PRB 00-16E

FINANCIAL HOLDING COMPANIES: BILL C-8 AND NEW OPTIONS FOR FINANCIAL CONGLOMERATES

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12 October 2000

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FINANCIAL HOLDING COMPANIES: BILL C-8 AND NEW OPTIONS FOR FINANCIAL CONGLOMERATES

INTRODUCTION

In 1996, the Minister of Finance asked the Task Force on the Future of the Canadian Financial Sector to advise the government on what was needed for the Canadian financial system to remain strong and dynamic. In its 1998 report, the Task Force made a number of recommendations, including the suggestion that the government permit banks and demutualized insurance companies to be organized as non-operating financial holding companies. Following two parliamentary reviews (House of Commons Finance Committee and Senate Banking Committee), the Minister of Finance released the federal government White Paper (*Reforming Canada's Financial Services Sector: A Framework for the Future*) which called for the creation of financial holding companies, a proposition which follows the lines of the Task Force recommendation. In June 2000, Bill C-38 was given first reading, but died on the Order Paper with the calling of the 2000 election. Bill C-8, its successor, was given first reading in February 2001.

Worldwide, the financial services' marketplaces are in a state of general transformation, deregulation and consolidation. And with the current pace of progress in information and communication technologies, the financial industry in Canada and abroad is set for major changes in the future. The need for financial regulatory reform has been spurred by:

- the wave of worldwide consolidations;
- the emergence of new competitors;
- expanded choices for consumers, and their increasing level of sophistication; and
- the increasing complexity of the institutions and financial products themselves.

By allowing bankers and insurers to form holding companies, the government hopes that additional structural flexibility will promote competition and result in efficiency gains for the Canadian financial sector. Most likely, banks will reorganize their activities under a holding company structure which would help them to: better compete with unregulated financial institutions; better tackle and take advantage of innovations in financial markets; and, combined with new ownership rules, form joint ventures with foreign and/or domestic institutions.

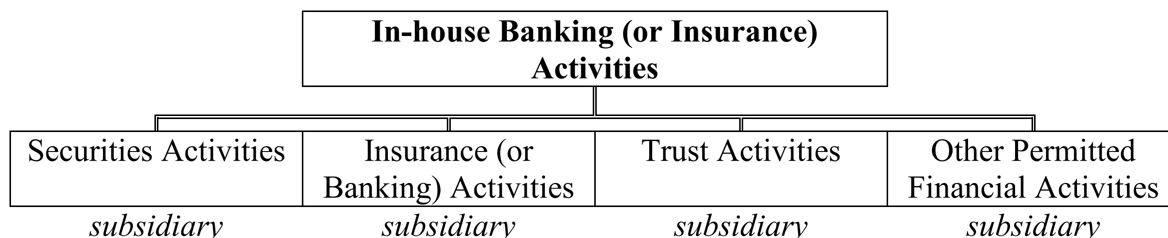
The six remaining sections of this paper:

- briefly review the current structural regime that applies to banks and other financial institutions;
- deal with the changing financial landscape and point out some related issues regarding the need for organizational flexibility in the financial industry;
- review the main prudential risks traditionally associated with financial holding companies;
- provide an overview of the provisions included in Bill C-8;
- examine the international experience with respect to regulation and supervision of holding companies; and
- present conclusions.

CURRENT PERMITTED ORGANIZATIONAL STRUCTURES

Schedule I Banks – Schedule I banks are required to be "widely held," i.e., no shareholder may acquire more than 10% of any class of shares of a Schedule I bank. Mutual insurance companies, by their very nature, are effectively widely held. This restriction ensures that Schedule I banks cannot be owned and controlled by another institution or corporation, or individual. A bank cannot act as a trustee for a trust or underwrite insurance risks, and is limited in the scope of its securities-dealing activities. However, following the 1992 legislative revisions, any regulated financial institution can own any other regulated financial institution as a subsidiary. Thus, a bank can now own investment dealers as well as insurance and trust companies. Because Schedule I banks (and mutual insurance companies) are required to carry on many of those related financial services through subsidiaries, they are *de facto* **operating** financial holding companies.

DIAGRAM 1
THE FINANCIAL INSTITUTION PARENT ORGANIZATIONAL MODEL (ALSO KNOWN AS OPERATING FINANCIAL HOLDING COMPANY) CURRENTLY IMPOSED ON SCHEDULE I BANKS AND MUTUAL INSURANCE COMPANIES



Domestic Schedule II Banks – Domestic Schedule II banks may be closely held by a widely held Canadian financial institution, much like in the diagram above where a bank is a subsidiary of a mutual insurance company. This organizational structure for Schedule II banks does not enable it to circumvent the widely held requirement.

Foreign Schedule II Banks – Foreign Schedule II banks may be closely held by an eligible foreign financial holding company, an eligible foreign bank, or a widely held foreign financial institution. However, foreign Schedule II banks may adopt a variety of structures to conduct financial services in Canada. For example, a foreign bank holding company may carry on regulated financial activities (such as securities-dealing activities) in Canada as the Canadian part of the bank's foreign securities operations, separate from its banking subsidiaries in Canada and abroad. The Minister may require the foreign institution to carry on all regulated financial services in Canada exclusively through a Schedule II bank subsidiary.

Furthermore, a foreign bank may carry on unregulated financial activities in a narrow market segment, such as credit card operations, through an unregulated entity once an exemption order is obtained from the Minister. In 1999, Bill C-67 amended the *Bank Act*, permitting foreign banks to have branch operations in Canada. A foreign bank is now able to conduct wholesale banking activities through a branch of the parent bank as well as retail banking, including retail deposit-taking activities, through a Schedule II bank subsidiary. Foreign banks have the structural flexibility to divide their wholesale banking operations from their retail banking business, and take advantage of the reduced regulatory burden that applies to a foreign bank's branch.

However, "most of the foreign banks in Canada are involved in wholesale banking or niche financing, and their physical presence often consists of a head office and one branch. An exception is the Hongkong Bank of Canada, which has an extensive branch network and accounts for close to one-third of foreign bank assets in Canada."(1)

Other Financial Institutions – The Task Force stated that "there is currently no wide-ownership requirement for trust companies or stock insurance companies and these institutions can be, and often are, owned by holding companies. Such companies are not regarded as financial institutions and are not regulated." For example, federal trust and insurance companies may be owned by unregulated non-financial holding companies. Therefore, these unregulated companies may carry on almost all of the same regulated financial services as banks, through trust affiliates, while still carrying on bank-restricted commercial activities such as automobile leasing in other unregulated affiliates. They thus enjoy a regulatory advantage over banks. In practice, the Task Force stated that "OSFI [Office of the Superintendent of Financial Institutions] obtains undertakings from the owners of financial institutions held by unregulated holding companies. These provide OSFI with reasonable assurance that it can discharge its responsibilities with regard to the safety and soundness of the Canadian-regulated financial institution."

INNOVATIONS IN THE DELIVERY OF FINANCIAL SERVICES, AND THE NEED FOR MORE STRUCTURAL FLEXIBILITY

A. Innovations in Financial Markets

"Traditional" core banking functions have changed considerably in the past century. For example, until 1954, banks were unable to provide residential mortgages. Since then, banks have been gradually taking on new functions as markets changed. As a result of the 1992 legislation, banks are now able to provide insurance, trust, and securities-dealing services through their subsidiaries. The financial markets are in constant evolution, and new products are emerging at an accelerated pace. In recent years, banks have begun to convert loans, such as mortgages and credit card balances, into securities that are sold to investors – a process known as

(1) Department of Finance, "Canada's Banks," September 1999.

securitization. Securitization helps move assets off the balance sheet, reducing the need to hold regulatory capital and allowing investment in potentially higher-yielding opportunities.

As financial markets change and innovate, the role and functions of banks are shifting as well. Traditionally, banks' basic role has been to act as the intermediary between depositors and borrowers. The way banks fulfil this basic function is changing, and will probably undergo even more transformations in the near future. Three of the many factors that are pressing banks worldwide to reorganize and redefine their role are presented below.

Customer Sophistication – Customers are becoming more sophisticated in their demands for financial services, as their preferences and their tolerance for risk change.

> Customers are becoming more involved, more knowledgeable, and more aware of financial product characteristics and provider choices. Their concerns about the potential loss of government- and employer-supported retirement programs, combined with lower inflation and lower returns on deposits, have led them to become more involved in their own investment planning and decisions. With this increasing sophistication, customers have also become more accepting of non-traditional providers and more comfortable with alternative delivery methods, including electronic channels.[(2)]

With the rapid technological change in the information technology and communication (ITC) industry, customers are now able to fulfil most of their investment and banking needs on electronic platforms. As a result, customers have more choices and more convenience, there is less customer loyalty for financial services providers, and the opportunities to integrate a wide range of services under the same umbrella have increased.

Above all, customers have gained access to a much larger pool of financial information and advice, and at a very low cost. As access to convenient information increases, the level of involvement and sophistication in individuals' own investment planning rises as well.

New Delivery Channels and Select Product Lines – Increasingly, consumers are shifting away from their traditional deposit accounts and are investing their savings in other product lines

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(2) McKinsey & Company, "The Changing Landscape for Canadian Financial Services," *Research Paper Prepared for the Task Force on the Future of the Canadian Financial Services Sector*, September 1998, p. 25.

which are close substitutes. For example, consumers can bypass deposit accounts and invest directly in capital markets through mutual funds, stocks, bonds and other instruments. Insurance companies offer products such as deferred annuities, which are similar to Guaranteed Investment Certificates sold by banks. Some other companies specialize in selected product lines, and are able to offer very competitive prices and returns. The advent of Internet banking has opened the door to a truly integrated personal financial management platform, where consumers are able to quickly compare and assess the characteristics of different financial products, empowering these consumers to directly invest in and borrow from the institutions they choose.

E*Trade Group, one example of such branchless financial institutions currently operating in the United States, is composed of:

- a bank (E*Trade Bank, formally Telebank);
- a securities dealer (E*Trade Securities);
- an asset management firm for retail fixed income products (E*Trade Capital Markets); and
- the U.S.'s largest independent ATM network (Card Capture Services Inc., acquired May 2000) with more than 8,800 machines throughout the U.S.

Such Internet-only financial institutions can offer cheaper services. As well, they are able to offer much better interest rates than those offered by traditional "bricks-and-mortar" institutions. For example, E*Trade offers a free Internet chequing account combined with free unlimited bill payments, free cheques and free unlimited ATM operations. Customers can also transfer money into a trading account, where they can directly invest in stocks, mutual funds and other capital market products. Customers are also only clicks away from purchasing insurance products, auto loans, mortgages and credit cards. Everything is processed through the Internet, which saves money and time.

Customers have responded positively to those new institutions. The total assets of E*Trade Bank grew from $1 billion in 1998 to $7.5 billion in 2000, a 750% increase in only two years. Since 1998, at least five other Internet-only banks emerged in the U.S., and they all experienced phenomenal growth.

Globalization – In 1953, the Mercantile Bank of Canada became the first foreign-owned bank to be incorporated in Canada. Since then, the legislation for foreign banking has been considerably liberalized, allowing foreign-owned banks to organize and carry on financial services in much the same way as domestic banks. Forty foreign banks now operate in Canada.

Canadian banks are very active abroad. The Canadian Bankers Association reports that approximately 49% of Canadian bank earnings are currently generated outside Canada. Increasingly, Canadian and non-Canadian banks see the world as their marketplace.

With the advent of new forms of electronic delivery of personal financial services, it will now become easier for foreign business to compete with local providers. Moreover, it makes it easier for non-financial companies and multinationals to offer a select line of financial services to their consumers. Multinationals such as Toyota, GM, BMW and Sony have plans to offer financial products by expanding their operations. These companies are already benefiting from an active global network.

Customer sophistication, financial delivery innovations and globalization have important implications for banks and their primary role as investment intermediary between depositors and borrowers. Deposits represent a large percentage of banks' personal financial services profits, and the shift away from deposits and traditional debt to other investment and debt products means shrinking assets for banks. Increasingly, banks need to reorganize and develop new innovative products to deal with a potential loss in assets and market share.

New consumer preferences also raise questions for regulators. For example, what are the implications for federal deposit insurance if investment activity is shifting increasingly towards non-insured financial products?

B. Competition and the Regulatory Burden

Banks are heavily regulated because of their retail deposit-taking activities, which are typically subject to deposit insurance. As well, they are the primary agents in the payments system, and a failure in one bank could threaten the integrity and efficiency of that system. Regulations are designed to help protect the integrity of that system of deposit insurance as well as maintain the safety and soundness of the financial system, which could be subject to contagion. Other financial institutions which do not take deposits are less regulated, or sometimes not regulated at all. As regulation is costly for financial institutions, this has competitive implications when a non-bank subsidiary of a bank competes in a market segment

with unregulated or less-regulated financial services providers because bank subsidiaries (unlike their unregulated, non-bank competitors) are affected by the capital and other requirements of bank regulation, even though they are not directly involved in deposit-taking activities.

For example, trust companies – which also take deposits – have the additional structural flexibility to organize via an unregulated holding company. These companies do not face the same structural restrictions as do banks; unlike banks, they are permitted to disaggregate functions between regulated and unregulated affiliates. Therefore, federal trusts and other non-bank financial institutions that face the same restrictions on automobile leasing as do banks nonetheless can participate in the leasing market indirectly through an affiliate which is not subject to the same regulations.(3)

> The changing financial markets have also led to the emergence of new participants that compete with traditional financial institutions in select product lines. Independent mutual fund companies are dominant in the mutual fund market, accounting for about two thirds of assets under management. Asset-based lenders, such as Newcourt Credit Group,(4) have emerged as significant competitors in certain commercial credit markets. Such asset-based lenders, because they do not take deposits from individuals, are not regulated institutions. Mutual funds fall under the jurisdiction of provincial securities commissions. Mutual fund companies are regulated, but because market risks are assumed by the investors, regulators focus only on market conduct and not on safety and soundness.
>
> There is a growing dichotomy between activities that are not regulated or less regulated when carried on in some institutions, and more regulated when carried on in others. As markets become more competitive, the cost burden of regulation on the same activities in some institutions and not in competing institutions can affect competition in the marketplace.(5)

The venture capital industry is one example. Independent venture capital corporations are not regulated financial institutions. However, venture capital subsidiaries of

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(3) Canadian Bankers Association, "Structural Flexibility in the Canadian Financial Services Sector," Submission to the Task Force on the Future of the Canadian Financial Services Sector, May 1998.

(4) Please note that Newcourt Credit Group has been acquired by the CIT Group, the largest publicly owned U.S. company in the commercial financial industry, in March 1999.

(5) Task Force on the Future of the Canadian Financial Services Sector, "Organizational Flexibility for Financial Institutions: A Framework to Enhance Competition," Background Paper #2, September 1998, p. 45.

banks are regulated on the same basis as the parent bank, which places additional impediments on them. These impediments include the following:

- the *Bank Act* limits the amount that a bank may commit to equity financing, to 5% of total regulatory capital;
- banks' venture capital subsidiaries are restricted from owning more than 25% of the equity of the companies they invest in;
- banks are required to terminate their investment in ten years, imposing what might be a sub-optimal strategy on the venture capital arm; and
- banks' subsidiaries are taxed fully on their capital gains, unlike regular corporations for which only 66% of the gains are currently taxable.

Other types of venture capital corporations do not face these constraints. Therefore, the regulatory environment creates a playing field that is unequal for venture capital corporations that are subsidiaries of banks. This restricts banks' ability to operate in that marketplace on the same basis as the competition. The Task Force believed that two institutions performing the same functions should have those functions regulated in the same way.

Regarding financial services, Canada has a constitutional division of powers between the federal and provincial governments. The federal government has exclusive jurisdiction over banking and the incorporation of banks. Provincial governments have exclusive jurisdiction over property and civil rights in the provinces and the incorporation of companies with provincial objects. This suggests that the activities of trust and loan companies, insurance companies, securities dealers and financial co-operative institutions that are "provincial" in scope do not fall within federal banking jurisdiction. Therefore, a truly "functional approach" to regulation is, in practice, hard to implement.

Although regulation must continue to be based on institutions, it is possible to move closer to a "functional approach" by allowing more flexible organizational structures for regulated financial institutions. Allowing for the creation of financial holding companies accomplishes this by helping banks to:

- better compete with unregulated financial institutions;
- form joint ventures; and
- reorganize their activities to better tackle and take advantage of innovations in financial markets.

RISKS ASSOCIATED WITH A HOLDING COMPANY STRUCTURE FOR BANKS

Supervisory issues are associated with financial conglomerates, mainly because some institutions within the conglomerate benefit from the government safety net while others do not. Under the current operating holding company regime, the parent and its subsidiaries are regulated on a consolidated basis whereas all the subsidiaries face the same level of regulation. However, under a non-operating holding company regime, some affiliates of the group may not be regulated, or may face a lower regulatory burden than their regulated counterparts.

This might give rise to situations of regulatory arbitrage and moral hazard that were not present under the current regime. Sub-sections A. and B. expose prudential risks present in both types of financial conglomerates regime, while sub-sections C., D. and E. deal with prudential risks mainly present in non-operating holding company regimes, because in such regimes the level of regulatory supervision imposed on deposit-taking institutions can well vary from the regulatory burden faced by the non-bank (and possibly commercial) affiliates.

A. Quality of Capital and Excessive Gearing

The term “excessive gearing” (also known as multiple counting of capital) refers to the fact that:

> […] it is possible for all entities in a group to fulfil their capital requirements on an individual basis, but for the own funds of the group as a whole to be less than the sum of those requirements. Such a situation occurs where the same own funds are used simultaneously as a buffer more than once – i.e., to cover the capital requirements of the parent company as well as those of a subsidiary (and possibly also those of a subsidiary of a subsidiary).[6]

In such circumstances, the evaluation of the total capital of the conglomerate overstates the real value. However, this can be avoided by adopting a consolidated measure of capital adequacy (an illustrative example of that is provided in the appendix).

The quality of capital available in the holding company to support its downstream affiliates is another important issue. This problem can arise where the holding company issues

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(6) Tripartite Group of Bank, Securities and Insurance Regulators (BIS, IOSCO, IAIS), “The Supervision of Financial Conglomerates,” July 1995.

capital instruments of one quality and then uses the proceeds to invest in downstream entities as instruments of a higher quality. On this subject, the OSFI mentions that:

> From a safety and soundness standpoint, the attributes of capital raised by a holding company should, inter alia, be consistent with the attributes of the capital subsequently invested in downstream financial institutions. If this principle is not respected (e.g., if limited-term capital raised by a holding company is reinvested in permanent capital of a financial institution subsidiary), what might appear to be a very well capitalized financial institution could be vulnerable to unexpected pressures from a parent who may be struggling because of the demands imposed by a weaker (i.e., less permanent) capital position.[(7)]

A situation of excessive leverage is an example of that. In this case, the holding company issues debt and uses the proceeds to finance a regulated affiliate in the form of equity or other elements of regulatory capital.

> […] the greater the propensity for a bank holding company to use debt to finance equity investments in its subsidiaries, whether regulated or unregulated, the greater the risk of undue pressure on the regulated financial institution subsidiaries to generate sufficient income and cash flow to support dividend payments required by the holding company to meet its debt servicing requirements. The resulting focus on the need for upstream cash flow could skew management decisions in the regulated financial institutions toward short-term objectives and away from more appropriate long term goals. This kind of situation also puts pressure on management of financial institutions in the group to institute questionable accounting and other practices in order to boost income. When this occurs, the holding company that is expected to be a source of strength for its financial institutions subsidiaries can instead become a destabilizing factor, indeed a source of weakness.[(8)]
>
> […] we have seen several examples of this in Canada with some of the financial institution failures of the last ten years.[(9)]

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(7) Office of the Superintendent of Financial Institutions, "A Proposal Regarding a Bank Holding Company Model," *Submission to the Task Force on the Future of the Canadian Financial Services Sector*, June 1998, p. 7.

(8) *Ibid*., p. 15.

(9) *Ibid*., p. 7.

B. Contagion

Contagion is probably one of the most important issues in a holding company structure. Contagion, or domino effect, occurs when problems in one entity of the group are transferred to other parts. The Bank for International Settlements (BIS) has identified two types of contagion.(10) The first of these essentially relates to market perception, where financial difficulties in one part of the group results in a drop in public confidence in other entities of the holding, notwithstanding their individual financial situation. The reluctance of capital markets to deal with a tainted group can significantly impair the holding company's ability to capitalize its liquidity-restrained subsidiaries.

The second type of contagion relates to the potential transfer of capital from the regulated entity, as might occur when it attempts to rescue another group member from financial difficulties. Such intra-group transfers may be evident, as in the case of loans, investments and guarantees, or may be hidden through biased pricing of intra-group transactions. The BIS noted that intra-group exposures can significantly exacerbate problems for a regulated entity once contagion spreads to it.

> OSFI has experienced a number of cases where financial difficulties afflicting a closely-held financial institution were precipitated or accentuated by problems in upstream holding companies and/or other parts of the conglomerate structure. Each situation varied depending on its own particular circumstances, but it has been recognized that contagion played a role in the downfall of a number of financial institutions in Canada and elsewhere.(11)

C. Abuse of Regulated Safety Net

In a holding company structure where different entities face different levels of regulation, there is an obvious risk of regulatory arbitrage, i.e., the shifting of certain activities within a conglomerate, either to avoid a situation of relatively more strict prudential supervision compared to another, or to abuse from the safety net linked to some financial institutions. Also,

(10) Tripartite Group of Bank, Securities and Insurance Regulators (BIS, IOSCO, IAIS), "The Supervision of Financial Conglomerates."

(11) Office of the Superintendent of Financial Institutions, "A Proposal Regarding a Bank Holding Company Model," p. 8.

there can be management bias at the holding company level to influence banks and other regulated financial institutions to support other unregulated affiliates.

> Some believe that, where a conglomerate structure includes both financial institutions that benefit from the safety net and other unregulated financial service entities that do not, there is an incentive to place riskier loans and investments in the regulated financial institutions and higher quality assets in the unregulated entities. The premise for this argument is that the latter entities may be more sensitive to market scrutiny because of the nature of their funding activities and their lack of direct access to the safety net.(12)

D. Commercial Links and Self-dealing

Commercial links between controlling shareholders at the holding company level (this applies especially to closely held conglomerates) and other non-financial entities can lead to conflicts of interests, where the resources of regulated financial institutions are unduly used for shareholders' other commercial interests, to the detriment of the financial institution.

> The potential for conflicts of interest in a financial conglomerate is heightened when investors with substantial holdings in the conglomerate have contractual relationships with businesses in the group. In many financial conglomerates – although not necessarily confined to them – there is a distinct possibility that shareholders' interests may conflict with the interests of creditors, particularly those whom the supervisor has a duty to protect.(13)

However, the government has historically supported the separation of banking and commerce by requiring domestic banks to be widely held (the 10% rule), which avoids potential conflicts of interest.(14)

> The concern that financial institutions can be abused by way of non-arms-length transactions with significant shareholders or affiliated entities has long been a concern associated with closely-held financial institutions. As already noted, one of the benefits of the 10% rule has

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(12) *Ibid*., p. 8.

(13) Tripartite Group of Bank, Securities and Insurance Regulators (BIS, IOSCO, IAIS), "The Supervision of Financial Conglomerates."

(14) However, we haven't had the 10% rule for some other deposit-taking institutions (such as trusts), or insurance companies.

> been to ensure that no single shareholder can unduly influence a bank. However, even under a widely-held holding company structure, a bank is likely to have both regulated and unregulated affiliates, and the risk of transactions taking place that may benefit some parts of the group to the detriment of the bank or other financial institutions in the group cannot be discounted.[15]

E. Public Perception

OSFI noted that there is a possibility that:

> […] the public could perceive all entities, regulated and unregulated, that are part of a bank holding company group, as benefiting from the government safety net. This could arise due to the fact that major components of the group (a bank or other financial institution, and possibly the holding company) would be regulated. As a result of this perception, creditors of a financially troubled unregulated bank affiliate in the group could expect the regulator to take action to protect their interests when, in fact, the regulator is more likely to be taking action to protect the depositors, policyholders, and other creditors of the bank and other financial institutions in the group. Indeed, OSFI's mandate could lead it to take actions that are at odds with the interests of the unregulated entities in the group and their shareholders and creditors.[16]

Moreover, if the Superintendent extends his/her regulatory supervision to include the unregulated entities, there is a risk of reinforcing the public perception that the unregulated entities are somewhat covered by the government safety net as well. Despite the lack of an immediate solution to this problem, OSFI pointed out that initiatives designed to broaden the regulatory oversight to include unregulated entities "may need to be accompanied by other measures designed to mitigate against the risk of casting a 'regulatory aura' over the whole group."[17]

Finally, the use of nearly identical corporation names within a holding company group composed of both regulated and unregulated affiliates, or an unregulated controlling holding company, can further confuse public perception. Canada experienced some of these

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(15) Office of the Superintendent of Financial Institutions, "A Proposal Regarding a Bank Holding Company Model," p. 9.

(16) *Ibid.*, p. 9.

(17) *Ibid.*, p. 9.

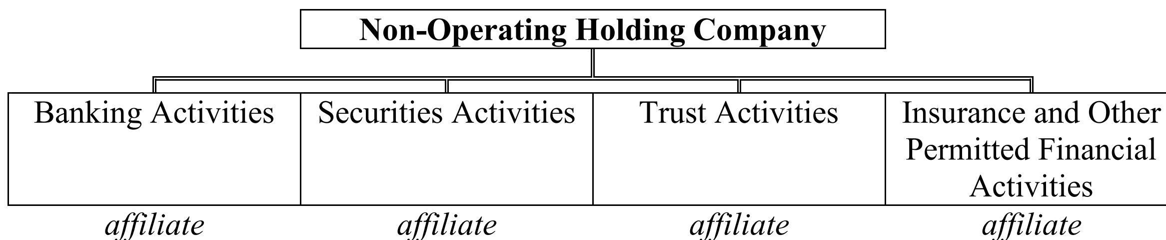
problems in the past where confusion surrounded financial conglomerates which possessed a regulated trust company somewhere in the empire. The Parliamentary Sub-Committee on Financial Institution submitted the following thoughts in its 1992 Fourth Report to the Committee:

> Investors assess different institutions differently and would attach different levels of risk to a financial holding company as opposed to a regulated trust company. The assessment on the part of investors is made more difficult when the trust is called Central Guaranty Trust Company while the management company is called Central Guaranty Trustco. The names of associated companies should be able to reflect such associations, but they should not mislead. We see the use of the word "trustco" as serving no useful purpose while leading to much confusion.(18)

THE PROPOSED LEGISLATION

Bill C-8 proposes to allow for the creation of non-operating bank holding companies. Because holding companies would be required to be non-operating, they would only be allowed to acquire, hold and administer permitted investments, and to provide management, advisory, financing, accounting and information-processing services to entities in which they have a substantial investment. They would not be permitted to undertake any core banking or financial services such as credit assessments.

DIAGRAM 2
THE NON-OPERATING FINANCIAL HOLDING COMPANY MODEL



(18) Sub-Committee on Financial Institution, "Financial Institutions Legislation," Report to the Committee, Fourth Report, December 1992, p. 16:11-12.

The permitted investments for bank holding companies would be the same as for banks. Moreover, a bank holding company and its subsidiaries could only acquire shares or ownership interests of an entity, other than permitted investments, up to a point that the aggregate value of those ownership interests, plus the value of its interests in or improvement to real property, did not exceed the prescribed percentage of its regulatory capital. Finally, a bank holding company could not hold more than 10% ownership of a non-financial entity.

Existing banks could convert to a bank holding company structure. The ownership structure of the bank would automatically become the ownership structure of the bank holding company. The bank holding company would also be required to own a majority of the shares of its bank subsidiary, which would result in *de jure* control of the bank. Other regulated affiliates would be subject to control "in fact," where a minority of shares can be held, but control can nevertheless be exercised by direct or indirect influence. The same control restrictions would apply to affiliates that engaged, as part of their business, in any financial activity that exposed the entities to material or credit risk (e.g., credit cards, small business loans, consumer loans).

Bank holding companies would be divided into three main classes: ones with equity of $5 billion or more, ones with equity of between $5 billion and $1 billion, and ones with equity of less than $1 billion.

A bank holding company with equity of $5 billion or more would have to be widely held, i.e., no shareholder could hold more than 20% of any class of voting shares, and no more than 30% of any class of non-voting shares. Moreover, the widely held requirement would apply to the total direct and indirect ownership of a bank subsidiary that is itself controlled by a widely held bank holding company with equity of $5 billion or more:

1. other than the controlling bank holding company, no other shareholder could hold more than 20% of any class of voting shares of the bank subsidiary, and no more than 30% of any class of non-voting shares;

2. no shareholder who held more than 10% ownership of the bank holding company could also hold more than 10% of the bank subsidiary.

This would mean that no single investor would be able to use the holding company to exceed bank ownership restrictions for widely held banks.

Bank holding companies with equity under $5 billion could be owned and controlled by a commercial enterprise. However, bank holding companies with equity of $1 billion or more would be required to maintain a 35% public float of voting shares, i.e., 35% of voting shares would be traded on a recognized stock exchange in Canada and not owned by any major shareholder. Finally, bank holding companies with equity of under $1 billion would have unrestricted choice in ownership structure.

The bank holding company would be subject to consolidated supervision. The Superintendent of Financial Institutions could request, by order, information and documents from the bank holding company or any of its affiliates, to review both financial and non-financial activities conducted under the holding company. From time to time, the Superintendent could examine and inquire into the business and affairs of each holding company. If necessary, the Superintendent could order the bank holding company to undertake necessary actions to comply with regulations, or to remedy a situation believed to be prejudicial to the interests of depositors, policyholders or creditors.

The holding company group would be subject to consolidated capital adequacy requirements, and the Superintendent could require the holding company to increase its capital and liquidity where circumstances warranted. Also when warranted, the Superintendent could, by order, direct a bank holding company to divest a subsidiary or other investments.

When a contract was being considered by a bank holding company, any director or officer who was in a conflict of interest would have to disclose in writing, or request to have entered in the minutes of the meetings, the nature and extent of that personal interest. Moreover, the director would have to be absent from any meetings of directors while the contract was being considered (some exceptions would apply). Ultimately, the Superintendent could, by order, remove from office a director or senior officer of a bank holding company if the Superintendent believed that this person was not suitable to hold that office.

Finally, a bank holding company would not be permitted to adopt a name that is substantially similar to that of a bank unless the name contained words that, in the opinion of the Superintendent, indicated to the public that the bank holding company was distinct from any bank that was its subsidiary. Moreover, every bank holding company would have as part of its name the abbreviation "bhc" or "spb."(19)

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(19) BHC is the acronym for Bank Holding Company and SPB is the French acronym for Société de Portefeuille Banquaire.

FINANCIAL HOLDING COMPANY LEGISLATION AROUND THE WORLD

OSFI commissioned a study of the legislation and regulation of financial holding companies in foreign jurisdictions.[20] This section reviews the main conclusions of this study that relate to the proposed legislation in Canada.

Non-operating financial holding companies are commonly found in other countries, and some jurisdictions go as far as to require the establishment of such holding companies when different non-banking businesses are bundled with banks. However, financial conglomerates in many countries have a variety of options in how they may organize their activities, and they have responded by choosing a variety of organizational structures. There is thus no empirical evidence that the holding company structure is necessarily more efficient than other structures, provided that rules governing all types of structures are similar.

A. Supervision

All around the world, financial holding companies are highly supervised and regulated. The key concern is to protect depositors and policyholders, and to ensure the stability of the financial system. In some instances, for example in the U.S., the mandate of supervisors includes consumer protection.

Most jurisdictions have adopted the principles of consolidated regulation and supervision at the top of the holding company structure. In terms of capital adequacy, both the capital of the consolidated holding company and its affiliate entities are examined. This is consistent with the proposed legislation.

Bill C-8 also proposes to give the necessary powers to the Superintendent to permit ongoing access to a wide range of information concerning the financial business of holding companies and their affiliates. This practice is similar to that in other countries.

The European Commission specifies that the aggregate value of inter-company transactions for credit institutions (or bank holding companies) should not exceed 25% of the

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(20) The study, "Current Thought on the Regulation and Supervision of Financial Holding Companies and Lessons from Foreign Regulatory and Supervisory Jurisdictions," prepared by Gordon Roberts of York University and Lawrence Kryzanowski of Concordia University, is part of an OSFI submission to the *Task Force on the Future of the Canadian Financial Services Sector*, June 1998.

group's equity. This is to limit the level of exposure a bank has to a single client, or a group of connected clients, as well as to control affiliates' transactions to limit the risks of contagion.

In Canada, the proposed legislation would impose a limit on the value of the transactions that a bank may enter with an affiliate[(21)] (under the same holding company umbrella) to 5% of the bank's regulatory capital. Furthermore, the limit would be at 10% for all the transactions with all of the affiliates.[(22)]

B. Ownership Rules

A major change included in this legislation is the new size-based ownership regime that would apply to banks and bank holding companies. The bill proposes to allow for small- and mid-sized bank holding companies to be closely held and controlled by commercial or financial interests, subject to a "fit and proper" test. Large institutions would have to remain widely held, but the limit on ownership by a single shareholder would be increased to 20%, from the current 10%. Thus, there is a clear intention in this bill to allow individual shareholders to have a greater stake in financial institutions. This would favour strategic alliances within Canadian institutions, but also with foreign institutions which could facilitate expansion in cross-border financial services. This new ownership regime would also be in line with the international experience.

> Countries differ in their practices concerning closely held financial holding companies. Many jurisdictions are not concerned over this matter. Regulators and supervisors in Germany, for example, have no thresholds for reporting changes in a bank's ownership and control. Similarly, in the U.S., both closely and widely held holding companies are allowed. In practice, in that country, closely held holding companies are far smaller in size and are often family owned. In most countries surveyed, regulators and supervisors believe that closely held financial institutions pose little problem as long as the ownership structure is transparent. Close relationships that could hamper the task of regulation and supervision are prohibited in Denmark and monitored in other countries through "fit and proper" tests.

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(21) Except if this affiliate is a trust company, a loan company, an insurance company or a bank, licensed under a federal Act.

(22) *Ibid*.

> Technically, foreign ownership or control is not legally prohibited in most countries although some (e.g., U.K.) have unwritten rules discouraging foreign ownership of major clearing banks. At the other end of the scale are countries which require financial institutions to be widely held. In Australia, for example, there is a 10% ownership limit. However, this restriction can be waived by the government. […] Norway also has a 10% rule which applies to a holding company if it has a wholly owned bank subsidiary.
>
> Whether or not they allow financial institutions to be closely held, most jurisdictions require notification when ownership changes. In reacting to such notices, regulators and supervisors are concerned about the regulatory and supervisory regime in the home country in the case of applications from foreign banks. They also assess the roles of key individual controllers of those licensed banks. Similar rules are common in insurance regulation and supervision.(23)

On the other hand, most jurisdictions recognize that commercial ownership of credit institutions poses some concerns. For that reason, such arrangements are generally allowed only in special cases that generally involve smaller institutions. In Europe, many countries(24) comply with the European Commission Second Banking Directive which subjects to regulatory consent any ownership position in a credit institution of more than 10% of the voting rights, or any significant influence over its management. Switzerland imposes no restriction on non-financial ownership of banks.

This move toward more flexibility allows commercial groups such as supermarket chains (e.g., Sainsbury in the U.K., Loblaws in Canada) and telecommunication firms to form conglomerates that include banks and insurance companies. New information technologies are contributing to a widening of competition in the delivery of financial services, making it easy for other firms, institutions and organizations to do the same. Consequently, new competitors seem to be coming from every sphere of commercial business.

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(23) Kryzanowski and Roberts, "Current Thought on the Regulation and Supervision of Financial Holding Companies and Lessons from Foreign Regulatory and Supervisory Jurisdictions" (June 1998).

(24) The list includes: Austria, Belgium, France, Germany, Greece, Ireland, Luxembourg, Netherlands, Portugal, Spain, and United Kingdom.

C. Permitted Investments

Generally, bank holding companies are allowed to diversify across a broad range of investments in non-banking financial activities. Sometimes, this can only be done through a non-operating holding company structure, but many jurisdictions permit a variety of organizational structures.

The most common restriction prohibits the underwriting of insurance risks in deposit-taking institutions. Insurance risk must be underwritten in a separate legal entity. The sale of insurance products is a completely different matter. For example, in the U.S., France, Netherlands, Norway, Belgium and Switzerland, banks may sell the insurance products of a subsidiary or affiliated insurance company through their branch network. However, banking and insurance underwriting cannot be combined in the same legal entity.

Traditionally in North America, regulators and supervisors separated banking from commerce. In the United States, a bank holding company can participate in the capital of non-financial firms, but the investment is not permitted to account for more than 5% of the firm's outstanding voting shares. Likewise, in Canada, the proposed legislation would prohibit bank holding companies from controlling more than 10% ownership of a commercial firm, and the holding company could not commit more than the prescribed percentage[25] of its regulatory capital to all investments in commercial entities.

On the other hand, some jurisdictions permit bank holding companies to control commercial enterprises.

> In Australia, at least one bank has diversified into non-financial enterprises. In the U.K., the Bank of England's tolerance for commercial activities by financial holding companies is high especially when such activities involve smaller financial institutions. Concern arises only when such activities distract from the sound management of the holding company. At the other extreme, Switzerland discourages mixed conglomerates by requiring them to hold far higher levels of capital.[26]

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(25) The percentage is left for regulation.

(26) Kryzanowski and Roberts, "Current Thought on the Regulation and Supervision of Financial Holding Companies and Lessons from Foreign Regulatory and Supervisory Jurisdictions."

Not all countries regulate the association between banking and commerce as restrictively as in Canada and the United States. The European Commission (EC) Second Banking Directive does not prevent a bank from owning a non-financial firm, but the size of qualifying investments is limited to no more than 15% of a bank's own funds for investment in a single firm, and no more than 60% for all investments in non-financial firms. Many European countries – including Austria, Finland, France, Germany, Greece, Ireland, Luxembourg, Netherlands, Spain and the U.K. – adopted this EC Directive. Belgium adopted more restrictive rules.

D. Corporate Governance

Restrictions on the structure of boards of directors are common. Such rules may stipulate a minimum number of directors on the board and may put restrictions on the number of directors who are employees of, or affiliated with, the bank holding company. Nearly all legislation contains the power to deny the nomination of directors and officers or to remove them from office, based on a test of competence, experience, conduct and overall fitness. Canadian legislators impose similar rules on directors and officers.

CONCLUSION

In many respects, the proposed legislation responds adequately to the prudential concerns enumerated in the earlier section "Risks Associated with a Holding Company Structure for Banks." It is also consistent with international regulations and supervision principles, although some facets are more restrictive. Except for the prohibition of the sale of insurance products in bank branches, the Canadian legislation on holding companies resembles that of the United States.

On the other hand, it is still uncertain whether the bill's proposals will improve banks' ability to face competition and respond more efficiently to innovations in financial markets. Many details are left to regulations, and the bill is designed to be neutral (in the sense of powers and investments) with respect to organizational structure. Until the regulations are known, it is difficult to assess to what extent the regulatory burden on bank affiliates will be lessened, especially those affiliates that would otherwise be unregulated institutions.

APPENDIX

ILLUSTRATIVE EXAMPLE OF MULTIPLE COUNTING OF CAPITAL[27]

This example illustrates a situation of multiple counting of capital. The parent is a bank which owns completely an insurance company which in turn owns completely a securities firm.

Bank (Parent Company)

Assets		**Liabilities**	
Loans	9,000	Capital	1,500
Book value ownership in:		General reserves	500
Insurance Company B1	1,000	Other liabilities	8,000
Total	*10,000*	*Total*	*10,000*
Capital requirement: 1,500			

Insurance Company B1 (Subsidiary)

Assets		**Liabilities**	
Investments	5,000	Capital	1,000
Book value ownership in:		General reserves	500
Securities Firm B2	500	Technical provisions	4,000
Total	*5,500*	*Total*	*5,500*
Capital requirement: 800			

Securities Firm B2 (Subsidiary)

Assets		**Liabilities**	
Investments	4,000	Capital	500
		Reserves	250
		Other liabilities	3,250
Total	*4,000*	*Total*	*4,000*
Capital requirement: 400			

Without accounting for the consolidated corporate structure in measuring capital adequacy, it appears that capital requirements for the individual entities in this group are met. However, a portion of the capital of the parent bank, i.e., the amount of 1,000 invested in

(27) This is a slightly simplified version of a similar example figuring in a supplement to the *Capital Adequacy Principles* paper published by the Basle Committee on Banking Supervision, http://newrisk.ifci.ch/143570.htm

Insurance Company B1 is levered twice, once in the bank and again in the insurance company B1 (double counting of capital). Furthermore, the amount invested by B1 in the securities firm B2 (500) which has already been levered twice is now being levered a third time, in the securities firm (when capital is being levered more than twice, it is said to be an instance of multiple counting).

On the face of it, the group has total capital and reserves of 4,250 to cover total capital requirements of 2,700. If the multiple counting is eliminated, the adjusted capital and reserves reduce to 2,750 leaving a surplus of only 50 over the capital requirements of 2,700.

Group's Capital Adequacy

Individual Measurement		**Consolidated Measurement**	
Total Capital and Reserves	4,250	Total Capital and Reserves	2,750
Total Capital Requirement	2,700	Total Capital Requirement	2,700
Balance	*1,550*	*Balance*	*50*