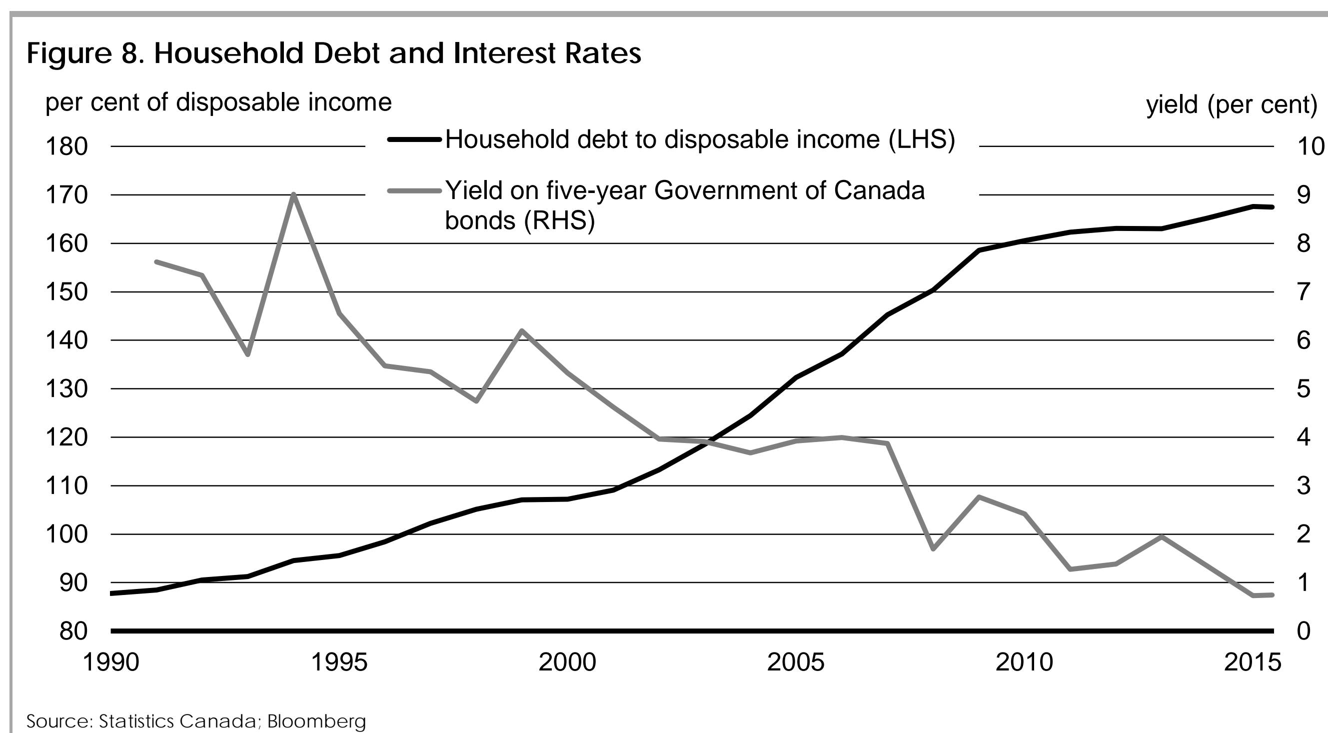
Trends and Environment

As outlined in the overview of this paper, the core policy objectives guiding this review are stability, efficiency and utility. This section sets out key trends that are influencing, and are expected to continue to influence, the financial sector. These trends inform the consultation questions in this paper, which seek views on how these and other trends in the financial sector should prompt policy responses to achieve the appropriate balance between policy objectives.

Macroeconomic Backdrop

The macroeconomic environment affects all players in the economy, including the financial sector. Important macroeconomic trends such as Canada's aging population, weak productivity growth, lower oil and commodity prices, low interest rates and increasing household indebtedness (see Figure 8) can influence how financial institutions conduct their business and provide services to their customers.

Figure 8. Household Debt and Interest Rates



Source: Statistics Canada; Bloomberg

Low interest rates in particular have had notable impacts on the financial sector. For deposit-taking institutions, low rates can compress net interest margins, i.e., the difference between the cost of borrowing and lending, thereby reducing profitability of core lending activities. Banks have reported continued compression of interest margins for over a decade. As income from borrowing and lending comes under pressure, banks may look to maintain profitability through increased back office efficiencies or greater reliance on fee-based income.

For life insurers, low interest rates can impact business and investment strategies, as the amount that they earn on their assets falls relative to the promised rates of return provided in long-term insurance contracts.

Pension plans are similarly affected by the protracted low interest rate environment, which, in combination with volatile market returns and increasing life expectancy, has put pressure on funding costs for some pension plans.

Canadian life insurers and pension plans have adopted a number of strategies to reduce their vulnerability to falling rates, including better matching their assets with their long-term liabilities, investing in non-traditional assets, and diversifying internationally.

Finally, the same trend of low interest rates affects consumers and investors. Low rates incent greater borrowing, leading to greater household indebtedness and encouraging investors to search for yield by selecting riskier assets.

Increased Concentration and the Changing Competitive Landscape

In recent years, the Canadian financial sector has become more concentrated. This has been driven by a number of factors, including mergers and acquisitions, large domestic conglomerates expanding their offerings, and foreign financial institutions exiting or reducing their presence in the Canadian market. Structural factors such as economies of scale have also encouraged concentration.

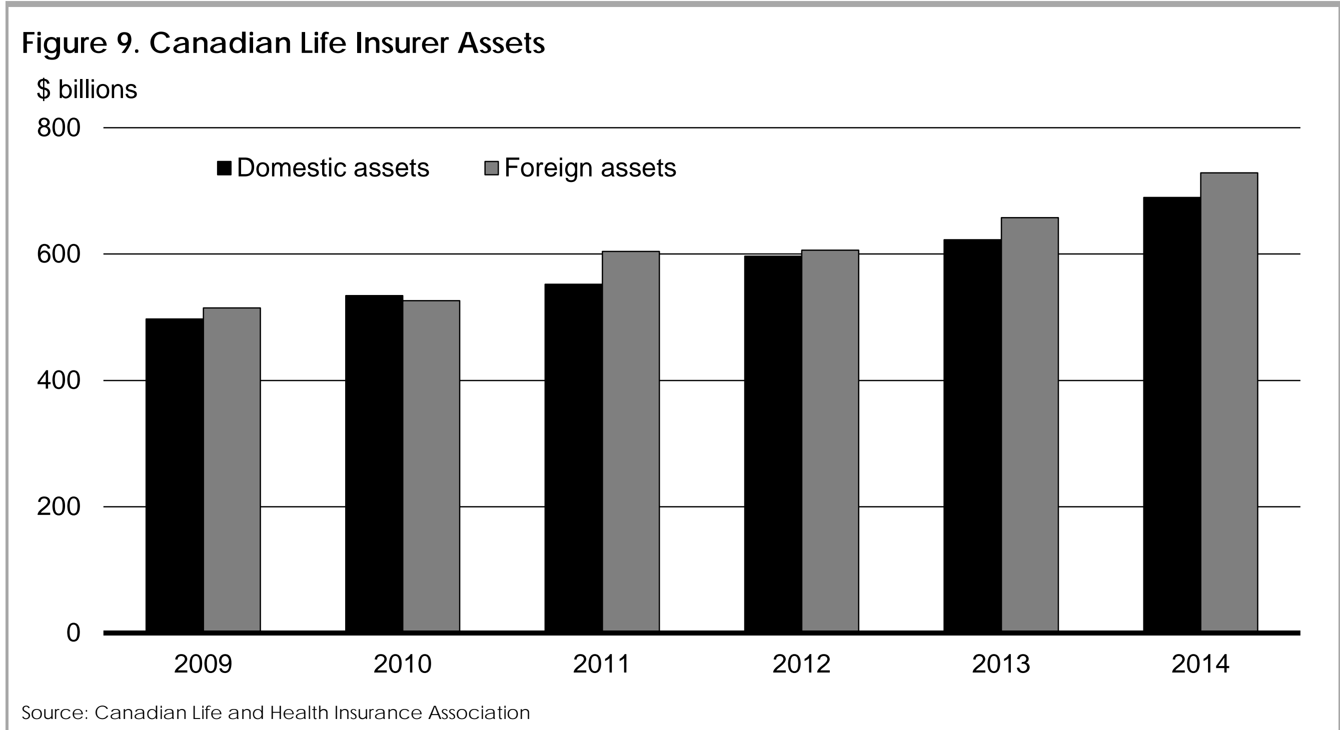
In the banking sub-sector, the six large banks have grown larger, with each bank pursuing independent business strategies, leading to greater size and geographic differentiation. As noted earlier, the six largest banks now have 93 per cent of assets in the banking sub-sector. In particular, the assets of the three largest banks as a percentage of total bank assets increased from 54 per cent in 2002 to 65 per cent in 2015. Consolidation has also occurred in other regulated sub-sectors such as credit unions, life insurance and P&C insurance.

Consolidation among regulated financial institutions impacts the competitive landscape. Exiting competitors may not be quickly replaced by new entrants. Small and medium-sized financial institutions have argued that they face challenges in establishing new businesses in Canada, and in competing and growing due to proportionately higher regulatory burden and tighter prudential requirements relative to large banks. Initiatives have been undertaken aimed at managing compliance burden, including measures to better ensure that the views of small and medium-sized banks are considered in the development of regulatory guidelines.

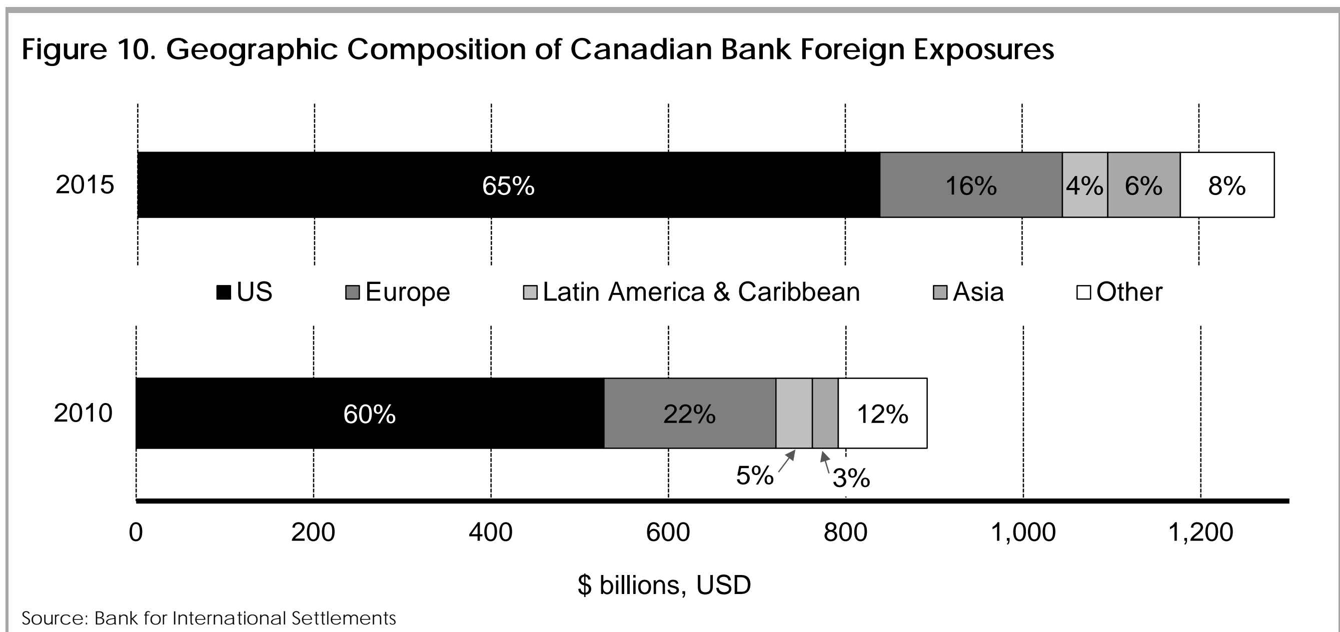
Internationalization of Canadian Financial Institutions

In addition to growing in Canada, Canadian financial institutions maintain a significant and increasing presence outside Canada's borders. Their operations, which include direct investments in foreign affiliates and cross-border activities, span key economies across the Americas, Europe and the Asia-Pacific. Between 2009 and 2014, the international assets of Canada's three large life insurers grew by 42 per cent, faster than their Canadian assets.

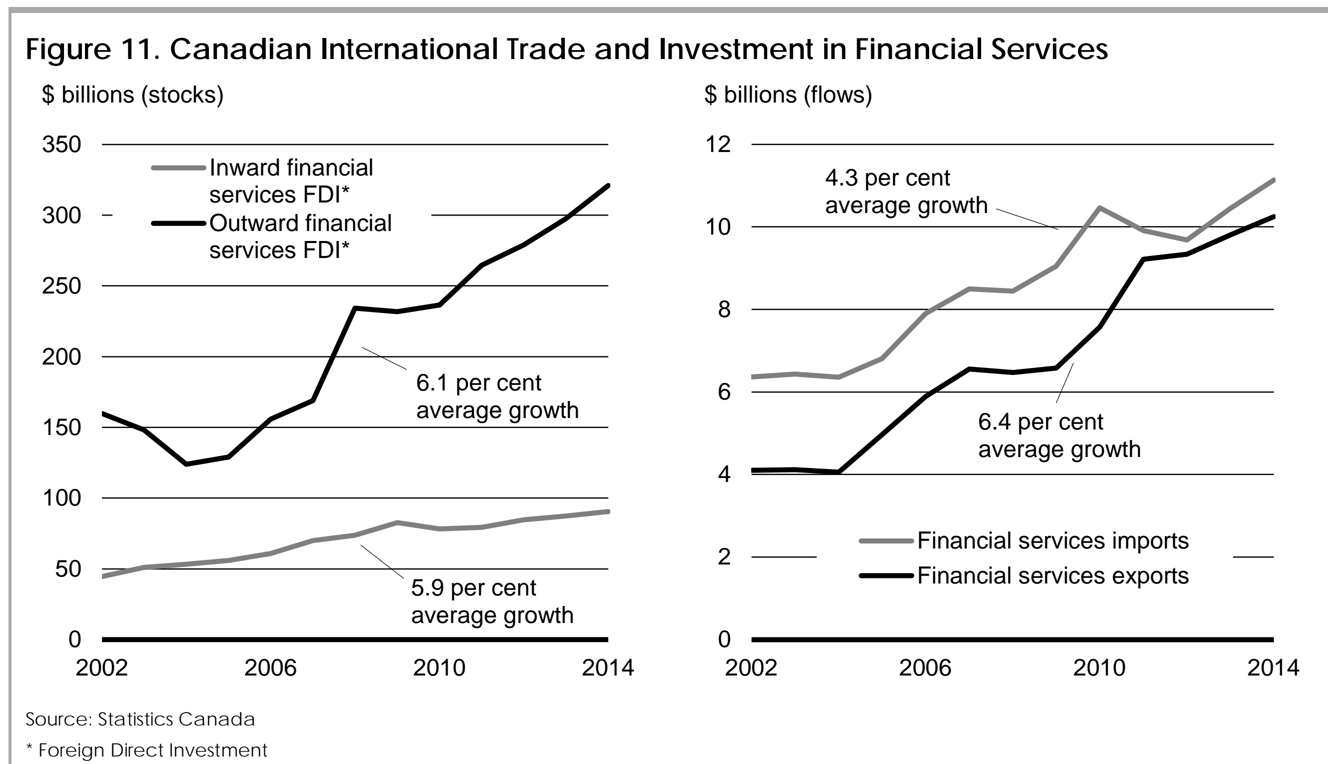
At present, life insurers generate over 40 per cent of their total premiums from abroad and hold over 50 per cent of their total assets outside Canada (see Figure 9).



Canadian banks have also expanded significantly abroad, with international assets growing by 43 per cent between 2010 and 2015. Proportionately, US and Asian assets increased, while European holdings declined (see Figure 10).



Driven primarily by the international operations of these large financial institutions, the stock of direct investment by Canadian financial institutions in foreign jurisdictions stood at $321 billion in 2014, more than double levels in 2004. During the same period, Canadian financial services exports nearly tripled, rising from $4 billion to over $10 billion (see Figure 11).



Since the financial crisis, financial institutions around the globe have taken a more strategic and targeted approach to operating internationally. Canadian financial institutions too have refocused and restructured certain operations abroad to cut costs, manage risk and bolster longer-term growth. They have also been selective in making foreign investment decisions around business lines and targeted markets.

While internationalization offers tangible economic benefits, the financial crisis highlighted the complexity of cross-jurisdictional stability risks. The process of internationalization is also characterized by financial institutions deploying “excess” capital abroad, tapping foreign debt and equity capital markets, and complying with the expectations of foreign regulators.

Evolving Financial Marketplace for Consumers

The environment in which Canadians interact with financial institutions is rapidly evolving. Most routine transactions are now conducted electronically, and branches are increasingly used to provide advice and value-added services. Some consumers value convenience and embrace new technologies such as online and mobile banking, while others continue to rely more on personal interaction through branches. In all cases, consumers are looking to be treated fairly.

Banks have adjusted their business models to respond to market conditions and technological advances. Banks are cutting costs and seeking efficiencies, including by adjusting their branch networks. These changes may have implications for consumers as well as for profitability. Concerns have been raised about the relative cost of services, including fees, and whether efficiency savings are being passed on to consumers.

Canada continues to score highly on measures of financial inclusiveness. Roughly 99 per cent of Canadians above the age of 15 have an account at a financial institution. Consumers can choose from a variety of ways to interact with their financial institutions, and can choose from hundreds of different chequing and savings accounts and credit cards, with a mix of fees and features to meet their needs.

Certain products are becoming increasingly complex as options for mortgages, credit and transaction products expand. Consumers often have limited experience in making key decisions that can have a large financial impact, such as taking a mortgage or managing their savings for retirement. Wider choice benefits consumers but can also demand greater time, effort and knowledge to understand, compare and select the most appropriate product to meet their needs. Consumers may not have easy access to traditional small short-term fixed loans and instead draw on revolving credit, which requires more discipline to avoid taking on too much debt or staying in debt longer.

Certain Canadians, including seniors, new Canadians and those in remote communities, may be faced with particular challenges. Older Canadians may be vulnerable to fraud and financial abuse. Education and financial literacy efforts can target some of these issues, and technological advancements provide opportunities for more inclusive financial services.

Financial Innovation and Emergence of Financial Technologies (Fintech)

The rapid pace of technological change in recent years has paved the way for the financial sector to leverage new technologies to deliver services to Canadians.

Canadians have long welcomed financial services innovations and have been early adopters of innovative technologies such as automated teller machines (ATMs), chip and PIN, and more recently, tap and pay technology. Rapid technological changes, such as the rise of mobile Internet, are once again changing how financial services providers transact with their customers. Canadians increasingly use online and mobile technologies, driven by convenience and speed.

Much of the recent innovation in the financial services space is the product of emerging fintech start-up companies. These companies operate in a range of business lines, including payments, lending and investment management. Other fintech companies provide services in data analytics, funds transfers, smart contracts, cybersecurity and currency exchanges. Some fintech companies use distributed ledger technology (blockchain) to record and validate transactions; this is a technology with the potential to be used in clearing and settlement activities. In addition, some information technology companies have evolved to offer fintech services.

Canada's fintech sub-sector is relatively new and small, but it is growing rapidly. There are several hundred fintech companies currently active in Canada that have attracted over $1 billion in capital since 2010. The majority of these companies are clustered in the Toronto-Waterloo corridor, although there is also a growing presence in Vancouver and Montréal.

The emergence of fintech companies, the corresponding shift in consumer demand, and the possibility of significant cost savings is changing how incumbent financial institutions operate. Financial institutions are responding to these trends with significant investments in technology and partnerships with fintech companies, and all of Canada's large banks have entered into at least one partnership with a fintech company. Technology is also driving banks to change the way they manage their back office operations, including clearing and settlement.

While fintech companies are creating the potential for more innovation and competition in the financial services sector, concerns have been raised regarding appropriate regulation of fintech companies, consumer protection, and how best to support a level playing field with regulated financial institutions.

Canada is in a position to take advantage of its many strengths to be a leader in financial innovation, whether through independent fintech companies or those partnering with incumbents. These strengths include the scale and sophistication of its established financial sector, abundant human capital, access to long-term investment, and innovation hubs clustered in several cities.

Demographic Changes

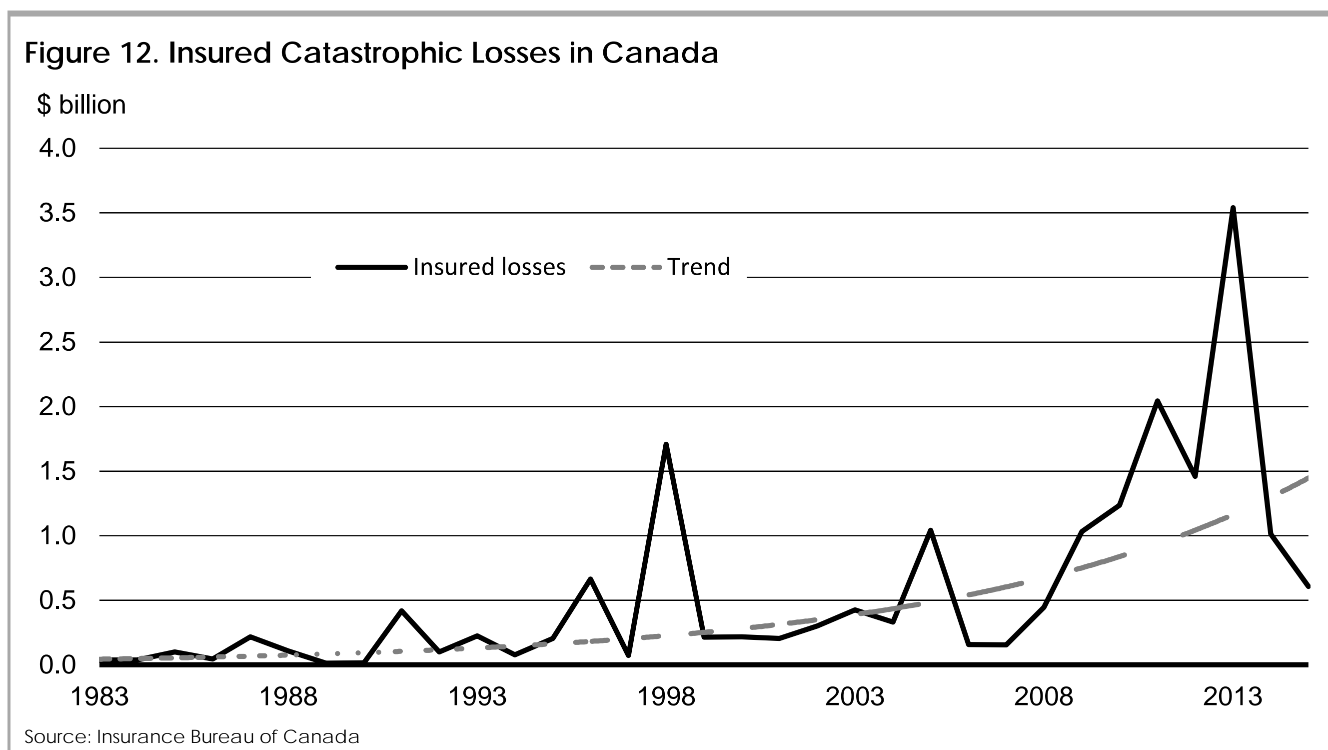
The financial sector has been adapting to the changing demographic environment, and in particular to Canada's aging population and the millennial generation. While much focus is on millennials, in 2015, the number of Canadians over age 65 exceeded the number under age 15 for the first time, and this older cohort is expected to make up about 20 per cent of Canadians by 2023.

As Canadians age, not only will their financial services needs change, but their preferences for service delivery methods may also shift. Some of the financial sector implications of an aging population have been anticipated by the sector, such as a greater draw-down of retirement savings, while others may be less predictable. Financial institutions remain focused on meeting Canadians' savings and retirement income needs, developing options to help them draw on savings and manage the risk of outliving their savings, such as reverse mortgages or more flexible annuity products. As baby boomers retire, the nature of their demand for wealth management services may change. The increasing complexity of financial products and services may be a challenge for many parts of the Canadian population.

Emerging Risks

Financial institutions are facing an array of new and emerging risks, including catastrophic risks, that have a low probability of occurring and yet could result in high potential losses (see Figure 12). Factors such as increased urbanization, terrorism, and climate and environmental change have increased the potential for losses from catastrophic events.

Figure 12. Insured Catastrophic Losses in Canada



Source: Insurance Bureau of Canada

Cyber threats are also a growing concern for government and industry due to their potential to disturb or disrupt financial services. Fears over the theft of personal information, financial loss and compromised individual privacy can erode consumer trust and confidence in the marketplace.

Policy Objectives

The sector is evolving in response to the trends identified above. The financial sector framework must keep pace with this evolution, preserving its current strengths while positioning it for the future. In considering where policy action is warranted, the federal government balances three core objectives:

- **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
- **utility:** the sector meets the financial needs of an array of consumers, including businesses, individuals and families, and the interests of consumers are protected

Taken together, these three core objectives provide context to help assess whether Canada's financial sector is functioning effectively going forward.

To this end, this paper has highlighted current trends and provided background on Canada's financial sector to inform public comments. The intention is to receive stakeholder views on the priorities for reviewing the financial sector framework. Following this consultation, specific proposals will be developed for public comment. While the questions that follow build on the trends and themes highlighted in this paper, all comments are welcome.

Questions for Consultation

1. What are your views on the trends and challenges identified in this paper? Are there other trends or challenges that you expect to significantly influence the financial sector going forward?

2. How well does the financial sector framework currently balance trade-offs between the three core policy objectives of stability, efficiency and utility?

3. Are there lessons that could be learned from other jurisdictions to inform how to address emerging trends and challenges?

4. What actions could be taken to strengthen the financial sector framework and promote economic growth, including with respect to the identified themes? How should those actions be prioritized?

   For example:

   - How should the financial sector framework support innovation and competition while maintaining stability of the system?
   - How can the financial sector framework best promote competition, including by encouraging new entrants and fostering the growth of small entities and other players?
   - How can the benefits of an internationalizing financial sector best be obtained while ensuring the safety and soundness of the sector?
   - How can the financial sector framework support financial firms to best serve the evolving needs and interests of consumers?
   - Are Canada's federal financial sector oversight bodies well-positioned to support the sector in the future?

5. What other actions should be taken to ensure the financial sector framework remains modern and technically sound?

Appendix: Other Financial Sector Reforms

In addition to the post-crisis and stability-focused measures undertaken in the context of the G20 and Financial Stability Board financial sector reform agenda,[11] the Government of Canada has advanced a number of other policy reforms since the financial crisis. Following is a list of some key reforms.

Anti-Money-Laundering and Anti-Terrorist Financing
The federal government introduced legislative amendments to strengthen Canada's anti-money-laundering and anti-terrorist financing regime, and to improve Canada's compliance with international standards. The government is also in the process of developing supporting regulatory amendments.

Code of Conduct for the Credit and Debit Card Industry in Canada
The Code of Conduct for the Credit and Debit Card Industry in Canada (2010) promotes merchant choice, transparency and disclosure, and fairness in the credit and debit card market. The Code was amended in April 2015 to reflect the evolving nature of the payments landscape and to address specific issues associated with the emergence of mobile payments.

Voluntary Commitments on Interchange Fees
The federal government accepted separate and voluntary commitments from Visa and MasterCard to reduce their interchange fees. The government is monitoring the voluntary commitments, and Visa and MasterCard have each committed to provide annual verifications by independent third parties to ensure compliance.

Payments Canada Governance
Amendments were made in 2014 to establish a new governance framework for Payments Canada that have supported the modernization of its payment infrastructure. These changes have increased transparency through new corporate reporting requirements and required that a majority of directors be independent.

Consumer Protection Framework
Targeted steps have been taken to strengthen financial consumer protection, including by guaranteeing access to basic bank accounts and low-cost accounts, limiting cheque-hold periods, and imposing certain limits on business practices for credit products. Comprehensive reforms were proposed in Budget 2016 to modernize the financial consumer protection framework by clarifying and enhancing consumer protection in the Bank Act, and to work with stakeholders to support the implementation of the framework. These reforms will reaffirm the federal government's intent to have a system of exclusive rules to ensure an efficient national banking system from coast to coast to coast.

Financial Literacy
The federal government has supported consumers by strengthening financial literacy and promoting financial consumer education through the Financial Consumer Agency of Canada. Canada's first Financial Literacy Leader was appointed in 2014, and a national strategy for financial literacy was released in 2015.

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[11] For more information, visit the website of the Financial Stability Board (http://www.fsb.org/).

Housing Finance

The federal government put in place a number of structural enhancements to the housing finance framework to promote long-term stability and encourage the development of private mortgage funding markets, including increases to the minimum down payment requirement, changes to portfolio insurance and the funding of insured mortgages, and adjustments to CMHC securitization requirements.

Covered Bonds

The federal government implemented a legislative framework for covered bonds to support financial stability by assisting lenders to diversify funding sources and by making the market for Canadian covered bonds more robust.

Large Foreign Acquisitions

The federal government introduced legislative changes to require ministerial approval of substantial foreign acquisitions by Canadian financial institutions that could affect the shape, size and stability of the financial sector.

Property and Casualty Insurance Demutualization

A legislative framework was established in 2014 for the demutualization of federally regulated property and casualty insurers. Regulations were introduced in 2015 that outline the terms and conditions for an orderly and transparent demutualization process, providing for a fair and equitable treatment of all policyholders.

Small Banks

Steps have been taken to improve the ability of new entrants and smaller banks, domestic or foreign, to compete, including improvements to OSFI's bank entry process and improved access to CMHC funding for small banks. The federal government also consulted on access to brokered deposits for small federally regulated deposit-taking institutions. In 2014, a conference was held to facilitate discussion between federal oversight bodies and small and medium-sized federally regulated deposit-taking institutions where issues facing small banks were discussed.

Credit Unions

Measures were put in place to support the growth of the credit union system, including establishing the federal credit union legislative framework that gives individual credit unions an option to grow regionally or nationally, if they so choose. Recognizing that credit unions that are considering the federal framework may face transition challenges, the federal government developed temporary transition measures to provide targeted protection against transitional risks and facilitate a smoother entry process.

Federal-Provincial Cooperation

The federal government implemented the announcement that OSFI would cease joint supervision of provincial credit union centrals with provincial regulators. Following OSFI's withdrawal, on January 15, 2017, provincial credit union centrals will be supervised solely by provincial regulators. In December 2015, following extensive consultations with the credit union system, the Bank of Canada reinforced its existing policy to provide Emergency Lending Assistance to qualifying provincially supervised institutions, subject to the establishment of an indemnity agreement. Each level of government has clear responsibility for the prudential oversight and management of stability risk of their respective institutions. In this context, officials and regulators benefit from collaboration on financial sector policy issues in support of financial stability.

Trade and Investment Protection Agreements

Canada and the European Commission are committed to swift implementation of the Canada-European Union Comprehensive Economic and Trade Agreement, and the Government of Canada continues to consult Canadians on the merits of ratifying the Trans-Pacific Partnership, which would offer opportunities to increase trade with Asia-Pacific countries. In addition, Canada engages internationally with its key financial sector partners on policy and regulatory issues. Going forward, the government is also working to deepen financial services trade relationships and dialogue with NAFTA partners and large emerging markets, including China and India.