<u>The Canadian Banking Act</u>

"An Overview of Changes Made to the Bank Act in Relation to Small Banks"

By: Alphanorth Research and Small Business Consulting Service

August 2002

Executive Summary

This report will highlight relevant changes to the Canadian Bank Act in relation to size-based ownership regimes. A series of reports were used to gather the information, and confirm the changes to the Canadian Bank Act were put into practice. Bill C-8 had all of the recommended changes, and was given Royal Assent on June 14, 2001.

One of the most significant changes to the Canadian Bank Act was the creation of a tiered ownership regime based on the size of the Schedule I bank. The three tiers are:

- Small Banks (Banks with less than $1 billion in equity),
- Medium Banks (Banks with less than $5 billion in equity, but more than $1 billion in equity), and;
- Large Banks (Banks with over $5 billion in equity).

Since the focus of this project is small banks the rest of the executive summary will concentrate on changes that affect rural communities and small Schedule I banks.

In the past, investors in banks could only own 10 percent of any class of share. Under the new sized-based ownership regime for Schedule I banks, a small bank can be closely held. This means that an investor can own up to 100 percent of the shares in a small Schedule I bank. As well, an initial equity investment of $ 5,000,000 is required to open a bank as opposed to the previous amount of $ 10,000,000.

There are two major concerns about opening a bank for Northwestern Ontario that is centered in Thunder Bay. The first concern is the regional location of the proposed bank. Many U.S. banks have gone bankrupt because the region they were serving experienced a prolonged economic downturn. This could happen to a bank serving Northwestern Ontario. The other concern is the economy of Northwestern Ontario is fairly reliant on the forestry, mining, grain, and construction industry. Although Northwestern Ontario is not as dependent on these industries as in the past, the region is still more reliant than the Ontario and Canadian average in these industries.

A final consideration would be whether or not a credit union would be more appropriate, and less risky than a Schedule I Bank for Northwestern Ontario. Credit Unions are normally used for smaller geographical locations, such as Northwestern Ontario. Further research would be needed to determine whether or not a credit union would be a better alternative for Northwestern Ontario.

Table of Contents

This report will highlight relevant changes to the Canadian Bank Act in relation to size-based ownership regimes. The report will demonstrate that the proper legislation is in place for the creation of a Northwestern Ontario bank to be set up and headquartered out of Thunder Bay. The report will also highlight some of the apparent risks associated with the creation of such a bank. The majority of findings are supported by the Task Force report on reforming Canada's financial institutions as well as Bill C-8, which was given Royal Assent on June 14, 2001.

Minister of Finance Announcement, June 25, 1999

On this date, Finance Minister Paul Martin announced a new policy framework for Canada's financial service sector, which includes domestic and foreign banks, trust companies, insurance companies, caisse populaires, credit unions, and other financial institutions. The new framework was developed by a financial task force, who also consulted on the next round of provisions to the current legislation regulating the financial sector.

The new policy framework is guided by four fundamental principles, which are found in the next section of the report (Reforming Canada's Financial Services Sector – A Framework for the Future).

According to the Minister, the changes were designed with the goal of better equipping the financial sector to adapt to the changing global environment. These changes will allow the financial sector to be flexible in reacting to change, while increasing competition throughout the sector. The changes will also maintain the integrity of the Canadian financial sector.

Reforming Canada's Financial Services Sector

The task force report was intended to serve as the basis for the next round of revisions to the legislation regulating the sector, Scheduled for no later than 2002. Its mandate was to assess and evaluate public policies affecting the financial services sector and to make recommendations to enhance:

- The sector's contribution to job creation, economic growth and the new economy
- Competition, efficiency and innovation
- The international competitiveness of the sector in light of the globalization of financial services, while at the same time maintaining strong, vibrant domestic financial institutions
- The ability of the sector to take full advantage of technological advances as they occur and to meet the competitive challenges resulting from the introduction of new technologies, and
- The contribution of the sector to the best interests of Canadian consumers

To this end, the Task Force offered 124 recommendations for enhancing competition and competitiveness, improving the regulatory framework, meeting Canadian's expectations and empowering consumers.

A particular challenge for Canada as identified by the Task Force is the shrinking population in small communities. This has implications for how financial institutions maintain national pricing policies while ensuring adequate access to financial services in small remote and rural communities (such as Northwestern Ontario).

In shaping the policy of the financial services sector, the government has been guided by the following four fundamental principles:

1. Financial institutions must have the flexibility to adapt to the changing marketplace and to compete and thrive, both at home and abroad, in order to retain their role as critical sources of economic activity and job creation
2. Vibrant competition is necessary to ensure a dynamic and innovative sector and that individual and business consumers have a range of choice at the best possible price
3. Consumers, regardless of their income or whether they live in an urban or rural area, and individual businesses, whether they be large or small, should receive the highest possible standard of quality and service; and
4. The regulatory burden should be lightened wherever possible, consistent with prudential and public interest objectives.

Recommendations for Fostering Domestic Competition

- Encouraging new entrants with liberalized ownership rules and lower minimum capital requirements
- Facilitating the ability of the credit unions to compete by allowing a restructuring of their system
- Expanding access to the payments system to provide additional competition in deposit-like services
- Allowing foreign banks to offer services to businesses and individual consumers via branches, in addition to subsidiaries

Recommendations for Empowering and Protecting Consumers of Financial Services

- Measures to improve access to financial services regardless of income or place of residence, including a standard low-cost account and a process to govern branch closures
- A Financial Consumer Agency to strengthen oversight of consumer protection measures and expand consumer education activities
- An independent Canadian Financial Ombudsman
- Measures to prevent coercive tied selling and improve the information consumers receive when purchasing services or making investments
- Public Accountability Statements for financial institutions to report on their contributions to the Canadian economy and society
- More and better statistics on and analysis of small and medium-sized business financing to provide a better understanding of their needs

The Widely Held Ownership Rule

The current "widely held" rule for banks applies to Schedule 1 banks as set out in the Bank Act. Schedule 1 banks must be widely held, which is defined to mean that no more than 10 percent of any class of share in a bank may be owned by a single shareholder, or by shareholders acting in concert.

The new application of "widely held" is as follows. The widely held rule will apply to all banks and demutualized insurers whose equity is over $5 billion. Banks and demutualized insurers under $5 billion can be closely held. The government will allow an investor to hold up to 20 percent of any class of voting shares, and up to 30 percent of any class of non-voting shares, of a widely held bank, subject to a "fit and proper" test. An investor would be allowed to own both types of shares up to the maximums allowed for each (i.e. 20 percent of any class of voting shares, as well as 30 percent of any class of non-voting shares).

<u>The Fit and Proper Test</u>

Generally, "fit and proper" tests are used to assess the suitability of prospective owners. These tests include and examination of the applicant's past record as a business person, the soundness of their business plan and the reasons why they wish to get into the particular line of business. They also seek to assess that applicants have the necessary integrity and fitness of character. These test help ensure that key shareholders are not a source of weakness to the regulated institutions.

Fostering Domestic Competition

The Canadian banking sector has a poor record of new entry. Since 1987, there have been only two new Schedule 1 banking charters in Canada, while the U.S. had 207 new banking charters in 1997 alone. The Task Force feels that the lack of new entry is not in the best interests of Canadian consumers. The government intends to facilitate new bank entry while at the same time introducing initiatives to strengthen the "second tier" of smaller financial institutions, often community-based, that provide an alternative to the larger financial institutions. It should be noted that measures to increase competition although possibly beneficial to consumers and to the economy as a whole, might increase risk to the financial system.

To enhance competition, the government will establish a size-based regime and reduce minimum capital requirements to facilitate new entry, strengthen the financial co-operative sector, expand access to the payments system, and permit foreign banks to offer services to businesses and individual consumers via branches, as well as through subsidiaries.

Ownership Rules for Banks

The new rules will be based on size with the "widely held" requirement applying only to the largest banks, where the concerns regarding the impact of failure on depositors and the surrounding economy are greatest. Small and medium-sized banks will have the added flexibility of being able to be closely held indefinitely.

The new ownership rules will have three size classifications – small, medium and large – based on the size of the bank as measured by equity. Equity, in this respect, means the sum of the shareholders' equity of the bank and the minority interests in entities controlled by the bank as they appear in the consolidated financial statements of the bank (Bank Act, subsection 381(4)).

Medium banks with equity of between $1 billion and $5 billion will be allowed to be closely held, but will be required to have a 35 percent public float of voting shares. This means that a single shareholder, or group of shareholders acting in concert can own 65 percent of the shares, either voting or non-voting. The remaining 35 percent must be publicly traded on a Canadian stock exchange, and cannot be owned by the same shareholder, or shareholder group.

Small banks with equity of under $1 billion will have unrestricted choice in ownership structure. This means that new banks can be 100 percent owned, even by a commercial enterprise, as long as their equity is under $1 billion.

When a bank grows from one threshold level to the next, it will have three years to make the transition to the ownership rule applicable to its new size category, but may apply to the Minister of Finance for an extension if unusual circumstances prevent it from receiving fair value for its shares during the transition period.

Table # 1 – New Ownership Structure

Ownership Regime for Domestic Banks			
Schedule I Bank Classifications	*Equity (In Canadian Dollars)*	*Ownership Type (Widely Held or Closely Held)*	*Ownership Restrictions of Share Class (Voting and Non-Voting Shares)*
Small Banks	Less than $1 Billion	Closely Held	• No ownership restrictions
Medium Banks	Between $1 Billion and $5 Billion	Closely Held	• Up to 65 percent of Shares can be closely held, • At least 35 percent of shares must be publicly traded
Large Banks	Greater than $5 Billion	Widely Held	• 20 percent Voting Shares, and; • 30 percent Non-Voting Shares

Governments require a minimum amount of money to be paid into a regulated financial institution. This minimum level of capital is required to ensure that the principal shareholders are strongly committed to the institution, and the new financial institution has enough capital to support its operations from the outset, and thereby reduce the likelihood of failure. The need for substantial minimum capital requirements must be balanced against the desire to encourage new entry. In order to address this concern, the minimum capital requirement to start a new bank, trust or insurance company in Canada will be lowered from $10 million to $5 million.

Empowering and Protecting Consumers of Financial Services

<u>Improving Access to Financial Services</u>

The change from personal to electronic service delivery leaves behind consumers uncomfortable with or unable to use the new technology, and who seek a level of face-to-face service that is becoming less and less available. Promoting equitable access for the less well off, for seniors and for people with disabilities is an important public policy objective.

The government will require federal deposit-taking institutions to provide four months' notice of branch closures to customers. Institutions will also be required to post notice of the closing date in the affected branch.

The government recognizes that four months' notice may be insufficient for many rural communities, which are often served by only one deposit-taking institution. In such cases, the closure of a branch results in complete loss of service. These communities need more time to explore possible options for maintaining financial services. Therefore, in rural areas where there are no other financial institutions within a 10-kilometre radius of the branch being closed, federal deposit-taking institutions will be required to provide six months' notice of closures.

Public Accountability

The government will require federal financial institutions with equity in excess of $1 billion to publish annual Public Accountability Statements. The statements will describe an institution's contribution to the Canadian economy and society, and will include:

- The national dollar amount of charitable donations and examples of philanthropic activities;
- Employee volunteer activities;

- Examples of funding provided to local government and voluntary agencies for community works;
- Investments or partnerships in micro-credit programs;
- Small-business financing initiatives such as venture capital programs, and dollar amounts of small business lending – broken down by loan size and reported by region
- Initiatives to improve access to banking services for low-income individuals, seniors and people with disabilities;
- The location of openings and closings of branches;
- The number of individuals employed; and
- Taxes paid to federal, provincial and municipal governments

Financial institutions will be required to make these statements available to the public, through their branches or Web sites. The government believes that the Public Accountability Statements, coupled with the other consumer-oriented measures outlined, will encourage financial institutions to be responsive to the needs to the communities they serve.

Financing Small and Medium-Sized Business

Ensuring that small and medium-sized enterprises (SMEs) have reliable access to capital is an issue of great importance for the government. Small and medium-sized business is a major engine that drives economic prosperity and job creation. While banks are the dominant players in the SME finance market, they represent only about half of the debt financing supplied to SME's. Additional information is needed regarding other suppliers and equity financing for SME's to ensure any gaps existing in the market can be effectively addressed. To this end, the government will undertake a comprehensive program of information collection and analysis to ensure that there is adequate information relating to the financing needs of SME's for the effective development of public policy. Statistics Canada will be given the mandate of collecting and publishing data on the supply of debt and equity financing to SME's.

To expand the government's analytical capabilities, Industry Canada will be given the mandate of establishing a dedicated SME Finance Group that would be responsible for analyzing the Statistics Canada data, conducting other surveys and undertaking continuing research on SME financing issues. Industry Canada will also report annually to the House Standing Committee on Industry regarding the state of SME financing in Canada.

Improving the Regulatory Environment

Preserving Safety and Soundness in the New Environment

In 1996, the government introduced an early intervention policy with three main components: 1) a legislated mandate for OSFI that recognizes the need for prompt action by the supervisor and by the institution to resolve problems; 2) Guides to Intervention that make clear to institutions the actions the supervisor will take if the financial condition of an institution deteriorates; and 3) The power to close a troubled institution while its capital is still positive, i.e. before it becomes insolvent. The government is committed to the principal of early intervention as a means of preserving the safety and stability of the financial services sector.

In support of the initiatives to promote greater competition in the financial sector, the Superintendent of Financial Institutions will have additional supervisory powers to deal with the potential for increased risk in the system.

Bill C-8

The Task Force Recommendations were originally reported in Bill C-38, which died on the order paper when the November 2000 general election was called. It was revived in the form of Bill C-8, and was given Royal Assent on June 14, 2001. The previous amendments mentioned in the Task Force Report were put into legislation in Bill C-8.

Other Points to Consider

There are two major concerns about opening a bank for Northwestern Ontario that is centered in Thunder Bay.

The first major concern is the regional location of the proposed bank. This is similar to many of the U.S. banks that have experienced failures. The U.S. banking system is a regional system, and economic slumps in specific areas of the country (which do not necessarily coincide with national downturns) can cause bank insolvency. This is because during economic downturns, more loans are defaulted on, and less money is being deposited into the bank. At the same time, people are taking out money from their accounts, and the bank has less of a float than during normal periods.

The second concern is the high level of dependence in the Northwestern Ontario economy on the forestry, mining, grain, and construction industry. If these industries experience a downturn at the same time, many of the bank's customers will be negatively affected. This would lead to loan defaults, less money being deposited by these customers, and money being withdrawn by these customers. If the downturn in these sectors is prolonged, then this could lead to the bank's eventual insolvency.

However, Northwestern Ontario is not as heavily dependent on these industries as it was in the past (Appendix 1 & 2). The Northwestern Ontario average for people working in agriculture and other resource-based industries is 5.41 percent, compared to the 3.15 percent Ontario average. Even though this percentage is higher in Northwestern Ontario, it is still relatively insignificant to the 75.20 percent of people working in service related industries (Ontario average 74.39 percent). With the majority of people in Northwestern Ontario working in the diverse service industry, the bank would not be as susceptible to industry downturns, but would still be at risk for regional economic downturns in Northwestern Ontario.

Given the findings of our research, the legislation is in place for the creation of a Northwestern Ontario bank, headquartered out of Thunder Bay. The legislation for the new Bank Act was officially implemented on June 14, 2001, and subject to a fit and proper test on management of the bank, no other time triggers are outlined in the act. Once the initial equity ($5 million) is raised, and a management team is in place, a fit and proper test will be performed on the management team, and the Superintendent of

Financial Institution and the Finance Minister, will make the decision on whether or not the bank would be approved.

A final consideration would be whether or not a credit union would be more appropriate, and less risky than a Schedule I Bank for Northwestern Ontario. Credit Union's are normally used for smaller geographical locations, such as Northwestern Ontario. Further research would be needed to determine whether or not a credit union would be a better alternative for Northwestern Ontario.

Appendices

Appendix # 1 – Number of People in Northwestern Ontario Employed in Major Industry Sectors

	Agriculture and Other Resource Based Industries	Manufacturing and Construction	Service Industry	Total # of Workers
Thunder Bay and surrounding Municipalities	2,205	11,210	49,405	62,820
Unorganized Municipalities around Thunder Bay	620	855	2,725	4,200
Fort Frances	135	955	3,270	4,360
Marathon	725	405	1,340	2,470
Atikokan	115	560	1,315	1,990
Terrace Bay	75	625	580	1,280
Geraldton	130	185	965	1,280
Longlac	245	375	615	1,235
Nipigon	70	290	730	1,090
Schreiber	110	215	600	925
Red Rock	10	265	405	680
Beardmore	25	70	135	230
Total	4,465	16,010	62,085	82,560

Appendix # 2 – Percentage of People in Northwestern Ontario Employed in Major Industry Sectors versus the Ontario Average

	Agriculture and Other Resource Based Industries	Manufacturing and Construction	Service Industry	Total # of Workers
Thunder Bay and surrounding Municipalities	3.51 %	17.84 %	78.65 %	100.00 %
Unorganized Municipalities around Thunder Bay	14.76 %	20.36 %	64.88 %	100.00 %
Fort Frances	3.10 %	21.90 %	75.00 %	100.00 %
Marathon	29.35 %	16.40 %	54.25 %	100.00 %
Atikokan	5.78 %	28.14 %	66.08 %	100.00 %
Terrace Bay	5.86 %	48.83 %	45.31 %	100.00%
Geraldton	10.16 %	14.45 %	75.39 %	100.00 %
Longlac	19.84 %	30.36 %	49.80 %	100.00 %
Nipigon	6.42 %	26.61 %	66.97 %	100.00 %
Schreiber	11.90 %	23.24 %	64.86 %	100.00 %
Red Rock	1.47 %	38.97 %	59.56 %	100.00 %
Beardmore	10.87 %	30.43 %	58.70 %	100.00 %
Total	5.41 %	19.39 %	75.20 %	100.00 %
Ontario Average	3.15 %	22.46 %	74.39 %	100.00 %

Bibliography

Armstrong, J. 1997. "The Changing Business Activities of Banks in Canada." *Bank of Canada Review* (Spring): 11 -38.

Bank of Canada. 1991. "The Implementation of Monetary Policy in a System with Zero Reserve Requirements." *Bank of Canada Review* (May): 23 – 34.

Canada. Department of Finance. December 19, 1996. Press Release.

Canada. Department of Finance. 2001. "Summary of Key Legislative Measures and Statements of Government Policy." Press Release

Daniel, F., C. Freedman, and C. Goodlet. 1992-93. "Restructuring the Canadian Financial Industry." *Bank of Canada Review* (Winter): 21 – 45.

Freedman, C. 1987. "Aspects of Securitization." *Bank of Canada Review* (January): 5 – 16.

________. 1992. "Universal Banking: The Canadian View." In *Financial Regulation: Changing the Rules of the Game*, edited by D. Vittas, 369 – 390. Washington, D.C.: The World Bank.

________. 1996. "Financial Structure in Canada: The Movement towards Universal Banking." In *Universal Banking: Financial Systems Design Reconsidered*, edited by A. Saunders and I. Walter, 724 – 736. Chicago: Irwin Professional Publishing.

Freedman, C. and C. Goodlet. 1998. "The Financial Services Sector: Past Changes and Future Prospects. Technical Report No. 82. Ottawa: Bank of Canada.

Garvey, Gerald, and Ron Giammarino. September, 1998. "Ownership Restrictions and the Value of Canadian Bank Stocks." University of British Columbia.

House of Commons. "Bill C-8: An Act to Establish the Financial Consumer Agency of Canada (LS-387E)." Accessed on http://www.parl.gc.ca/common/Bills_ls.asp?lang=E&Parl=37&Ses=1&1s=C8&source…

Martin, Paul. June 25, 1999. "Minister of Finance Announces a New Policy Framework for Canada's Financial Services Sector." Press Release. Accessed on http://www.fin.gc.ca/news99/99-059e.html.

June 25, 1999. "Reforming Canada's Financial Services Sector – A Framework for the Future." *Task Force Report*.