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Financial Institutions Division  
Financial Sector Policy Branch  
Department of Finance Canada  
James Michael Flaherty Building  
90 Elgin Street  
Ottawa ON K1A 0G5  
Email ([LegislativeReview-ExamenLegislatif@canada.ca](mailto:LegislativeReview-ExamenLegislatif@canada.ca))  
Telephone: 613-369-9347

**Re: Submission to the Consultation Process for the Review of the Federal Financial Sector Framework**

Meridian Credit Union is pleased to provide comments in respect of the first phase consultation on the federal financial sector legislative and regulatory framework.

We are providing the comments below from two perspectives: (i) as a provincially-regulated credit union operating within the Canadian financial services sector; and (ii) as an entity looking to establish a small to medium-size wholly-owned Canadian bank. Our concerns, and the areas that we would suggest the Department of Finance focus on in relation to your review, are generally the same from both perspectives.

Set out below are comments in relation to questions 1 - 4 posed within the Consultation Paper.

**Question 1: Our Views on the Trends and Challenges Identified in the Consultation Paper**

Overall, we believe that the Department of Finance has captured well the key trends that should be addressed in the next phase of amendments to the federal financial legislative and regulatory framework. We would highlight below comments in respect of two of the trends identified.

***Increased Concentration***

We appreciate that one of the trends highlighted in the Consultation Paper is the increased concentration within the banking sub-sector, and the related impact on competition. We also recognize that you have identified that small and medium-sized financial institutions face challenges in establishing new businesses in Canada, and in competing and growing due to heavy compliance requirements.

We believe the current regulatory framework facilitates, in part, this trend, since it favors the development and growth of large entities. We would encourage the Department of Finance to focus on how to foster further growth and competition from small to medium-sized institutions through the legislative and regulatory framework.

For example, it has been shown that large banks significantly benefit from the ability to draw on the internal rating-based (IRB) approach to setting credit risk weights for the purposes of calculating risk-weighted capital. A 2014 study by the Australian Financial System Inquiry (FSI) found that for an identical asset class, large banks were holding 18 cents of capital for each dollar of lending versus 39 cents (by virtue of the standardized approach) at smaller competitors. Since Basel rules are applied similarly in Australia and Canada, the scenario in Canada is likely analogous. We would submit that similar underwriting standards should attract similar capital treatment, regardless of the size of the institution. The differences between the IRB approach and standardized approach does not support such principle.

Furthermore, policymakers are increasingly substituting rule-based underwriting standards for the on-the-ground judgement of lenders, which is employed extensively by credit unions on account of the relationship-based, and community oriented, nature of our business. In its recent consultation on risk sharing, the Department of Finance concedes that the introduction of new additional forms of risk sharing could have deleterious effects for smaller institutions and for competition more generally. We would urge that off-setting measures be available to smaller institutions impacted negatively by rule-based underwriting standards.

### ***Fintech***

We would amplify the importance of recognizing the impact of fintech. It is imperative that there be some regulation in respect of the business of fintech companies in order to ensure stability and prudential monitoring of such innovation, but not so much as to prevent the growth of such entities that are meeting the needs of certain consumers. We would highlight that in addition to regulating fintech companies appropriately, the legislative framework should allow latitude to traditional, full-service deposit-taking institutions to incorporate innovative “fintech” products and processes within their businesses in order to compete effectively with fintech companies. For example, flexibility in lending restrictions in order to permit more customized or micro-lending are two examples of where further latitude could be provided.

### **Question 2: Balancing amongst Stability, Efficiency and Utility**

The current legislative and regulatory framework appears to place more weight on stability, as opposed to the other two core policy objectives of efficiency and utility.

The recent changes in the mortgage insurance framework and proposed risk-sharing models is an example of the focus on stability over efficiency (which allows for increased competitiveness). While aimed at dampening “demand side” pressure behind rapid housing price increases in Toronto and Vancouver, as noted in the Government’s “Consultation Document on Lender Risk Sharing for Government-Backed Insured Mortgages”, such changes are likely to have an adverse effect on

competition especially from smaller, traditional deposit-taking and loan-making institutions like credit unions.<sup>1</sup>

We understand that extra weight was given to stability following the 2008 financial crisis, but given the new realities of slow growth and increased competition in financial services, we would encourage the Department of Finance to explore changes to the legislative and regulatory framework that would increase efficiency and utility. Utility, in particular, is an area where Credit Unions and small to medium sized federal institutions have an opportunity to provide a material lift both to competition in the sector, and more importantly, to the overall well being of Canadian households and businesses. A thriving sector is a key ingredient to a stable sector. A balance of focus between utility and stability in the review will be strategically important to Canada's long term economic health.

### **Question 3: Possible Lessons from Other Jurisdictions**

It would be very beneficial to include a study of international trends in financial institution regulation before releasing the policy paper in 2017. There are international trends that will impact the Canadian financial services sector, which is why they should be in scope for this review.

For example, in Australia and the United Kingdom, fintech innovation hubs are being developed in partnership with government authorities and regulators. We are also seeing a similar approach to innovation in Ontario, with the Ontario Securities Commission developing its "LaunchPad". Elsewhere in Europe, the Netherlands has introduced a new credit union act that has already led to the formation of credit unions focused on SME lending. The Netherlands is seeking exemptions to Basel III norms (as applied in the European Union) because it wants to leverage the credit union model to its fullest extent and understands that the difference in form demands different regulatory treatment.

In the United States, the Office of the Comptroller of the Currency (OCC) has promoted the concept of "responsible innovation," which refers to innovation that satisfies the utility objective ("evolving needs of consumers, business and communities") but does so in a way that is "consistent with sound risk management" (i.e., the stability objective) and aligned with the financial institution's overall business strategy.

### **Question 4: Actions to Strengthen Financial Sector Framework and Promote Economic Growth**

In order to ensure that the interests of small to medium-sized financial institutions are continuously being considered when making legislative or policy changes, we would suggest that there be some form of *institutionalization* of the credit union and small bank perspective into the policy making process. While we appreciate the substantial current efforts to understand and accommodate these perspectives, it would be beneficial to ensure the importance of this is embedded within the Department of Finance and federal financial regulators, perhaps through the establishment of a credit union / small bank advisor policy unit.

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<sup>1</sup> The risk-sharing consultation document notes, for example, that "small lenders with fewer or less cost-competitive funding sources may also be less able than large lenders to absorb or pass on increased costs." It also notes that small institutions may be disadvantaged by their use of the standardized regulatory capital approach.

Furthermore, in order to promote and facilitate expansion of the business of credit unions into the federal financial sector, we believe there should be recognition and credit provided to such entities for their experience doing business within Canada's deposit-taking sector. Such recognition and credit could be incorporated into the assessment process that OSFI oversees in order to obtain necessary regulatory approvals.

Lastly, from a taxation perspective, we are concerned by the view of tax policy officials that the additional deduction for credit unions (ADCU) – which will be phased out completely after this year – was construed as a subsidy to credit unions rather than what it is – a *structural* feature of the tax system that recognizes our distinct co-operative form much like differential taxation of charities, non-profits and other entities recognizes their *structural* differences. Somehow, this understanding got lost over time – it was certainly there in the early days of credit unions when they were exempt from taxation. This understanding survived in the form of the ADCU with the introduction of credit union taxation in 1971 and was effectively *endorsed* in the work in the 1990's carried out by the McKay Task Force when it studied the Canadian federal financial services sector.

We would be pleased to provide further input into this review and look forward to reviewing the policy paper in 2017.

Yours sincerely,

A handwritten signature in black ink, appearing to read "Sunny S. Sodhi".

Sunny S. Sodhi  
SVP & Chief Legal Officer