

14. Banking and Financial Services

Canada’s financial system provides a stable and effective infrastructure for financial services entities in Canada conducting business within the country and around the world. An independent central bank administers an anti-inflationary monetary policy and expedites inter-bank operations. Chartered banks and trust companies provide deposit, credit and payment services. Stock exchanges provide a market to trade securities and investment dealers arrange financing for governments, institutions and corporations, and buy and sell securities for their customers. Insurance companies offer protection against a wide range of risks. In all, the financial industry employs over 600,000 Canadians.

The Bank of Canada

The Bank of Canada is the country’s central bank. It independently conducts the usual central bank functions, including the issuance of currency. It provides services to the government by honoring government cheques. It operates in foreign exchange markets to stabilize the Canadian dollar.

The Bank of Canada also governs monetary policy. The bank’s anti-inflation policies seek to keep the rate of inflation inside a target range established jointly with the Canadian government. Since 1993, the target range has been 1% to 3%. Principal purposes of this target range are to make the bank’s monetary actions more understandable to financial market participants and to the general public, and to serve as a measure for the evaluation of the effectiveness of the bank’s monetary policy.

The “bank rate” is regarded as a key indicator of monetary policy. This is the rate at which the Bank of Canada makes overnight loans to chartered banks. It is widely used by major money market

participants as a basis for their own short-term transactions.

Chartered Banks

Canada’s banking system has had a long history of stability. Twenty-one domestic banks are chartered and regulated by the federal government. The chartered banks provide deposit facilities, money transfer services, credit and a variety of investment services. As of March 31, 2006, Canada’s six largest domestic banks had total assets of CAD \$1,955.1 billion, as set out in the following table:

Canada’s Domestic Banks, 2006	
	Assets in CAD \$ billions
Royal Bank of Canada	503.6
Toronto-Dominion Bank	393.5
Bank of Nova Scotia	346.0
Bank of Montreal	314.5
Canadian Imperial Bank of Commerce	289.8
National Bank of Canada	107.6

Source: Office of the Superintendent of Financial Institutions

Canada’s major domestic banks and some foreign bank-owned bank subsidiaries have a highly developed network of branches. As of September 2004, there were approximately 46,200 shared ABMs in the Interac network in operation in Canada. Canada ranks first in the world in per capita usage of automated banking machines and debit card services.

Canadian banks are also very active in foreign markets. As of March 2006, foreign currency assets represented approximately 40% of total assets of Canada’s domestic banks.

Foreign banks are active in Canadian financial markets, with 22 active

subsidiaries, 24 foreign bank branches, and 33 representative offices. The subsidiaries and the foreign bank branches largely provide wholesale banking services and business lending rather than retail services.

Insurance Companies

Insurance companies sell annuities and issue policies for life, health and property and casualty insurance. There are presently about 105 life and health insurance companies and more than 200 property and casualty insurance companies operating in Canada. Most insurers have chosen to incorporate under the federal *Insurance Companies Act*.

Financial regulation and market regulation are the two components of insurance regulation in Canada. Financial regulation governs the corporate structure of insurers, and the financial and reporting aspects of their operations. Both the federal and provincial governments engage in the financial regulation of the insurance companies incorporated in their jurisdictions. Market regulation governs the relationship between insurers and insureds, including the form and content of policies and the market practices of insurers. Provincial governments regulate the market conduct of all insurance companies and insurance agents and brokers operating in their jurisdictions.

Life insurance companies are active in financial markets. They manage segregated investment funds and pension funds. They are not permitted to take deposits, but they compete with banks and other financial institutions in the provision of medium-term to long-term financing. Property and casualty insurance companies underwrite property, liability and various other kinds of non-life insurance. These companies require

liquid assets and generally deal only in readily marketable securities.

Trust and Loan Companies

Most trust and loan companies are incorporated under the federal *Trust and Loan Companies Act*. Many of these institutions take deposits and offer loans; in some respects, they compete with chartered banks. As with insurance companies, the financial regulation of a trust and loan company is overseen by its jurisdiction of incorporation, but market regulation, to varying degrees, is undertaken by each provincial jurisdiction in which the trust and loan company operates.

There are 68 trust and loan companies incorporated at the federal level, of which over half are owned by chartered banks or other financial institutions. Many of them specialize in making loans secured by mortgages. Trust and loan companies are substantially less active internationally than banks.

Credit Unions and Caisses Populaires

Credit unions and, in Quebec, caisses populaires are provincially incorporated cooperative financial services providers. While active across Canada, the credit union movement is strongest in western Canada and Quebec. Canada has the world's highest *per capita* membership in the credit union movement, with over 10 million members. The fundamental governance principle of every credit union is democratic ownership; every member has at least one share and one, but no more than one, vote. Credit unions' member services focus on residential mortgage lending and consumer credit and deposit services. They hold approximately ten per cent of the domestic assets of Canada's deposit-taking institutions.

As the middle tier of the national credit union system, eight provincial credit union centrals and, in Quebec, a federation of caisses populaires provide liquidity and operational support at a provincial level to member credit unions and caisses populaires. Six of those provincial centrals have chosen to register under federal legislation in addition to being regulated provincially.

The Credit Union Central of Canada oversees system liquidity at a national level and is federally regulated.

Government Financial Institutions

Government financial agencies are mainly focused on providing assistance to small and medium-sized enterprises. They complement rather than compete with private sector institutions, typically by providing loan guarantees. The most important federal financial institutions are the Business Development Bank of Canada (BDC) and the Export Development Corporation (EDC).

The BDC provides loans, loan guarantees, export financing and venture capital as well as management counselling and training. It operates mainly through strategic alliances with some of Canada's leading banks. For the fiscal year 2005, the BDC served more than 24,000 Canadian small and medium-sized businesses and the total financing authorized reached \$2.3 billion. The value of financing authorized increased by 9% from the previous year.

The EDC has a mandate to help Canadian companies to become more competitive in export markets. It provides a wide range of financial services, including export credit insurance, sales and project financing and export guarantees.

Venture Capital Funds

Venture capital is available in Canada through labour-sponsored investment funds, private firms, private equity funds, government-assisted funds and other sources including angel investors. Venture capital providers invested approximately CAD \$1.8 billion in Canada in 2005, an amount on par with 2004 levels. Although twenty-four per cent of the funds raised were directed at the life sciences sector, Canada maintains an international reputation as a place to raise capital for junior mining, oil and gas, and other resource-based projects.

Investment Dealers

Canadian investment dealers underwrite public offerings of securities, and buy and sell securities in the secondary market on behalf of their clients. A Canadian investment dealer may also sell securities on an exempt basis to corporations, institutions and other high net worth investors. Consistent with the mandate of promoting investor confidence and protection, Canada's provincial securities legislation is less stringent with respect to private placements than it is with respect to public issues.

Each Canadian province and territory has its own securities regulatory authority. Collectively, they are known as the Canadian Securities Administrators (CSA) and work together to regulate Canada's securities markets. Various initiatives are currently being considered to try to create a more cohesively regulated national securities market, although implementing ideas or initiatives, or reaching a consensus among securities regulators remains a challenge.

The Investment Dealers Association of Canada (IDA) is the national self-regulatory

organization that, in conjunction with the CSA, regulates investment dealers in Canada. Over 200 investment dealers are members of the IDA, including subsidiaries of major foreign companies. IDA members account for approximately 97% of the Canadian securities industry's revenues and capital. Plans are currently underway to merge the IDA with Market Regulation Services Inc. (RS). RS regulates trading activity on Canada's major stock exchanges.

Stock Exchanges

TSX Group Inc. owns and operates Canada's two national stock exchanges - the Toronto Stock Exchange, which serves the senior equity market, and the TSX Venture Exchange, which serves the small capitalization equity market. The Toronto Stock Exchange is fully automated and, combined with the TSX Venture Exchange, represents the third largest stock exchange in North America and the seventh largest in the world. In November 2002, the common shares of TSX Group Inc. began to trade on the Toronto Stock Exchange, representing the first public listing of a North American stock exchange.

The Montreal Exchange (ME) is Canada's principal market for trading derivative instruments. The ME offers a wide range of equity, interest rate and index derivatives to investors to protect and ensure the growth of their investments. The ME is the facilities manager and a major shareholder of the Boston Options Exchange (BOX), a U.S. equity options exchange, which was launched in 2004.

Mutual Funds

The Canadian mutual fund industry currently manages over CAD \$600 billion in assets for Canadian investors. The Mutual Fund Dealers Association of Canada

(MFDA) is the national self-regulatory organization that, in conjunction with the CSA, regulates mutual fund dealers in certain provinces of Canada. Effective July 1, 2005, the not-for-profit MFDA Investor Protection Corporation was commenced, creating a compensation fund to protect investors in the event of a MFDA member's insolvency. There are currently 176 members of the MFDA.

Regulatory Issues

Both the federal and provincial governments regulate aspects of the financial services sector. The federal government is exclusively responsible for the regulation of banks. The principal federal regulatory and supervisory institutions are the Department of Finance, the Bank of Canada, the Office of the Superintendent of Financial Institutions, the Canada Deposit Insurance Corporation and the Financial Consumer Agency of Canada. The provinces regulate stock exchanges, securities dealers, capital markets located in their jurisdictions and play a role in regulating financial services providers, other than banks.

Federal regulatory reforms effected in 1987, 1992, 1997, 1999, 2001, and 2005 have removed many of the boundaries between the traditional branches of the financial services sector. Banks, trust and loan companies, investment dealers and insurance companies are now allowed to develop new products and, in many cases, compete with each other by establishing or acquiring subsidiaries in the other financial services sectors. Banks and trust companies can now serve the market for securities and other types of investment. All the major domestic banks now own securities firms, trust companies and/or insurance companies. In general, there is greater flexibility than ever before for financial institutions to form joint ventures.

In March 1999, federal legislation permitting large Canadian life insurance companies to demutualize came into force. Since then, four federal and two provincial mutual life insurance companies have demutualized, giving them greater access to capital.

In June 1999, legislation permitting foreign banks to establish full-service or lending branches in Canada came into force. Foreign bank branches now enjoy essentially the same business powers as domestic banks and foreign bank subsidiaries, except for deposit-taking. Subject to limited exceptions, full-service foreign bank branches cannot take deposits under \$150,000, and lending branches cannot take any deposits. As of May 2006, 24 foreign bank branches have been established, a number of which represent “conversions” of their Canadian bank subsidiaries to branches.

In October 2001, after years of study, substantial revisions to federal financial institutions legislation came into force. The legislation provides domestic and foreign companies, who are seeking to invest in Canadian financial institutions, with significant opportunities to enter into strategic alliances or make acquisitions.

The 2001 legislation imposes different ownership rules for large, mid-sized and small banks, and demutualized life insurance companies. Large institutions have more than CAD \$5 billion in equity, mid-sized ones between CAD \$1 and CAD \$5 billion, and small ones under CAD \$1 billion. An investor is now permitted to hold over 10% and up to 20% of the voting shares of large banks and demutualized life insurance companies, and over 10% and up to 30% of the non-voting shares of those institutions. These investments will be subject to approval by the Minister of Finance, and the

investor meeting a “fit and proper” test. An investor is also permitted to acquire up to 65% of the outstanding voting shares of a mid-sized bank or demutualized insurer, while the remainder must be publicly traded on a Canadian stock exchange. An investor may wholly own a small bank and all other insurance companies.

The 2001 legislation also allows banking and insurance groups to operate using a regulated holding company structure, although to date none has been incorporated. Further, banking and insurance groups are permitted greater flexibility and broader scope for their substantial investments. Depending on the nature of their investment, control in fact and/or in law may be required. Life insurance companies, securities dealers and money market funds have been given access to the Canadian payments system operated by the Canadian Payments Association.

The latest revisions to financial institutions legislation, Bill C-57, *An Act to amend certain Acts in relation to financial institutions*, received Royal Assent on November 25, 2005. The Act is to be brought into application in three phases with the first phase having come into force on April 27, 2006. Along with numerous technical changes, the first phase of the legislation affords directors a due diligence defence more in line with the common standard by which a director’s duty of care is measured, and expands the eligibility of medium-sized insurers and trust and loan companies to apply for an exemption from the requirement to float 35 per cent of their voting shares on a stock exchange. Phases two and three of the amendments will clarify the roles of directors, modernize government practices, enhance the rights of shareholders, and increase disclosure of information in respect of participating and adjustable life insurance policies.

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Further revisions to federal financial institutions legislation are expected to be introduced in Parliament later in 2006.

Canada recognizes that the regulatory environment must continually adapt to meet the challenges of the rapidly changing global financial services industry.