November 15, 2016

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

VIA EMAIL: LegislativeReview-ExamenLegislatif@canada.ca

Dear Sirs:

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

On reviewing the full August 26, 2016 Consultation Document published with the request for input, including the description of the range of sector entities and the emerging trends that have become visible, it is clear that mortgage finance, **XXXX**'s primary area of business, and in particular residential mortgage finance, is only one area of a very broad range of interrelated, interdependent, constantly evolving and differently regulated financial sector entities and services being considered in the legislative review.

XXXX 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. **XXXX** does fall under each province's regulatory framework for mortgage lending, brokerage, administration and consumer protection.

While **XXXX**'s primary business is Canadian mortgage finance we have many years of experience in small commercial lending though our commercial leasing operation (which was sold to one of the big banks), 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.

In addition, 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've had the opportunity to see the impact of these changes and the effect they've had on the different market participants. Our comments are based on the broad range of the financial sector we have experience with and where we believe we can offer an informed perspective.

We understand that your request for input for the Review should be answered from a broader point of view, looking at the whole Financial Sector Framework ("FSF") and taking into account the three core policy objectives and corollary questions set out in the consultation paper:

- stability….is the sector safe, sound and resilient in the face of stress?
- efficiency….does the sector provide competitively priced products and services, pass efficiency gains to consumers, accommodate innovation and efficiently contribute to economic growth?
- utility….does the sector meet the financial needs of individuals and businesses and are the interests of consumers protected?

The consultation document posed a series of questions to which we offer these comments:

1. <u>What are our view on the trends and challenges identified in this paper? Are there others?</u>

I. The consultation paper details the continuing high degree of concentration of financial services and assets in the five largest banks ("Big Banks"), their capital markets brokerage subsidiaries and in the three largest life insurance companies ("Lifecos"). Smaller institutions are struggling to maintain a meaningful market share. We believe this is in part because we, as a country, are trying to apply an international regulatory standard for large international financial institutions to localized domestic operations. We believe a continuation of this will stifle future competition and in doing so reduce the likelihood or pace of innovation and reduce the chance that the benefits of competition and innovation will be passed on to consumers.

II. 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 Canadian financial system fared very well in times of international financial instability, partly because of the size and concentration of financial activity in our largest banks but also because they have been prudently regulated. Canada has been a leader in helping develop and then instituting international standards for "too big to fail" institutions. Between direct legislation, CDIC rules and OSFI regulation as the primary prudential regulator, there has been a myriad of rules established to protect the system and the country's economic health and stability…and in that regard it has been very successful. 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.

III. 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, 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. It must allow them to compete on an equal basis with the Big Banks and Lifecos.

IV. The consultation paper recognized another concerning trend, that Canadian consumers (especially young people) seem to be (somewhat unconsciously) prepared to trade off security of their personal information, for convenience and the "one button" solution (vs multiple layers of security). This lack of caring about security (at least until they get hurt by it) requires better consumer education across the entire financial sector…. a joint effort of the Government and the institutions.

V. Institutions strive for efficiency and cost savings, for example by allowing customers to "self–serve" most of their basic banking functions through online customer portals rather than through expensive manned contact centres. This links well with growing customer demand for mobile, 24/7 access to such services. But this form of self-service only goes so far. At the same time technology has allowed the financial sector to develop a broader, more complex range of offerings. We believe that the increasing amount of information available online will, on one hand be more efficient and assist consumers in starting their information gathering but, may also overwhelm them. Without some kind of guidance this can lead to poor decisions by the consumers which in turn, may also stifle innovation as easier, simpler solutions are taken.

VI. We expect that the role of the "trusted advisor", accessed through the internet, will become a more important part of the financial services sector. We've seen this happen with the growth of the independent mortgage broker over the last few years as mortgage offerings have become more complex. Through the internet these advisors will be able to service the country from any location, possibly even from outside of Canada. We need to reconsider how we ensure appropriate training, oversight and regulation of these advisors. The current fractured Provincial system is inadequate and must be coordinated with federal efforts in respect to financial institutions. Properly trained and overseen, such advisors can provide competition, efficiency and innovation. They also can create problems if left on their own (a few bad apples as such). It will be important to consider the role of these advisors as they will offer their services one way or another because of the internet. It is better if they become an accepted part of the financial system.

2. <u>How well does the FSF currently balance trade-offs between the three core policy objectives of stability, efficiency and utility?</u>

In a nut shell we see the FSF as currently very strong on "stability", in the middle on "utility", and weaker on "efficiency", as discussed below, and would prioritize accordingly.

I. Prudential regulation vs encouraging competition and innovation---finding the balance. Small to medium size players should not be less regulated 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 in the sector they're in. On the other hand, because of their size and the simpler nature of their business, a default or failure will be easier to manage and will have minimal effect on the overall financial sector. Their regulatory requirements and cost has 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.

II. If the cost of regulation is disproportionate for smaller players which have neither the size for economies of scale nor the range of funding sources of the big banks, it will eventually lead to further consolidation.

III. There needs to be more industry consultation and overall market impact analysis before policy decisions are made. For example the higher qualification standards for insured loans (the "New Rules") affecting first time buyers (and resulting in increased rental demand) while at the same time restricting credit availability for investors for single rental units (resulting in reduced rental supply and/or higher rental pricing) when rental markets are very tight. This is contrary to promoting overall economic growth and making our large urban centers where the jobs are being created more efficient and productive. This will likely lead to more "private money" lending which is not good for the financial sector as a whole.

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

I. We should always watch what is being done in other parts of the world and should analyze and compare the consequences abroad to what could likely happen in the Canadian situation. But while so watching we should not lose sight of the fact that Canada has had the most stable financial system in the world. Ours is not the one which is broken. It can always be improved, but given our system's performance to date, we have the luxury to taking small steps toward the three Objectives.

II. The one area we see some foreign countries leading in is in information gathering and dissemination; see below in 4(e).

4. <u>What actions could be taken to strengthen the FSF and promote economic growth?…and prioritize.</u>

(a) <u>How should the FSF support innovation and competition while maintaining stability of the system?</u>

I. 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.

II. Stability is enhanced by having more smaller, successful players in the market. Multiple smaller players provide alternatives, niche services and competition to the banks. Even in the event one small player collapses, it would be less likely to hurt the overall market or system, and is easier to "clean up".

III. Small players can and should work together with the larger banks for both their benefits and that of the consumer. **XXXX** has developed new mortgage products specifically at the request of our largest bank client. Both sides collaborated on the desired outcomes but it was built on our systems by our staff, to the bank's specifications, simply because we could do it faster and more efficiently then the bank could on their legacy systems. The bank now funds and purchases that new mortgage product that **XXXX** now generates through the mortgage broker channel.

(b) <u>How can the FSF best promote competition, including by encouraging new entrants and fostering growth of small entities and other players?</u>

I. It is critically important that the government take steps to encourage and assist competition and not create regulations that result in unintended effects that hurt smaller players (the primary source of the competition) resulting in further concentration of business in big banks. For example after the New Mortgage Rules the large balance sheet banks may now have a competitive advantage (over smaller players who have to fund through mortgage securitizations), by being able to underwrite low ratio loans at market rates, rather than at the much higher "insured stressed rates" applicable to all insured loans, thereby capturing a larger market share. Broad industry consultation should take place across all market participants to make sure there is a fair and equal result.

II. Qualified smaller entities have the ability to issue CDIC insured deposits as a funding source for their lending operations but, because many do not have the nationwide established branch network and customer base, they have to obtain deposits through independent deposit brokers (often working for the banks) where depositors have to be attracted to their deposits by higher rates. The added layer of deposit broker cost plus higher paid interest for smaller entities reduces, makes less competitive or eliminates the effectiveness of CDIC deposits as a source of prime loan funding. If issuing CDIC deposits is not a competitive source of funding, its higher cost will inevitably drive the smaller players up the risk scale on their investments and business operations, in order to achieve the offsetting yield. But CDIC deposit insurance does need to be the only solution. The CMHC programs support the Canadian housing market through the use of MBS and CMB guarantees for large and small institutions to access the capital markets. Similarly, the Federal Government should consider other ways to assist smaller players to access more efficient funding. For example the government, through CDIC or otherwise, could provide some level of guarantee support in lieu of the guarantees they currently offer on deposits (within existing prudent caps, criteria and leverage limits) to smaller players to allow them to access more cost effective funding through the capital markets.

Not only can they then access lower cost more efficient funding but they will have access to longer term funding as well. This would promote innovation and efficiency on the funding side which in turn will flow through to innovation and productivity on the product and services side of the business.

(c) <u>How can the benefits of an internationalizing financial sector best be obtained while ensuring the safety and soundness of the sector?</u>

I. Foreign institutions operating in Canada add an element of competition to the domestic market. Therefore, for the same reasons the government must be careful in the imposition of its regulatory regime not to unduly hamper smaller domestic competitors, that consideration likewise applies to foreign owned entities. Some of those foreign entities have also brought experience in areas of innovation ("like virtual" banking) that were ahead of domestic systems, thereby offering new services to Canadian consumers and spurring our domestic players to "catch up".

(d) <u>How can the FSF support financial firms to best serve the evolving needs and interests of consumers?</u>

I. Historically lack of competition has resulted in higher costs to consumers. If market players are not incented, by potential loss of market share, to be either faster, more efficient, or to provide better service at a reasonable price, they won't. Even the threat of possible competition has often caused better performance.

II. Meeting needs----evidenced by the public's take up of new products: regulation should stimulate "new" and "innovative" by allowing easier "bring to market" scenarios like permitted pilot products and test markets recognizing the new product is not yet perfected, may still cause some minor problems, but is ready for and worth testing.

III. Regulation" is more than "registration". Too often regulators, particularly at the provincial level, want to maintain lists of market players (an honour system mainly just sending in contact info, and sometimes with minimum education standards). This minimal approach is likely the result of the regulator simply not having enough resources to more actively manage the sector or its players. The provincial regulators are often left to responding to complaints, which by definition means the problem has already developed, ie the regulators do not have the means of being out in the market to get ahead of impending risks and to prevent problems from developing. Historically we have seen many instances of bad market players that hurt innocent consumers. The resulting sequence of events has become very predictable. Everyone in the industry gets a black eye. Politicians and regulators feel pressured and compelled to do a knee jerk quick fix, usually in the form of quickly cobbled together further restrictive rules, which may not be effective and may have many unintended consequences. The better solution is to reduce duplication, then resource the appropriate regulators so they can actually have an effective guiding hand, truly understand their market, and only draft well thought out legislation.

(e) <u>Are Canada's federal financial sector oversight bodies well positioned to support the sector in the future?</u>

I. Government agencies should be the gatherers of as much market info and data as possible. Generally they are in the best position to do so directly, or to cause it to be gathered by other market players and reported to them. Then they should distribute that data or make it accessible. By providing a broad base of accessible raw data true innovators will find ways to use it to meet consumer demands.

II. For example, the consultation paper notes the percentage of total outstanding mortgage debt held by the banks when demonstrating industry concentration. This also shows mortgage finance companies growing from 6% in 2007 to 12% in 2015. That is only one view of the data that was gathered, and may be a somewhat rear view perspective. More important to some than total outstanding mortgage debt (because with a long term asset like mortgages this is built up over decades and is slow to run off) is current levels of origination and whether it is through the big bank branch networks, roving bank business development officers, the broker channel, or info techs (rate hubs)…the most recent years' numbers would be significantly different than the total outstanding debt positon and provide present day information for analysis and better planning.

III. Who should regulate? Federal vs Provincial: Who has the best resources? ---But do not duplicate. Example: FCAC vs provincial consumer protection Ministries: the two levels of government could divide/allocate regulation by function not by entity, ie. if an entity takes deposits it would be regulated with respect to the deposit taking function without distinction between federal or provincial credit unions, trust companies, or whether they are MICs or banks. This could be coordinated for substantial consistency even if split between federal and provincial agencies. The combined regulatory system needs to grant clear exemptions from one or the other level if an entity or a function is already regulated by the other. We recognize the constitutional issues of regulatory empowerment, but with a reasonable level of cooperation a single system, probably overseen federally, could be created where entities could "opt in" to the regulatory regime. If it applied consistently across the country it would provide an element of clarity and certainty which the business world always desires, so there would be considerable market force pushing entities to opt in. There would be cost saving to the entity for "belonging" and more consistent regulatory protection for the consumers. This is especially important as more and more financial services are offered electronically across the country but where the financial institution is physically located only in one.

IV. Example: regulation of "syndicated mortgages"…given that we are moving rapidly towards a single federal securities regulator or at least to a much more coordinated federation of provincial securities regulators, there is an opportunity for more consistent, effective regulation. The "evil" of syndicated mortgages is when they are sold to uneducated consumers when it is an inappropriate product for the person's risk profile. Securities legislation is already in place to require securities brokerages to ensure the product sold is appropriate for the customer. Let those existing regulations be applied to syndications of mortgages to consumers (making it very clear that syndications amongst institutional players are exempt).

V. Example: **XXXX** is itself somewhat of a regulatory “square peg in a round hole”. Mortgage lenders like **XXXX**, because they are not directly OSFI regulated, do not fall into the exemptions for federally regulated entities found in provincial mortgage brokerage legislation, and are caught in the broad definitions of “broker” even though they do not play the traditional role of Cupid between borrowers and lenders, that normally defines a broker. **XXXX** must meet applicable OSFI standards in order to originate, sell to or service mortgage loans for the OSFI regulated banks, but with its nationwide lending operations, must also comply with each and every province’s regulations, an example of inefficient regulatory duplication.

5. <u>What other actions should be taken to ensure the FSF remains modern and technically sound?</u>

I. It should be noted that the “sunset clauses” built into the primary federal financial sector legislation and the resulting Department of Finance’s FSF consultation and review process is unique, and should always be continued.

It is **XXXX**’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 **XXXX**, 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,

XXXX
Chief Executive Officer