Scotiabank submission to the Consultation for the Review of the Federal Financial Sector Framework

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This submission provides Scotiabank's response to the Consultation for the Review of the Federal Financial Sector Framework. We agree with the Government's core policy objectives of ensuring the stability, efficiency and utility of the financial services sector.

We also believe that this review offers an excellent opportunity to update the *Bank Act* and other financial sector legislation for the 21st century. Our key recommendations fall in the following areas:

- **Regulatory sandbox**: We encourage the Government to follow the lead of the UK by adopting the idea of a "regulatory sandbox." This would allow financial institutions to test innovative products, services, business models and delivery mechanisms in specifically approved instances without the burden of excessive regulation, while maintaining appropriate safeguards to protect consumers.
- **Serving customers**: We call for the amendment of legislation and regulations to enable customers to do business with their banks in a digital manner.
- **Altering philosophy**: The *Bank Act* should shift to an activity-based approach to regulation as opposed to an exclusively entity-based approach. This would enable appropriate and proportionate regulation of both banks and non-banks engaged in activities such as payments and lending.
- **Investment**: The *Bank Act* should be amended to give banks greater flexibility when it comes to making investments that enhance the provision of digital services, networking with other firms for this purpose and working with the latest advances in data science.
- **Seamless regulatory framework**: We welcome the recently tabled legislation aimed at ensuring exclusive federal jurisdiction over consumer protection and urge the Government to use this review to deal with issues that may arise as it is implemented.
- **Global regulatory change**: Given the many regulatory changes since the 2007-08 financial crisis, we ask that the government ensure that the regulatory framework is striking the right balance among safety, soundness, growth and competition, and that rules are as harmonized as possible across jurisdictions.

Introduction

Scotiabank is pleased to have the opportunity to provide this submission to the government's consultation on the Review of the Federal Financial Sector Framework.

We welcome this review and the Government's aim of updating the *Bank Act* for the 21st century as well as the three policy goals of stability, efficiency and utility. The *Bank Act* is outdated – there has not been a substantive review of the *Act* for 10 years. Meanwhile, the pace of technological change has increased dramatically and new competitors have arisen in the form of fintechs and other disruptors. The banking industry is in the middle of radical change, almost without precedent.

It is time to take stock of where we are today and where the industry needs to be in the future. We believe the priority for this review should be to modernize Canada's regulatory framework. It must reflect the reality that financial institutions in Canada are now heavily investing resources in digital capacity in an effort to provide the most innovative and advanced services to customers while maintaining the safety and security of the financial system as Canadian banks are known for doing.

It is also important to remember that the next mandated legislative review of the financial sector framework for Canada is not scheduled to occur until 2024. By then, major advances are expected in artificial intelligence, quantum computing and the use of technologies such as blockchain. Consumer-driven trends will push innovations such as the Internet of Things and enhanced connectivity that will change the way commerce is carried out and what kinds of firms engage in it.

And that is only what we know now. It is near impossible to predict how existing or new technologies may change the world we live in, let alone how we do our banking.

All of this means that the federal financial services regulatory framework must be flexible and principles-based while also remaining seamless and comprehensive. This can be done by updating the rules around how financial institutions interact with customers and how they invest in digital technologies.

We also believe that the industry will be positioned to meet these challenges if the federal financial framework for banks is seamless and exclusively federal, and we welcome the proposed amendments in the second draft *Budget Implementation Act*, 2016.

Banking in the 21st century

EMBRACING THE DIGITAL FUTURE

We believe this review is a unique opportunity to position Canada as a digital leader in the world. We can do this by creating a framework that supports and encourages the innovation and experimentation with the most advanced technologies. Other jurisdictions, such as the United Kingdom, are placing an emphasis on experimentation that will unleash a transformation of financial services. We believe that Canada's financial sector can be a leader in this space as well – as long as the public and private sectors rally together around a call to make it happen. The central role of financial services in the economy means that a digital transformation of banks and banking will have exponential impact for non-financial firms, investors and consumers across the country. With the right changes today, banks can be enabled to build the economy of the future, a truly digital economy that works for all Canadians.

REGULATORY SANDBOX

Jurisdictions around the world have been adapting to the rise of fintech companies and how they are challenging the traditional financial services model. These companies are innovative, flexible and agile, but they tend to lack scale, understanding of business functions and a distribution network. As a result they often need to partner with larger, established players in the market. However, it is difficult for small fintech firms to develop their ideas in a partnership that subjects them to the regulatory requirements of a bank. Likewise, banks find it difficult to develop their own fintech solutions under existing regulations.

We would ask the Government to consider the "sandbox" models that are being developed in various jurisdictions such as Singapore and the United Kingdom. Fintech is an intensely creative area, and this should be encouraged. However, policymakers will need to find ways to ease the regulatory burden on banks and fintech firms in specifically defined areas to allow them to experiment and innovate, while at the same time maintaining appropriate safeguards to protect consumers as well as the safety and soundness of the financial system as a whole.

The regulatory sandbox can also be used to create a safe space or a lab-like setting where fintech companies, financial institutions and regulators can come together to look closely at an innovative process, product or service without the potentially stifling effect of regulation. This can help both private and public actors gain a deeper understanding of the impact and potential of innovative ideas.

More broadly, perhaps such a process could also yield insights that would inform the broader regulatory framework for banks, helping to identify what is necessary and useful in regulation and what is not.

SERVING CUSTOMERS

Customers today have a wide range of digital and non-digital options for conducting their banking. Along with this variety has come a desire for increased speed and convenience. Our customers have come to expect the same speed and efficiency in their banking services that they experience in other areas of their increasingly digitized day-to-day lives. It is fair to say that when our customers are considering whether to use one of our services, they do not compare them only to those of other banks, or even to some idealized notion of banking. Rather, they compare the quality, speed and convenience of our services with those of any company operating in the digital space.

In step with consumer preferences, we have seen a wide variety of new entrants into the financial services markets, especially in payments. We believe the *Bank Act* can and must be updated to reflect this evolution in order to support the digital economy and customer expectations, while also continuing to maintain the safeguards that are important for a safe and sound banking system.

The question of digital identity is central to improving the customer experience and transforming our legislative framework for the future. The very essence of banking depends on the trust of our customers in the security of their savings and investments. This means our sector is well placed to play a role in helping to develop secure digital identities for Canadians. Working together with regulators, government and fintech firms, banks can help to prepare our economy for the future in this regard, for instance by developing blockchain enabled identities.

ALTERING PHILOSOPHY

One part of modernizing the *Bank Act* involves shifting to an activity-based approach to regulation as opposed to an exclusively entity-based approach. Non-banks involved in aspects of financial services should be regulated according to what they do, not what kind of entity they are. This means that proportional but robust regulation should include both banks and non-banks involved in payments, lending or engaging in activities that are tantamount to taking deposits, such as holding substantial funds for customers so that they can carry out payments in the future. Naturally, banks as universal providers of the full range of financial services will necessarily fall under a broader regulatory framework, but rules that capture specific activities will enhance the ability of regulators to adapt to innovative new firms that provide only one financial service.

In line with this, we believe that Canada needs a fundamental shift in the way our legislative framework treats the supply of banking services. Our legislative framework currently still envisions banking as a largely paper-based activity with a digital addition for advanced customers and firms. As a bank, we are moving beyond this rapidly. Our legislation needs to follow suit by assuming the opposite: a digital banking environment with a paper option for those who would prefer it.

One example of an area of the *Act* which must be updated is the unnecessarily restrictive electronic documents provision in Part XVIII, which combines consumer interactions with shareholder communications – two very different activities. These provisions tacitly view paper as the preferred option, with any electronic delivery requiring a form of consent. Failure to meet this standard can result in unenforceable disclosure. This is out of step with the expectations of our customers and shareholders today.

These and other consumer provisions do not take into account how the delivery of financial services has changed in recent years – most notably how financial services are increasingly provided on a smartphone screen. Regulation needs to adapt to this growing expectation. This is a fact for all commerce, banking being no exception, and we urge the Government to implement the necessary changes to acknowledge this fundamental shift in consumer preferences.

Finally, we would like to note that we welcome the recent changes to the *Proceeds of Crime (Money Laundering) and Terrorist Financing Act* regulations with respect to ascertaining identity. Further to the above point on digital identity, we would encourage the Government to consider further changes that acknowledge the need for safety and soundness but also allow for flexibility.

Positioning Canada's financial sector for the future

Success in our emerging digital age depends on making strategic investments in research and development to build cutting edge digital capacity. Banks and other financial institutions are already driving massive investments in technology to meet this opportunity. In order to help with this digital transformation, the *Bank Act* also needs to be updated so that financial institutions – both big and small – have the flexibility to make the necessary investments in step with the pace of change.

There are several sections of the *Bank Act*, which may have reflected the policy of the day, but which now only over-complicate and restrict banking activities. Our key concerns lie with the following categories of provisions.

INVESTMENT

First, we urge the Government to amend the provisions in Part IX of the *Act* that restrict banks to investing only in financial institutions or companies that carry on a business that the bank could undertake. These provisions require that the business of the acquisition be limited to a list of financially-related activities. Fintech firms and suppliers generally engage in a number of activities that are not necessarily on that list and therefore banks are restricted from investing in an area directly linked to the future of financial services.

We understand the policy rationale for preventing banks from engaging in certain kinds of activities that are not related to the business of banking either because the nature of the activity or the scale of the bank's involvement may pose a challenge to the safety and soundness of the system. Nevertheless, while giving due consideration to the importance of safety and soundness, we believe the investment rules should be amended to enable banks to make substantial investments in companies that may have other, non-financial lines of business. We believe the categories of entities in which a bank is permitted to invest should be made much more expansive as long as they are aimed at enhancing and improving the delivery of financial services and proper consideration is given to safety and soundness.

We would further suggest that smaller investments that have no impact on capital should not require any regulatory approvals or divestiture obligations. This would provide much-needed capital to smaller fintech firms in an efficient manner.

At the same time, we believe sufficient regulatory oversight could be maintained through a review of the health of the whole enterprise. Furthermore, larger investments could continue to be subject to regulatory review, as is currently the case.

Taken together, these changes would enable Canadian banks to compete effectively in the new digital economy while also maintaining appropriate safeguards for the financial system.

DIVESTMENT

The *Bank Act* provisions on the divestiture of an investment should be re-visited. If an investment does not meet the requirements set out above, the *Act* currently requires that it be divested as early as two years after it is made. The provision acts as a disincentive to investment for both banks and the recipients of the investments because:

1) the two-year limit is not enough time for investments to meet their full scope and potential to be reached; and
2) it does not allow for the fact that a company might initially meet the test for an investment but be out of scope for a subsequent investment because of an expansion in the direction of its business. The latter problem imposes onerous requirements on banks to engage in intensive monitoring of the investment and/or interfere with the normal management and expansion of the company that has received the investment.

WORKING WITH DATA

The digital transformation sweeping across the financial services industry is based in large part on data science. It has enabled a host of new services that have improved the convenience, speed, reliability and sophistication of digitally enabled banking. Financial institutions need to be able to engage with data in order to compete in this new world.

At present, Section 410 of the *Bank Act* requires that banks secure the approval of the Minister of Finance to carry on certain information processing, Internet and IT services. These provisions seem to be geared to limit banks from engaging in data management. Since much of the fintech revolution involves exactly these activities, this requirement unnecessarily complicates the participation of banks in digital innovation.

We see no policy reason for continuing to restrict financial institutions in this manner, and we strongly believe that FIs should be able to engage in financially-related data management without restrictions, like other fintechs. The requirement of ministerial approval for a number of activities merely slows down the process and makes it more onerous.

NETWORKING

Finally, we also question the networking provisions under Section 411, which permits a bank to network with another financial institution or permitted entity. This has been interpreted restrictively to mean that a bank can network only with entities that it would be permitted to own without regulatory approval or with entities for which it has obtained such regulatory approval.

For instance, banks must obtain ministerial approval if they want to make a substantial investment in or acquire control of an entity that engages in financial intermediary activities which expose it to material market or credit risk. In such cases, the current interpretation of Section 411 would mean that banks would also need ministerial approval to network with that entity as well.

We would like to see these provisions clarified and left open-ended. This can be done by simply identifying a list of entities where networking arrangements would not be permitted for reasons of regulatory prudence.

Seamless regulatory framework

One of Canada's advantages during the global financial crisis and afterward has been our seamless regulatory framework according to which primary responsibility for the financial sector rests with the federal government. We believe this continues to be a source of strength for the sector and a competitive advantage over other jurisdictions, where regulation is more fragmented. A coherent regulatory framework ensures the safety and soundness of the system, while also ensuring the transparency that investors and financial institutions need in order to compete effectively.

We welcome the proposed amendments in the second draft *Budget Implementation Act* that are aimed at establishing an exclusive set of federal consumer protection rules for banks.

While we believe that the changes introduced in this bill will go a long way to ensuring exclusive federal jurisdiction over banking, we urge the Government to use the Review of the Federal Financial Sector Framework to deal with issues that may arise as this legislation is implemented. We would also encourage the Government to carry forward the concept of federal paramountcy into the subsequent regulations.

Global regulatory change

Since the global financial crisis of 2007-08, Canada has joined other countries around the world in an effort to bring changes to the regulatory framework for banks. Many of these changes, aimed at making banks more resilient and easier to resolve in times of distress, were necessary and have created a stronger global financial sector.

Nevertheless, given the sweeping extent of the changes that continue to be implemented as we write, we would welcome a comprehensive assessment of the impact on the financial sector. This would serve as a means to ensure that the regulatory framework is striking the right balance among safety and soundness, growth and competition. Given the global nature of our business and activities, we also encourage the government to continue to work with counterparts in other jurisdictions to ensure that regulatory requirements are as harmonized as possible.

We recognize that such an assessment may be beyond the scope of the current review but would encourage the government to begin to consider how such an assessment might be carried out.

Global regulation

Since the last fulsome review in 2006, our country's major banks have continued to expand their operations abroad to compete successfully in other markets. Scotiabank has a long history of such expansion, dating back to our first forays into the Caribbean in the 19th century. Today, we are Canada's international bank and a leading financial services provider in North America, Latin America, the Caribbean and Central America, and Asia-Pacific. We are proud of our roots and our international reach.

At the same time, we understand the complexities of regulating banks with widespread operations in different jurisdictions. This is why we put great store in cross-border international regulatory cooperation, whether that be in the form of the OECD process for tax cooperation, common global standards for capital and liquidity, the mutual recognition of similar regulatory regimes or cooperation by supervisors through colleges or trade agreements that include financial services provisions.

In this regard, we would stress the importance of mutual recognition, and the need for the federal regulators to take the lead in negotiations with other jurisdictions in areas such as derivatives or securities. Canada can gain much when it stands united in cross-border regulatory discussions.

Conclusion

We conclude by reiterating the need to seize this moment to update the financial sector framework to reflect the emerging digital economy. Canada's financial industry has demonstrated that it is capable of competing and innovating on a global scale while also maintaining its reputation for safety and soundness. Updating our regulatory framework in a careful and considered fashion will only enhance those abilities.