Submission on Bill C-67

Bank Act and Related Amendments (Foreign Bank Entry into Canada)

NATIONAL BUSINESS LAW SECTION
CANADIAN BAR ASSOCIATION

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PREFACE

The Canadian Bar Association is a national association representing over 35,000 jurists, including lawyers, notaries, law teachers and students across Canada. The Association's primary objectives include improvement in the law and in the administration of justice.

This submission was prepared by members of the Financial Institutions Committee of the National Business Law Section of the Canadian Bar Association, with assistance from the Legislation and Law Reform Directorate at National Office. The submission has been reviewed by the Legislation and Law Reform Committee and approved as a public statement of the National Business Law Section of the Canadian Bar Association.

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I. INTRODUCTION

This submission concerns Bill C-67 (the Bill), *An Act to amend the Bank Act, the Winding-Up and Restructuring Act and other Acts relating to financial institutions and to make consequential amendments to other Acts.* The Bill is intended to allow foreign banks to branch directly into Canada. We identify technical issues with the Bill and point to certain areas where the federal government's policy objectives, as outlined in the Department of Finance's press release and related documents,[1] may not be fully addressed.

The issues in this submission are addressed in the order in which they arose in the press release, related documents and the Bill.

II. OPERATING A LENDING BRANCH AND A FULL SERVICE BRANCH OR A FOREIGN BANK SUBSIDIARY

The branching regime is designed to give foreign banks the same opportunities to compete in the Canadian financial services market as Canadian financial institutions.[2] According to the Backgrounder, because Canadian banks are subject to full regulation and are not permitted to establish lighter-regulated financial

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1 Department of Finance, News Release 99-016, "Government Introduces New Legislation to Allow Foreign Banks To Branch Directly Into Canada," including "Backgrounder on Foreign Bank Entry Bill," February 11, 1999.

2 "Backgrounder on Foreign Bank Entry," *ibid*.

institutions to serve particular market niches, foreign banks that choose to operate a lighter-regulated lending branch will not also be permitted to operate a fully-regulated bank subsidiary or a full-service branch.[3]

We do not comment on those policy objectives. However, in our view, the current *Bank Act* already contains enough flexibility for Canadian banks to establish lighter-regulated institutions to serve particular market niches with regulatory approval. In particular, section 468(1)(m) permits a Canadian bank to incorporate or acquire a body corporate whose activities are ancillary to the business of the bank with approval of the Minister of Finance under section 468(3) of the *Bank Act*. A July 1997 draft guideline of the Office of the Superintendent of Financial Institutions (OSFI) entitled "Ancillary Activities" indicates OSFI's view that an entity making loans is not engaged in activities which are ancillary to the activities of a bank and therefore cannot seek approval under section 468(1)(m) of the *Act*. However, if OSFI changed this draft interpretation guideline to permit Canadian banks to establish lending subsidiaries, the branching regime could also be changed to enable foreign banks to operate a lending branch on the one hand and a full-service branch and/or a foreign bank subsidiary on the other.

From a capital perspective, allowing foreign banks to have lighter-regulated branches would not give them a competitive advantage over Canadian banks. Neither a Canadian bank nor a foreign bank could use a lending subsidiary or a lending branch to avoid maintaining sufficient capital because the capital rules established by the Bank of International Settlement in Basle are applied on a consolidated basis. As a result, the operations and investments of all subsidiaries and branches are consolidated with the parent bank for the purposes of determining whether the parent bank and its consolidated subsidiary are sufficiently capitalized.

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3 *Ibid*.

III. INCOME TAX RULES - CONVERSION

There is no special transitional relief to allow a foreign bank subsidiary to transfer its business to the authorized foreign bank on a tax deferred rollover basis. As a result, any transfer of the assets and business (including goodwill) would be deemed to have occurred at fair market value and could result in taxable gains to the foreign bank subsidiary. Similarly, there are no special rules to preserve any tax losses accumulated by the foreign bank subsidiary. These omissions are a significant disincentive for foreign banks to convert to branch status.

Also, the failure to allow for a rollover may create a competitive disadvantage for those foreign banks that already have a presence in Canada. Foreign banks with no previous presence in Canada will not suffer income tax costs in setting up branch operations. However, current Schedule II banks may suffer immediate tax consequences on conversion. We see no policy reason for such a distinction.

RECOMMENDATION:

In order to ensure that the conversion to branch status does not result in negative tax consequences, the National Business Law Section recommends that the government provide both a specific tax deferred rollover and preservation of tax losses in connection with the conversion.

IV. DEFINITION OF FOREIGN PROPERTY - SECTION 206(1) OF THE *INCOME TAX ACT*

As the legislation currently stands, deposits held in a Canadian branch of a foreign bank would be considered foreign property under section 206(1) of the *Income Tax Act*. Under Part XI of the *Income Tax Act*, tax-exempt entities (such as pension

plans) and registered investments (such as many mutual funds) must limit their investments in foreign property to 20% of their assets. Many of these institutional investors manage their investment portfolios to maximize their content of foreign property. This will create a competitive disadvantage to foreign banks wishing to branch directly in Canada because deposits at Canadian branches of foreign banks are considered foreign property but deposits in domestic institutions are not. We do not believe the Government intended such a result and do not see any policy objective for such an outcome, as the Bill will require essentially the same level of capital in Canada regardless of whether the business is undertaken by a branch or subsidiary.

RECOMMENDATION:

The National Business Law Section recommends that the government amend the *Income Tax Act* to allow deposits in a Canadian branch of a foreign bank to be considered Canadian property.

V. DEFINITION OF BANK - SECTION 2

The regulation of "banks and banking" is a matter of exclusive federal jurisdiction. However, because the activity of banks spills over into provincial jurisdiction over property and civil rights, provincial governments have generally included exemptions for "banks listed in Schedule I or Schedule II to the *Bank Act*" or similar phrases from the application of particular provincial legislation. For example, a deposit in a bank listed in Schedule I or Schedule II to the *Bank Act* is not a "security" under provincial securities law. A summary of certain exemptions currently available under Ontario legislation is contained in Schedule A. Similar exemptions are contained in the legislation of other provinces.

Unfortunately, the way the Bill is currently structured may leave authorized foreign banks open to the application of this provincial legislation. The Bill defines a "bank" to mean a bank listed in Schedule I or II of the *Act*. An authorized foreign bank will not be considered as a "bank" under the *Act* and will be listed in Schedule III. We recommend that consideration be given to including an authorized foreign bank in Schedule II and to providing that it be governed by and subject to the appropriate provisions of the *Act* to shelter it from the unintended consequences of this provincial legislation. Under the Bill, authorized foreign banks will be subject to (i) a regulatory regime in Canada, (ii) a capital equivalency deposit in Canada, and (iii) regulation in their home jurisdiction satisfactory to the Superintendent of Financial Institutions (the Superintendent) as a prerequisite to becoming an authorized foreign bank under the *Act*. Therefore, it would appear to be appropriate to treat authorized foreign banks and Schedule II banks in the same manner. If a provincial legislature no longer wished to exempt authorized foreign banks from any particular legislation, it could amend the exemptions accordingly.

In our view, from a legal and regulatory perspective, there is very little difference between the treatment of a Schedule II Bank which opts out of deposit insurance and the treatment under the Bill of an authorized foreign bank which will not have its deposits insured by the Canada Deposit Insurance Corporation (CDIC).

The Bill already recognizes the similarity between Schedule II Banks and authorized foreign banks. For example, proposed section 555 of the *Bank Act* states that, with respect to special security that a bank may charge under the *Act*, any reference to a "bank" will be deemed to be a reference to an authorized foreign bank.

RECOMMENDATION:

The National Business Law Section recommends that for limited purposes "authorized foreign banks" be listed in Schedule II of the *Bank Act* and be included in the definition of "bank" in the

proposed Part XII.1 of the *Bank Act* and such other parts as may be relevant. Alternatively, the Section recommends that the federal government encourage the provincial governments to take steps, whether legislative or otherwise, to ensure that the new flexibility granted to foreign banks in the Bill is not unduly restricted at the provincial level.

VI. INVESTMENT RESTRICTION - FOREIGN BANKS - SECTION 518(1)

Proposed section 518(1) restricts investments in Canadian entities by foreign banks or entities associated with a foreign bank. Sections 518(1.1) and (1.2) then go on to provide a more explicit regime with respect to a full service branch and a lending branch, respectively. Section 518(1) should be made expressly subject to sections 518(1.1) and (1.2) in order to make these provisions more cohesive.

RECOMMENDATION:

The National Business Law Section recommends that the introductory words to section 518(1) be amended to provide that it is subject to sections (1.1) and (1.2).

VII. MINISTERIAL CONSENT REQUIRED - SECTION 518(2.3)

Proposed section 518(2.3) provides that nothing in sections (1) to (1.2) should be construed as derogating from any requirement for ministerial approval under section 521. As a result, the acquisition of entities by the foreign bank, whether directly or through the authorized foreign bank, will require ministerial approval under section 521. Under the *Bank Act*, Canadian banks making substantial investments in certain entities, such as factoring corporations, financial leasing corporations, investment counselling and portfolio management corporations, mutual fund corporations,

mutual fund distribution corporations, real property brokerage corporations, real property corporations, services corporations and real property holding vehicles, do not require the prior approval of the Minister or the Superintendent. As noted above, an authorized foreign bank will be subject to (i) a regulatory regime under the Bill, (ii) a capital equivalency deposit in Canada, and (iii) regulation in its home jurisdiction satisfactory to the Superintendent. In these circumstances, we question whether any policy objective is served by the requirement to have an authorized foreign bank receive approval from the Minister for such investments.

RECOMMENDATION:

The National Business Law Section recommends that the requirement for ministerial approval under section 518(2.3) be changed to eliminate the need for approval in any circumstances that a Canadian bank would not require approval.

VIII. EXCEPTION - SECURITIES UNDERWRITER - SECTION 518(3.2)

Proposed section 518(3.2) makes an exception to the normal approvals and restrictions that apply to foreign banks or associated entities making substantial investments. These approvals and restrictions do not apply to substantial investments acquired by a securities underwriter in a failed securities offering. This exception only applies for a six-month period, which cannot be extended by the Minister or the Superintendent. This is in contrast with most other provisions of the *Bank Act* dealing with unintended acquisitions of substantial investments by Canadian banks or foreign banks, where a much longer period is provided. Normally, this is in the range of five years (see, for example, loan work-outs and realizations, sections 472 and 473 of the *Act* or proposed section 519(2), discussed below). The Superintendent or the Minister usually retains the ability to grant an extension from the prescribed time period.

Failed securities offerings do not occur frequently in Canada but, depending on the circumstances, it may be difficult for the securities underwriter to divest its position to an amount less than a "substantial investment" without incurring a significant loss. Moreover, the securities underwriter would be motivated to divest the substantial investment as soon as commercially reasonable as a result of the capital rules applicable to the securities underwriter by the Investment Dealers Association.

RECOMMENDATION:

The National Business Law Section recommends that section 518(3.2) be amended to extend significantly the initial holding period and to grant the Superintendent the power to extend the six-month period.

IX. LOAN WORK-OUT BY FOREIGN BANKS - SECTION 519(2)(a)

Proposed section 519(2)(a) provides an exception to the approvals for and restrictions on making substantial investments if the substantial investment resulted from a default under security for a loan "made by" the foreign bank. This should be extended to include loans which are "acquired by" the foreign bank or any entity associated with the foreign bank. There are a number of circumstances in which a bank may "own" a loan which was "made by" another bank through syndications and other transfers of loans between institutions.

These circumstances are currently addressed for Canadian banks under section 472 of the *Act*.

RECOMMENDATION:

The National Business Law Section recommends that section 519(2)(a) be amended to include loans acquired by the foreign bank or any entity associated with the foreign bank.

X. EXEMPTION - MINISTERIAL APPROVAL - SECTION 521(1.001)

Proposed section 521(1.001) provides an exemption from the prohibition in section 521(1) for assets which are acquired or held through a foreign bank subsidiary. Some foreign banks currently carry on business as trust companies in Canada and other foreign banks may, in the future, carry on business as loan or trust companies. Therefore, section 521(1.001) should be amended to apply to trust or loan companies incorporated by a foreign bank under the *Trust and Loan Companies Act*.

RECOMMENDATION:

The National Business Law Section recommends that section 521(1.001) be amended to apply to trust or loan companies incorporated by a foreign bank under the *Trust and Loan Companies Act.*

XI. TRANSFER OF LIABILITIES - SECTION 537

Proposed section 537 places restrictions on the transfer of all or substantially all of the liabilities of an authorized foreign bank. There is no comparable provision applicable to Canadian banks. Conversely, section 232 of the *Bank Act* places restrictions on the sale of all or substantially all of the assets of a Canadian bank. No similar restriction is proposed with respect to authorized foreign banks.

We believe that the current regime applicable to Canadian banks is more appropriate than that proposed in the Bill. When liabilities are transferred from one institution to another institution, the transferring institution remains liable to creditors in the event that the assuming institution fails to honour the obligations. The sole exception occurs when the creditor has consented only to have recourse to the assuming institution (except where a specific statutory regime provides for a novation of contract: see, for example, section 39.2(6) of the *CDIC Act* which is not relevant here). Therefore, creditors generally can maintain their claims against the transferring authorized foreign bank and do not need to be protected from unexpected transfers to another institution.

By contrast, creditors look to the assets of the authorized foreign bank to satisfy their claims. If all or substantially all of these assets are sold and not replaced by other assets (including cash), there may not be sufficient assets to satisfy the claims of creditors.

RECOMMENDATION:

The National Business Law Section recommends that section 537 be amended to restrict the sale of all or substantially all of the assets, rather than the transfer of liabilities, of an authorized foreign bank.

XII. DETERMINATION OF "RETAIL DEPOSIT" - SECTION 545(1)

The definition of "retail deposit" fails to address properly the key difference between a retail and a wholesale or institutional banking relationship. This difference is based more on the nature of the customer than the amount of its deposits. In the Bill, retail deposits mean deposits of less than $150,000 subject to a *de minimus* exception for an aggregate of 1% of deposits. Under this definition, any individual with $150,000

to deposit would be considered an institutional client while a sophisticated institutional investor such as a mutual fund or a pension fund with less than $150,000 in a cash account would be defined as a retail deposit. We believe that the minor amendment to the legislation described below can remedy this technical concern while maintaining the integrity of the legislative proposals.

RECOMMENDATION:

The National Business Law Section recommends that proposed section 545(1) be amended to allow compliance under one of two tests: (a) the customer meets the numeric formula as proposed (i.e. $150,000 with a 1% of deposits *de minimus* exemption); or (b) the customer is "a prescribed entity or a member of a prescribed class of entities". These prescribed depositors could be set out in the *Bank Act* regulations and could include a range of sophisticated institutional investors which do not require the same protection as truly retail or individual depositors. Examples include pension funds, mutual funds, government agencies, insurance companies and other institutional investors such as those who do not require prospectus disclosure on the trade of securities under provincial securities legislation.

XIII. INVESTMENT STANDARDS - SECTION 581

The Bill requires an authorized foreign bank to establish and adhere to investment and lending policies, standards and procedures that a reasonable and prudent person would apply in respect of a portfolio of investments and loans to avoid undue risk of loss and obtain a reasonable return. This is the same requirement applicable to Canadian banks.

One of the primary reasons that foreign banks have been requesting the ability to carry on business through a branch in Canada is to be able to make loans based on the capital of the parent foreign bank, rather than the Canadian subsidiary. As a result, most foreign banks will likely have a relatively small number of large loans rather than a large number of small loans. Some of these loans may be several times larger than the capital equivalency deposit of the foreign bank in Canada. On a stand alone basis, that loan portfolio might be viewed as imprudent for the authorized foreign bank in Canada. However, the loan portfolio may be completely appropriate when the capital and the other investments and loans of the parent foreign bank are taken into account. Therefore, we do not believe that developing investment standards and guidelines based on the local authorized foreign bank branch would be appropriate.

RECOMMENDATION:

The National Business Law Section recommends that the requirement in section 581 be amended to provide that the *parent* foreign bank must establish investment standards with respect to its lending activities in Canada which are acceptable to the Superintendent as a condition of obtaining and maintaining authorized foreign bank status.

XIV. CONCLUSION

As we have outlined, there are several technical issues which should be addressed for the Bill to be internally consistent, to accord with provincial legislation and to achieve the legislative objectives set out by the Department. While, again, we do not comment on these objectives, we believe our recommended changes would improve this proposed legislation.

SCHEDULE A

Ontario Statutes Containing Exemptions for Banks Incorporated Under the *Bank Act*

Name of Act or Regulation	Exemption
Collection Agencies Act	Section 2(e) exempts a bank listed on Schedule I or Schedule II to the *Bank Act* from the application of the statute.
Commodity Futures Act	Section 31(a) exempts a bank listed on Schedule I or Schedule II to the *Bank Act* from the requirement to register as an adviser.
Regulation 90 under the *Commodity Futures Act*	Section 7 includes banks to which the *Bank Act* applies in the definition of "financial institution". Section 28(3) exempts financial institutions from the requirement of registrant scrutiny with respect to the trading suitability of the customer.
Regulation 182 under the *Corporations Information Act*	Section 6 exempts corporations subject to the *Bank Act* from the requirement to file either initial returns or annual returns.
Corporations Tax Act	This statute establishes a provincial scheme of taxation for banks. For example, section 57.1(2)(e) and section 66.1 set out the calculation of "net income or net loss" of a bank, which is different than that for other corporations. "Bank" is defined in section 1(2) to mean a bank to which the *Bank Act* applies.
Mortgage Brokers Act	Section 2(c) exempts a bank under the *Bank Act* from the application of the statute, except sections 11 through 21. The sections from which a bank is exempt deal with, among other things, non-resident shareholding restrictions (section 9), and the requirement to register under the statute (under sections 4 and 8).

Name of Act or Regulation	Exemption
	Section 11(3) exempts mortgage transactions in which a bank to which the *Bank Act* applies acts as mortgagee or as assignee from the application of sections 12 through 19. These sections include a prospectus requirement for any mortgage transaction in respect of a lot or unit of land located outside Ontario (section 12(1)), the ability of the other party to rescind within 90 days of signing the mortgage contract (section 12(3)), and the requirement for advertising approval by the Superintendent of Mortgage Brokers with respect to such transactions (section 19).
Regulation 798 under the *Mortgage Brokers Act*	Section 4.1(10)(g) exempts a bank under the *Bank Act* from the need to receive certain documentation contained in sections 4.1(3) through (6) of the Regulation at least 48 hours prior to investing money with a mortgage broker.
Securities Act	The definition of "security" in section 1(1) exempts deposits held by banks listed on Schedule I or Schedule II to the *Bank Act* from the definition. Similarly, the definition of "underwriter" in section 1(1) excludes banks listed on Schedule I or Schedule II to the *Bank Act* from the definition when dealing in certain section 35(2) indebtedness (discussed below). Section 34(a) exempts banks listed on Schedule I or Schedule II to the *Bank Act* from the requirement to register as advisers. Section 35(1) treats trades where a bank listed on Schedule I or Schedule II to the *Bank Act* purchases as principal and not as underwriters, as an exempt trade for the purposes of the registration requirements.

Name of Act or Regulation	Exemption
	Section 35(2) treats bonds, debentures and other evidences of indebtedness of or guaranteed by a bank listed on Schedule I or Schedule II to the *Bank Act* as exempt securities for the purposes of the registration requirements. Section 72(1)(a)(i) treats trades where a bank listed on Schedule I or Schedule II to the *Bank Act* purchases as principal is exempt trade for the purposes of the prospectus requirement.
Regulation 1015 under the *Securities Act*	Section 2(3) relaxes some of the *Securities Act* requirements with respect to the preparation of financial statements for, among others, a bank listed on Schedule I or Schedule II to the *Bank Act*. Sections 86(1) and 87(1) provide that certain information needs to be provided on every statement of portfolio investments of a mutual fund, including short-term debt held pending investment. However, according to sections 86(2) and 87(2), respectively, such information with respect to short-term debt held pending investment need only be provided in the aggregate if the issuer of the debt is, among others, a bank listed on Schedule I or Schedule II to the *Bank Act*. Section 114(5) exempts banks listed in Schedule I or Schedule II to the *Bank Act*, among others, from the requirement of dealer scrutiny with respect to the trading suitability of the customer. Section 151(f) exempts from registration trades in bonds or debentures by way of unsolicited order given to a bank listed on Schedule I or Schedule II to the *Bank Act*, provided certain other conditions are also met.

Name of Act or Regulation	Exemption
	Section 209(10) and Blanket Order 32-502 of the Ontario Securities Commission exempt banks listed on Schedule I or Schedule II to the *Bank Act* from certain of Ontario's universal registration trading and advising requirements that limit access to the exempt market for securities.