September 28, 2017

Director,
Financial Institutions Division,
Financial Sector Policy Branch,
Department of Finance Canada,
James Michael Flaherty Building,
90 Elgin Street,
Ottawa, ON K1A 0G5

VIA EMAIL: review-examenlegislatif.fin@canada.ca fin.legislative

Dear Sirs:

We write in response to the Department of Finance's second round of requests for input with respect to the Federal Financial Sector Framework Review (the "Review").

XXX is one of a handful of players having nationwide scale in mortgage lending operations that are not directly federally regulated but still must understand and meet applicable OSFI standards to be allowed to provide outsourced services to our customers, most of which are OSFI regulated financial institutions. **XXX** does fall under each province's regulatory framework for mortgage lending, brokerage, administration and consumer protection. **XXX** is neither an insurer nor a deposit taker.

While **XXX**'s primary business is Canadian mortgage finance we have many years of experience in small commercial lending though our commercial leasing operation (**XXX**), we are a significant commercial borrower and are very active in the Canadian capital markets through our mortgage securitization programs (CMHC sponsored and private sector sponsored). As such we constantly deal with large and small OSFI regulated financial institutions, investment dealers and Canadian pension funds.

The mortgage finance sector has grown and evolved significantly over the last few years and has been directly affected by a number of Federal Government regulatory changes. We have had the opportunity to see the impact of these changes and the effect they have had on the different market participants. Our comments are based on those parts of the financial sector we have experience with and where we believe we can offer an informed perspective.

Since this Consultation Paper presented a series of specific areas of requested input, most of which relate to matters outside of **XXX**'s scope of mortgage products, services and operations, we have limited or comments to the areas of:

a) the role of smaller FIs in driving long term economic growth, innovation of products and services required by Canadian consumers and;

b) competition in the financial sector

At the risk of being repetitive, we reiterate some of our earlier comments in our response to the first Consultation Paper.

The Canadian financial landscape has evolved into two components basically separated by sheer size. There are the Big Banks and Lifecos, and there is everyone else. The problem is, despite its attempts to accommodate the differences between the Big Banks and Lifecos and all the other FRFI's, there is not currently enough regulatory flexibility to recognize the fundamental differences between the two.

Most of the smaller players operate only domestically within Canada and often with limited product and service offerings. While they must compete with the big institutions they have more limited and more expensive funding options. They need a "made in Canada" regulatory regime/solution that recognizes Canada's unique domestic financial landscape which is distinct from the international one. The optimal solution must allow them to compete on an equal basis with the Big Banks.

As we reported earlier, we see the Financial Services Framework as currently very strong on "stability", in the middle on "utility", and weaker on "efficiency".

In trying to find the correct balance between prudential regulation and encouraging competition and innovation, small to medium size players should not be less regulated just because they are smaller, but they should be appropriately regulated for the business they are in. By their very nature, in certain circumstances they will be at a higher risk of failing simply because of their narrower product offerings and smaller size, even if they are as well or better run in terms of operations, portfolio quality and risk management, as their larger competitors. However, if they are well managed and have high quality compliant assets their businesses can be easily absorbed into the system, which limits the risk of contagion. Their regulatory requirements and costs have to be appropriate and competitive for the nature and size of their business. If regulators put more weight on the specific, appropriate risk practices of each individual smaller institution, tailored to its limited product lines or services, and establish methods to monitor their adherence to them, there may be more room for flexibility for the better performers. This would also provide the incentive for better risk management by those smaller players. Neither a "one size fits all" (even if unintended by the regulators) or a framework of inflexible rules will work effectively to create a competitive landscape. This also goes back to the need for a "made in Canada solution". International standards are far less relevant to a localized operation.

Only competition will force all players to embrace innovation and ultimately to pass some or all of the efficiency savings (through use of technology) through to consumers. The "nimbleness" of smaller players (primarily because of their smaller size, limited product list and possibly far less entrenched legacy systems) allows them to more quickly bring the benefits of new technologies to their customers. This more rapid provision of newer, more user friendly services being demanded by the consuming public, provides the competition that spurs the response from the bigger banks.

One of the outcomes of the steady stream of regulatory edicts over the past two years has been to drastically reduce the number of "tools" available to smaller FIs that previously allowed them to better compete with the big banks. The restriction on selling insured mortgages into the conduits; the requirement that all insured loans be underwritten at the qualifying rate (+/- 2 % higher than current market rates); the requirement for more capital in the mortgage insurance companies resulting in them having to increase their premiums (by a factor of 3 times for bulk insurance) plus increased CMHC/CMB program fees have effectively made MBS uneconomic as a source of prime low ratio mortgage funding. This in turn has also had the effect of hurting the viability of some smaller FIs that either do not take deposits or do not have sufficiently large balance sheets to fund from non-MBS sources. In particular the smaller FIs that relied on MBS and CMB to fund their prime mortgages are in intense competition (possibly a race to the bottom) to generate high ratio insured mortgages to stay alive, simply because

that is the only product they can fund. They have no source of funding for the newly created "uninsurable prime loan" category and bulk insuring low ratio insurable prime loans is now uneconomical.

Only applying the October 2016 rules to insured loans has given the big banks a systemic advantage as they do not have to comply with the new rules for their conventional mortgages. The most recent proposed changes will eliminate part of that advantage relating to "stress testing" but they will still have the other advantages relating to the other mortgage insurance rules.

The big banks also have the advantage of using AIRB to determine their capital requirements. Smaller FIs can only use the Standard methodology, which results in much higher capital requirements which in turn gives the big banks a significant pricing advantage. At the same time the big banks have access to more cost effective leverage through covered bonds and access to international capital markets. This gets us back to the need for a "made in Canada" solution that drives healthy competition by taking into account domestic market realities, not just international standards.

If the cost of regulation for smaller FI's continues to be disproportionate, more capital is required for similar high quality products and services and access to efficient cost of funding is limited, smaller FI's will be forced out of the lower end of the spectrum (the big banks will own the prime high quality space such as prime residential mortgages, personal loans and small business commercial with little or no competition). The smaller FIs will be forced up the risk curve (which creates more systemic risk). While there may be some innovation from smaller FI's that will better serve the consumer the primary focus will be on marketing high risk products and employing intense collection practices needed to mitigate loses from the riskier lending. In addition, in the event of a failure of a small FI, the broader market will not be able to step in because the assets will not meet or come close to their requirements.

Stability is enhanced by having more smaller, but successful players competing in the prime segment of the market, relying on innovation and technology to compete with the scale, size and legacy systems of the big banks. Forcing the smaller FI's up the risk curve is counter-productive to innovation and counter to the objectives of the Department.

A vibrant "small FI sector" of the financial services industry that is not disadvantaged based on their size and limited offering (Canadian only) is most likely to speed the development and introduction of innovation and delivery of new and better services to consumers. The smaller players (like mortgage finance companies) can concentrate their efforts and investment in product specific areas. They have newer more adaptable IT systems with which to develop, test and bring new products to market, when compared to the big banks multiple non-interfacing legacy systems. In this way the smaller FI's also play the role of being a fintech provider to the larger institutions.

XXX has worked with major banks to develop, on their behalf, and to their specifications, new mortgage products and then to subsequently originate, sell to and service back those products, for the big banks, all in a much accelerated timeline to what the big banks could do internally. These new products are driven by market demand from consumers. They are underwritten to the big bank's specific lending criteria and specifications and can also be partly processed through the bank's existing systems, to which **XXX** can link with the processing of the new features being handled on **XXX**'s more adaptable system, all under the supervision of the Bank.

The Department and OSFI should encourage this kind of collaboration and to the extent that this involves outsourcing or referrals, the prudential regulatory framework is already in place (OSFI B-10). Smaller players can also, for example, put all their efforts into niche roles, like being a "virtual bank" without the need to invest in or support a branch structure, or focus products and services directly at new Canadians or self-employed entrepreneurs, again rapidly and specifically fulfilling consumer needs as they develop.

Another example of a smaller FI (and in this case a mortgage finance company) working hand in hand with the big banks is where a particular bank's credit criteria or exposure limits (geographic or product limitations) forces it to decline a customer's mortgage application. They do not want to lose this customer, especially to a competing large bank, whose loan criteria may be different, and especially if the first bank also provides other products or services to the customer. The larger institution can refer its customer to a mortgage finance company, like **XXX**, to get the customer's mortgage requirement fulfilled, without fear that the mortgage finance company will also "steal" all the customer's other banking business, simply because the mortgage finance company only does mortgages and is in business to work with the broader financial community. This benefits the customer and the Bank and can occur on a smooth and seamless basis.

Recent market share statistics showed the damage unbalanced regulation can do. In the two quarters since the new mortgage rules came into effect in the independent broker originated residential mortgage market where the small FI's compete, the major banks picked up significant market share. Lastly, in the area of cyber security, we support the Department's work with Public Safety Canada and with the G7 and G20 nations to improve cyber resilience in the financial services sector. We need international cooperation, information sharing and coordinated joint enforcement against the perpetrators. We caution again however that internationally developed standards for big international banks may not be applicable to smaller FIs with only limited domestic operations. The Consultation Paper speaks of the application of the concept of "proportionality" in prudential risk regulation. It is imperative to go beyond the theory and intent and that this actually be put into operational practice.

As small and large FI's strive for efficiency and cost savings by allowing customers to "self–serve" most of their basic banking functions through online customer portals, and the growing customer demand for mobile, 24/7 access to such services, the potential to expose more personal information and data to the criminal element escalates. We expect high profile data breaches like the very recent Equifax incident may well trigger a much more demanding, specific, even prescriptive, regulatory response. This may not be optimal.

What Canada should strive for under the leadership of the Federal Government is a coordinated, efficient, flexible framework of federal and provincial legislation that is cost effective, able to adapt and adjust to a continuously changing environment and recognizes that not all FI's are the same.

As with the first round of the consultation process, it is **XXX**'s objective to be a relevant and constructive participant in the Canadian financial sector. We therefore thank you for the opportunity to express these thoughts and views.

We would be pleased to further discuss any of the points raised herein at your convenience. Questions should be directed to **XXX**, CEO. We consent to the disclosure of this submission in whole or in part but would request that any identifiers be removed prior to publication.

Yours truly,

XXX
Chief Executive Officer