



**Review of the Federal Financial
Sector Framework**
Finance Canada

November 15, 2016

Introduction

Desjardins Group is the leading cooperative financial group in Canada and the sixth largest cooperative financial group in the world, with assets of more than \$260 billion.¹ To meet the diverse needs of its members and clients, Desjardins offers a full range of products and services to individuals and businesses through its extensive distribution network, online platforms and subsidiaries across Canada.

As a leader in the Canadian financial sector, Desjardins Group is particularly interested in the review of the federal financial sector framework. Our distinct structure, unique market position and relationship with our members and clients allow us to shed a different light on the financial sector's regulatory framework. For this reason, we regularly participate in the work and discussions affecting Desjardins Group's business sectors and want to be included in the discussions on renewing the federal financial sector framework in Canada.

Here are Desjardins Group's responses to the five main questions in the first step of the process.

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?

Regulatory pressure

Since 2008, the financial sector has experienced a significant increase in national and international regulatory requirements. These changes, although necessary, have created a heavy burden for financial institutions. The increase in regulations in turn increases the investment costs needed to comply with the new requirements, particularly in terms of technology. The increase in regulatory risk, due to additional international standards introduced to Canadian law and additional federal and provincial regulations, constitutes a new model for the traditional financial sector. The increase in standards presents a real risk of inconsistencies between them and creates a mounting challenge for compliance.

In addition, in the current context of low interest rates in which the traditional financial intermediation model should be redefined, alternative mechanisms are emerging and growing in the market to provide alternative sources of financing and increase returns. This contributes to the expansion of shadow banking. Shadow banking operates outside the traditional financial sector framework and is not subject, at least in part, to

¹ According to results for the third quarter of 2016.

regulatory oversight. If the regulatory framework is limiting, then the emergence of an unregulated financial sector constitutes a significant additional risk factor to the financial stability of the Canadian financial system.

In terms of capitalization, the new Basel III standards are adding pressure on the profitability of banking activities for large banks and an expected internal recapitalization (bail-in) regime for systematically important financial institutions will only add to it. Under pressure, these institutions seek to diversify their fee-based activities. The growth sectors are subject to more competition, which in turn creates new downward pressure on profitability.

Excessive debt and the real estate market

Several lenders that entered the Canadian market over the last 25 years preferred, and still prefer, to offer consumer credit at very low interest rates. The almost non-existence of brick and mortar service structures supports such rates. What's more, this phenomenon puts downward pressure on rates among the main actors despite uncharacteristically low profit margins. These reactions are intended to shelter the overall business relationship with the borrower but have also contributed to overspending by creating purchasing incentives.

In the same vein, we feel that the measures announced in October by the Government of Canada to slow the real estate market and reduce household debt are necessary. However, having financial institutions take on part of the mortgage insurance risk will have a major influence on the financial sector and the Canadian economy as a whole. Caution is necessary when implementing measures that will increase the burden on financial institutions. It's therefore crucial for the government to establish a dialogue to measure the full scope of a potential tightening.

Desjardins Group's federation structure

Financial institutions with federation structures are the exception on the Canadian financial landscape despite the fact that this structure raises awareness of the diverse needs of its territory. And because it is rooted in communities by its very nature, it contributes to stability in the territory. This type of structure should be given special attention when it comes to adapting the standards adopted based on a generic banking model.

For example, when it comes to the fight against money laundering and terrorist financing, Desjardins Group's structure causes a significant and unjustified competitive disadvantage compared to the generic banking model. Because caisses are separate legal entities, each one is individually subject to the same obligations,

requiring significantly more resources than those deployed in a generic banking model. Regulations that are ill-adapted to this reality represent a substantial cost and we ask the government to take a closer look at these decentralized structures.

Internationalization of Canadian financial institutions

As Canadian financial institutions become international, new risks lead to new compliance requirements. It's crucial to line up Canadian regulations with those from other countries when it comes to fighting money laundering and terrorist financing. Disparities create operational problems when Canadian and foreign requirements need to be respected. Canada must also adapt its regulations to meet the expectations of the Financial Action Task Force on Money Laundering (FATF).

In addition to the disparities between different countries' regulations, there are sometimes lengthy delays in adopting some international rules. Given the efforts required for compliance, this issue is a growing problem for the financial sector, for example, the Financial Stability Board's rules for large hedge funds and other types of fund managers. The process to develop these rules was initiated almost two years ago and no decisions have been made since. The longer the delays in adopting the standards, the more risks there are due from a lack thereof.

Lastly, aggressive tax evasion and avoidance remain major challenges for the Canadian financial sector. In this context, the government should become an ardent promoter of the G20 and OECD's BEPS Project, an action plan resulting from both organizations' initiative to counter base erosion and profit shifting. Also, if possible, the government should quickly implement the 15 measures recommended in the action plan.

Financial innovation and new technologies (Fintech)

Technological innovation has given rise to new non-banking actors in the payment and crowdfunding fields. While innovation is welcome, it's unfair and risky for these players to enjoy a competitive advantage by not being subjected to the same liquidity, capital and regulatory standards.

Consequently, all stakeholders should be regulated (financial technologies, e-cash) to remain fair and maintain a competitive balance among the various financial sector stakeholders and to ensure consumer security. Regulations should keep up with rapidly changing technologies as well as changes in consumer behaviours and habits. However, the legislator must account for how complex it is for financial institutions to implement regulatory changes.

In the consumer credit sector, several small actors are offering high-rate credit to high-risk borrowers. Payday loans are a good example: a recent study sponsored by the Ministry of Government and Consumer Services of Ontario presents cases with fees equivalent to an annual rate of 546%. Technological innovation upholds this type of offer on a larger scale and therefore should be considered for stricter frameworks or frameworks that call for the involvement of the main actors in the financial sector actors for these high-risk segments.

As part of their development strategies, some fintech companies, mainly in the credit sector, offer their services directly to consumers. The type of prudential risk framework should perhaps be considered.

As technology evolves, new ways of reaching consumers and offering services appear. For example, mobile technology is reaching consumers in new ways (authentication, recognition, electronic signature) and providing new ways of doing business. It's important that the regulation adjusts quickly to allow the financial services industry to keep up with social trends.

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

The current framework establishes a relative balance between the objectives of stability, efficiency and utility and could benefit from readjustments. This is due to more stringent regulatory standards that promote stability, sometimes to the detriment of efficiency and utility. This burden hinders access to the deposit-taking financial institution market, and breeds a new form of competition among specific market segments such as payment and direct credit.

What's more, the complexity of credit, savings and investment products makes it difficult for consumers to truly understand these products and make informed decisions. In this context, the utility and efficiency of the rules or any federal program will depend on how consistent they are with pre-existing provincial initiatives in effect for several years now. It would also avoid adding to the regulatory burden that is already sufficiently constraining.

Overall, the regulatory framework could continue to foster stability while leaving room for innovation, which is key to guaranteeing the financial sector's efficiency and utility.

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

We've found that the government must focus on sharing expertise with other administrations, such as the provinces', and take part in collaborations and initiatives to achieve stability and efficiency in the financial sector. A good example is Desjardins Group's involvement on the Advisory Committee on the fight against money laundering and terrorist financing.

Specifically, complementary initiatives emanating from the industry, with support from the government and/or regulatory authorities, could facilitate the regulation's interpretation and application by the reporting entities. A good example is the U.K.'s Joint Money Laundering Steering Group.

Finally, the government must take into account the fact that following the adoption of the *Dodd-Frank Act* framework in the U.S., several American and international institutions had to redefine the planning of their U.S. activities due to the heavy regulatory burden, thereby reducing the appeal of the U.S. market and international competition.

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?

In regard to the objective of efficiency, the government should be concerned with avoiding regulatory duplication and multiplication in favour of transforming and harmonizing the regulatory framework. To achieve this objective in light of features specific to the Canadian system, it would be beneficial, especially with respect to systemically important Canadian financial institutions, for regulatory authorities to agree on a common management and implementation framework in line with each one's competencies.

In the same vein, it is beneficial to ensure close and effective cooperation between federal and provincial regulatory authorities. This will provide an accurate global view of the entire financial sector and its resilience.

To guarantee that the adoption of regulatory requirements fits with the strategic and budget planning of entities to which they apply, the deadlines given to comply with new regulations should be reviewed to take into account the necessary implementation efforts. Many regulatory changes require technological adjustments in addition to updates to compliance programs. These technological changes are often long and costly and affect third-party platforms developed by independent international suppliers. Financial institutions must have

enough time to ensure implementation with their suppliers. The Financial Transactions and Reports Analysis Centre of Canada (FINTRAC) must be at the forefront and share its regulatory project as soon as possible to give the industry the leeway it needs to comply.

To promote economic growth and innovation, the regulatory framework must be more in line with Canadians' behaviour and the features of the financial products they favour. In this light, it would be good to extend deposit insurance to registered education savings plans (RESPs) and registered disability savings plans (RDSPs) given the popularity on RESPs and the special features of RDSPs.

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

Self-regulatory mechanisms are contingent measures that are an essential complement to the general framework, especially in sectors of strong innovation. The use of these measures in the payment industry is a good example. The approach promotes a healthy evolution of the financial sector while meeting stability and efficiency objectives. Codes of conduct and standards developed in partnership with industry actors, such as PCI, ISO 20022 and EMV payment standards are good examples. These flexible and changing tools allow the industry to keep up with rapidly changing technologies. They represent an approach that the government should promote and encourage in fast-changing sectors of activity while playing a supervisory role to ensure that all actors are applying them. Conversely, laws and regulations are less likely to quickly adapt to technological changes and instead should be used for high-level frameworks.

As for information security, cybersecurity is an enormous challenge. Although each company has their share of the responsibility, the government still has a role to play to ensure consistency across the industry when it comes to system stability. The government must resist the temptation to redistribute the overall risk to each participant. What's more, it's important that this issue does not get addressed by each company in a vacuum, but rather as a collaborative effort involving the entire industry and the government. This collaboration should also extend to universities in major Canadian cities that are hubs for cybersecurity entrepreneurs. The industry's commitment, combined with government support, could make Canada a leader and exporter of solutions in this field, in addition to ensuring the financial sector remains solid and at the forefront of innovation.

In property and casualty insurance, two measures could contribute to ensuring a solid financial sector. To begin, the government must make a financial commitment to ensure that the industry remains solid and

effective in the event of a major disaster. The Government of Canada has a crucial role to play here. Then, as recommended by the Insurance Bureau of Canada, the financial sector must be adapted to ensure the financial system's stability, efficiency and utility in the event of a major disaster.

Conclusion

Desjardins Group believes that the financial services sector is well supported. The federal, provincial and territorial governments must continue their efforts to ensure harmonized regulations that should not be unnecessarily heavy or constraining for financial institutions. The government must find a balance between its objective to ensure stability in the financial sector and its supporting role. An approach that is too restrictive may hinder access to some services, leading the government to play a supportive role to the financial sector for which it is not necessarily equipped.

Changing technologies is shaking up the status quo in many areas of the economy and the financial services sector is no exception. The regulatory framework must therefore also be able to adapt quickly to technological changes that will prove crucial for this sector and consumers. What's more, government authorities should take international standards into account in their regulatory decision-making.

Finally, cooperation among all actors in the industry remains the cornerstone for adequate supervision. That's why Desjardins Group wishes to thank the Department of Finance Canada for the opportunity to take part in its review of the federal financial sector framework. We will be happy to continue to work with all government stakeholders on matters pertaining to the supervision and regulation of the financial sector and will participate in phase 2 of these consultations.
