The Banking Regulation Review

The Banking Regulation Review
Reproduced with permission from Law Business Research Ltd.

This article was first published in The Banking Regulation Review - Edition 6
(published in May 2015 – editor Jan Putnis).

For further information please email
Nick.Barette@lbresearch.com

Chapter 10

CANADA

Scott Hyman, Carol Pennycook, Derek Vesey and Nicholas Williams[1]

I INTRODUCTION

Canada has a mature, competitive and centrally regulated banking system. The Canadian banking sector is composed of domestically owned banks, subsidiaries of foreign banks operating in Canada as Canadian chartered banks (foreign bank subsidiaries), full-service branches of foreign banks, branches of foreign banks with limited access to Canadian source funding (referred to as lending branches) and foreign bank representative offices. The six largest Canadian banks by assets and market capitalisation are Royal Bank of Canada, the Toronto-Dominion Bank, The Bank of Nova Scotia, Bank of Montreal, Canadian Imperial Bank of Commerce and National Bank of Canada, each of which has been designated by the Office of the Superintendent of Financial Institutions (OSFI), the Canadian federal bank regulator, as a domestic systemically important bank (D-SIB). These six banks account for more than 90 per cent of Canada's total banking assets. In addition to these domestic banks, as of 2 April 2015, there were 22 other domestic banks, 24 foreign bank subsidiaries, 26 full-service branches, three lending branches and 25 representative offices.

Canada also has an active public debt market in which domestic and foreign securities dealers assist clients in issuing and placing a wide variety of corporate and institutional commercial paper, medium-term notes, bonds, debentures and hybrid instruments. Many of the securities dealers are bank-owned. However, the banking sector is the dominant source of capital for those seeking conventional financing. Canadian banks also dominate the residential and commercial mortgage market. Canada does not have a deep market for second-lien loans, mezzanine or venture capital finance, and merchant banking financing is relatively limited when compared with other competitive

1 Scott Hyman, Carol Pennycook, Derek Vesey and Nicholas Williams are partners at Davies Ward Phillips & Vineberg LLP.

financing jurisdictions. Canada also has an active credit union and non-bank financial sector.

The Canadian banking sector is regulated by the federal government under the auspices of one regulatory authority, OSFI. OSFI regulates all Canadian federally incorporated financial institutions (FRFIs), including banks, insurance companies, trust and loan companies, and credit unions. However, banks are the only financial institutions that fall exclusively within the regulatory purview of the federal government; all other forms of financial institutions can be incorporated and regulated at the Canadian provincial and territorial level. In many cases, the provinces and territories have ceded jurisdiction on a *de facto* basis to the federal regulator to avoid the inefficiencies of regulation by two levels of government.

Canadian banking regulation is characterised by prudential regulatory concerns and a focus on depositor protection. In general, OSFI has adopted a very conservative approach in the regulation of the Canadian financial services sector, and the banking sector in particular. Canadian regulatory requirements often impose higher capital requirements and lower leverage than has been allowed in other jurisdictions. In addition, Canada has not adopted the concept of universal banking, keeping distinct differences in focus among the Canadian banking, insurance, auto leasing and securities dealing sectors of the financial economy.

This approach served the Canadian financial services sector well during the economic downturn from 2007 to 2010. During this period (and throughout the subsequent period to date), Canada did not experience any bankruptcies or failures among FRFIs. Further, the government did not have to bail out any FRFIs or the Canadian financial services sector generally. Actions taken by the government and the Bank of Canada to ease credit in the Canadian financial services sector were taken to maintain the competitiveness of Canadian financial services companies and to respond cooperatively to initiatives taken in the United States and Europe, with a view to stabilising the international financial services sector, promoting open markets and maintaining a level playing field and fair competition across the integrated global banking sector.

II THE REGULATORY REGIME APPLICABLE TO BANKS

i OSFI as regulator

OSFI was established under the Office of the Superintendent of Financial Institutions Act (Canada). OSFI works in conjunction with the Bank of Canada, which monitors and controls the money supply, and provides overnight and short-term lending facilities to banks; the Canada Deposit Insurance Corporation (CDIC), which provides deposit insurance to the general public on certain kinds of Canadian dollar-denominated deposits placed with member institutions; and the Financial Consumer Agency of Canada, which acts as a consumer protection watchdog with respect to the activities of banks in Canada as they pertain to consumers.

OSFI has very broad powers and oversight in regulating the activities of domestic and foreign banks in Canada. Its multifaceted mandate includes ensuring prudential regulation of FRFIs generally and the banking sector in Canada in particular, protecting depositors, and maintaining the integrity and stability of the Canadian financial services sector.

To achieve these objectives, OSFI has been given the authority, and exercises control, over the commencement and operation of business by banks in Canada and their leverage and capital requirements. OSFI also monitors and ensures prudential and responsible corporate governance. OSFI regularly publishes guidelines, directives and bulletins on all of these subjects, and regularly meets with Canadian banks and other FRFIs to ensure compliance with OSFI requirements.

At present, the activities of securities dealers and other participants in the securities market are regulated at the provincial and territorial level by the provincial and territorial securities commissions. The federal government has been engaged in the process of working with provincial and territorial governments to establish a centralised single national securities regulator. However, recent attempts to implement a national securities regulatory regime have been struck down by the Supreme Court of Canada on constitutional grounds.

ii Bank Act (Canada) (Bank Act)

A bank may carry on business in Canada as a licensed Canadian chartered bank or a branch of a foreign bank, or by opening a subsidiary to carry on a financial service or other business. A bank may also maintain a marketing presence in Canada through the establishment of a representative office. All domestic banks in Canada and foreign bank subsidiaries, foreign bank branches, foreign bank representative offices and subsidiaries of foreign banks established to provide limited financial services or to carry on another business in Canada are subject to regulation under the Bank Act.

Incorporation under the Bank Act is subject to the discretion of the Canadian Minister of Finance (Minister) and to obtaining permission from OSFI to commence carrying on business. Canadian chartered banks may be owned and controlled by a bank holding company incorporated under the Bank Act. In such cases, the capital adequacy regime normally applied by OSFI to the balance sheet of a Canadian chartered bank is applied at the bank holding company level. As such, Canadian banks have not seen any benefit in adopting bank holding company structures similar to those seen in the United States and Europe.

The application processes for the establishment of a Canadian chartered bank or for the establishment of a foreign bank branch in Canada are relatively similar. In both cases, the application must be filed with OSFI, together with an extensive amount of information about the bank's primary shareholders or the bank itself (in the case of the opening of a branch) together, without limitation, with a detailed business plan (including *pro forma* financial statements and projections) with respect to its proposed business in Canada, and a list and the CVs of those persons who will serve as directors or primary officers of the Canadian bank or branch. Such individuals typically undergo a security review and background check by the Royal Canadian Mounted Police, Canada's federal police agency and, where applicable, the Canadian Security and Intelligence Service. In general, it can take anywhere from nine months to a year to incorporate a Canadian chartered bank and open for business, and up to six months to establish a foreign bank branch in Canada, from the time application materials are first submitted to OSFI. OSFI has published administrative guidelines to assist applicants in preparing materials in support of applications to be submitted for review and consideration.

iii Foreign banks

As a general rule, but with some limited and rarely utilised exceptions, regulated, licensed or self-identified foreign banks and entities associated with foreign banks (i.e., entities within the subject foreign bank's group or control that are not incorporated or existing under the laws of Canada or a province or territory of Canada) are prohibited under the Bank Act from carrying on any business in Canada, owning a position in a Canadian enterprise above a prescribed threshold, or taking legal or *de facto* control of any Canadian enterprise. Foreign banks cannot undertake such activities directly or indirectly through an agent or nominee. The Bank Act regulates the activities and investments of foreign banks and entities associated with a foreign bank in relation to both banking and non-banking services in Canada.

The concept of a foreign bank is broadly construed under the Bank Act to include, *inter alia*, an entity called a bank that engages in the provision of financial services, whether or not it actually maintains a bank licence, and an entity that is a bank or is regulated as a bank or deposit-taking institution according to the laws of its incorporating jurisdiction or any place in which it carries on business. An entity is associated with a foreign bank if it controls, is controlled by, or is under common control with, a foreign bank.

Canada does not apply its banking laws extraterritorially to foreign banks. Accordingly, foreign banks are free to carry on business with Canadians and to solicit business from Canadians without offending the Bank Act as long as such activities are undertaken by the foreign bank from outside Canada. In addition, foreign banks may access the Canadian capital markets from offshore as long as they do not retain an agent for the placement of such securities in Canada and they comply with other restrictions imposed by OSFI and the Bank Act.

OSFI is vigilant in monitoring any illegal activities of foreign banks in Canada and publishes a list of offending foreign banks. OSFI also pursues such offending banks with a view to having them comply with the Bank Act or cease their activities in Canada.

Foreign banks are permitted to carry on business in Canada with the permission of the Minister. The Minister has the authority to issue orders permitting a foreign bank to carry on business in Canada through the incorporation of a foreign bank subsidiary, the establishment of a branch or the ownership or control of Canadian enterprises. The Minister also has the authority to exempt a foreign bank from the application of the Bank Act. To our knowledge, no such blanket exemption order has been issued under the Bank Act to date.

Where a foreign bank establishes a foreign bank subsidiary, such a subsidiary is incorporated under the Bank Act and is subject to the same regulatory regime and capital requirements, and has the same powers and market access as domestically owned and controlled Canadian chartered banks.

A foreign bank may establish a full-service branch or a lending branch. In either case, the foreign bank is permitted to carry on the same business activities in Canada through its branches as the Canadian chartered banks. However, branches of foreign banks are not permitted to accept retail deposits in Canada. Retail deposits are measured by a formula contained in the Bank Act, but can be loosely interpreted as deposits of under C$150,000. Lending branches differ from full-service branches in that they cannot access the Canadian capital markets or take any deposits in Canada. Foreign bank branches are exempt from regulatory capital rules applied by OSFI to Canadian chartered banks on the assumption that the capital of such foreign banks is regulated by the regulator in their home jurisdictions. In lieu of the application of Canadian regulatory capital standards, full-service branches are required to maintain a capital equivalency deposit equal to 5 per cent of their Canadian branch liabilities on deposit with a Canadian financial institution. Lending branches are only required to maintain C$100,000 on deposit.

Representative offices maintained in Canada by foreign banks are not permitted to carry on business or provide financial services in Canada. Their sole function is limited to the promotion to Canadians of the foreign bank's business outside Canada, and to acting as a liaison between the foreign bank and Canadians in respect of the business between them that is conducted outside Canada.

III PRUDENTIAL REGULATION

i Relationship with the prudential regulator

OSFI has very broad powers and oversight in regulating the activities of banks in Canada. The regulatory model generally adopted by OSFI is one where banks are required to self-police and self-assess compliance with the Bank Act and related regulations, as well as OSFI guidelines, directives and bulletins. In order to evidence such self-compliance, Canadian banks and foreign bank branches are required to submit a series of monthly, quarterly and annual reports to OSFI and the Bank of Canada on a wide range of matters, including regulatory capital information, loan loss provisions, liquidity, compliance with adopted and approved bank policies, loan and asset concentration, deposit information, and real estate appraisals and lending.

In addition, OSFI supplements its extensive reporting requirements by subjecting Canadian banks to annual and sometimes quarterly inspections and audits. Branches are generally subject to annual inspections, although it is not uncommon for such inspections to be held less frequently.

OSFI is particularly focused on compliance with its regulatory capital guidelines, having adopted capital guidelines modelled on the Basel III Accord, effective as of January 2013 with some limited exceptions. In general, OSFI adopts capital adequacy guidelines for Canadian banks that exceed the minimum capital standards required under the various Basel accords. Any failure by a bank to meet the minimum capital adequacy standards set for it by OSFI is met with swift regulatory action measured in four stages, with stage one comprising notification of failure and a requirement on the part of the bank to submit a plan to OSFI to demonstrate quick and consistent future compliance with such guidelines, and stage four being full regulatory intervention and takeover of the bank's affairs by OSFI.

On other matters, OSFI will issue compliance directives, and meet with and monitor the bank's progress in implementing and meeting regulatory requirements and timelines. However, OSFI retains its authority, and can utilise its staged approach to compliance with respect to any regulatory matter.

ii Management and corporate governance

The Bank Act functions as the governing corporate statute for Canadian banks. Canadian banks are governed by a board of directors, the composition of which is subject to the Bank Act. The Bank Act also mandates certain board committees, including an audit committee and a conduct review committee. In addition, OSFI guidance on corporate governance also mandates additional committees, such as a dedicated risk committee to assess and monitor overall risk management on an enterprise-wide basis. Among other prescribed requirements, the board of directors of a Canadian bank must consist of at least seven directors, at least half of whom must be residents of Canada. No person who is an agent or employee of a foreign government may be a director of a Canadian chartered bank. The chief executive officer of a Canadian chartered bank must be a director of the bank and a resident of Canada. OSFI guidance on corporate governance specifies that the role of chair of the board must be separated from the chief executive officer to maintain board independence and to allow the board to execute its mandate.

While the Bank Act does not mandate the appointment of any officers of a bank or branch beyond the chief executive officer of a bank and the principal officer of a branch, OSFI requires each to have customary officers appointed to oversee areas such as risk management, audit, compliance, human resources and operations, as a condition for OSFI permitting the bank or branch to commence carrying on business.

All boards of Canadian banks are required by law to exercise their authority independently, and in all cases, including in the case of foreign bank subsidiaries, independent of shareholder requirements. Each director and officer of a Canadian chartered bank is required, in exercising powers granted to such person and discharging any duties of a director or officer, to act honestly and in good faith with a view to the best interests of the bank, and exercise the care, diligence and skill that a reasonably prudent person would exercise in comparable circumstances. The foregoing duties apply to all directors and officers of all Canadian chartered banks regardless of their ownership. Compliance with the Bank Act's corporate governance requirements is closely monitored by OSFI. OSFI has issued best practice guidelines for corporate governance, which it expects banks to follow strictly, and has recently undertaken a review of corporate governance practices and released additional guidelines.

Currently, there is no law, regulation or direction on bonus payments to management and employees of a bank or branch. As the Canadian banking sector did not require or receive any government bailouts, it is not currently anticipated that the government will impose any such restriction. However, as part of a bank's corporate governance, it is assumed that a bank will have adopted and comply with a comprehensive compensation policy and, in general, compensation policies must be consistent with financial stability board principles for sound compensation and related implementation standards.

Foreign banks

There are no corporate governance requirements applicable to a foreign bank branch in Canada; however, a branch must appoint and retain a principal officer who is responsible for maintaining adequate records at the branch and who will be the branch's official contact with OSFI. This individual must be a resident Canadian.

Banks, including foreign bank subsidiaries, may outsource many of their functions to service providers, including, in the case of foreign bank subsidiaries, to their parents or affiliates. Such functions commonly include product origination, credit approval, administration, data processing and records maintenance. However, this must be done pursuant to outsourcing guidelines issued by OSFI and comply fully with self-dealing restrictions contained in the Bank Act. These provisions regulate, and in some cases restrict, the ability of banks to undertake transactions with affiliates considered related parties under the Bank Act. In addition, certain functions (such as the maintenance of corporate records and corporate governance) cannot be outsourced.

iii Regulatory capital and liquidity

Canadian banks, which must follow OSFI's capital adequacy guidelines, are commonly considered well capitalised. OSFI implemented the Basel III Accord, effective from January 2013, notwithstanding the delays in implementation by other jurisdictions, notably the United States and European Union countries. Canadian banks are required to maintain total capital ratios of 8 per cent, with such capital ratios increasing to 10.5 per cent by 2019 through the phase in of gradually increasing capital conservation buffers commencing in January 2016. OSFI also expects Canadian banks to reach capital ratios in excess of 2019 targets (including capital conservation buffers) well before 2019. OSFI guidance specifies an all-in target common equity Tier I ratio of 6.625 per cent by the first quarter of 2016, and all-in target capital ratios of 8.625 per cent for total equity Tier I and 10.5 per cent for total Tier I capital by the first quarter of 2016. In addition, each of Canada's six D-SIBs is subject to a surcharge on its common equity Tier I capital equal to 1 per cent of its risk-weighted assets commencing 1 January 2016. Effective 1 January 2015, all Canadian banks are expected to maintain a leverage ratio (a ratio of a bank's all-in Tier I capital to its exposure, each calculated based on OSFI mandated methodologies) that meets or exceeds 3 per cent at all times. However, OSFI will retain the discretion to prescribe authorised leverage ratio requirements for individual Canadian banks based on institution-specific historical operational and regulatory considerations. OSFI considerations also focus on the bank's strategic and business plans, its view of the effectiveness of the bank's operational management and oversight function, the bank's risk profile, diversity of business lines and adequacy of capital, and the bank's track record in meeting its internal and OSFI-mandated capital targets. For a new market entrant, OSFI has traditionally limited its leverage to a level considerably lower than established banks until they have shown an ability to fully successfully execute the business plan that it presented to OSFI as part of the approval process for obtaining a bank charter.

A bank's regulatory capital is comprised of Tier I and II capital, from which capital amounts are deducted to meet specified regulatory requirements. Tier I capital is characterised by its permanence, and for Canadian banks generally comprises common share capital and hybrid instruments. Tier I capital must comprise not less than the percentage measured on a total capital basis specified by OSFI for the relevant calendar period up to and including the transitional period for capital adequacy minimum standards, which extends to 2019. Tier II capital issued by Canadian banks is primarily characterised by perpetual preferred shares and subordinated debt.

Regulatory capital ratios are measured for each bank or bank holding company on a consolidated basis with full deductions for the regulatory capital of other FRFIs within the bank's corporate group. All regulatory capital ratios are reported by each bank on a quarterly basis by filing regulatory capital returns with OSFI.

All Canadian banks are required to maintain liquidity in compliance with internal policies that they have adopted as mandated by OSFI and with OSFI's guidelines respecting liquidity. OSFI's guidelines require banks to establish and implement documented, sound and prudent liquidity and funding policies recommended by management, approved by the board of directors and reviewed annually by the board or a board committee. Such policies must address foreign currency obligations (where relevant), the holding by the bank of liquid assets and funding requirements. Liquidity policies must also provide for scenario testing and contingency planning to allow the bank to withstand funding requirements in specific disruption scenarios and address cash flow shortfalls in emergency situations. Each bank must also periodically review its efforts to maintain the diversification of liabilities, to establish relationships with liability holders and to develop asset-sales markets. Effective 1 January 2015, all Canadian banks became subject to a minimum liquidity cover ratio (designed to ensure that they have an adequate stock of unencumbered high liquidity assets consisting of cash or cash equivalents to meet liquidity needs for 30 calendar days) of 100 per cent. In addition, OSFI has indicated its intention to have in place a minimum requirement for a net stable funding ratio (requiring banks to maintain a stable funding profile in relation to the composition of their assets and off-balance sheet activities) by 1 January 2018.

Foreign banks

Neither the Bank Act nor OSFI impose regulatory capital standards on foreign bank branches other than the above-mentioned capital equivalency deposits, as it is assumed that the foreign bank's home jurisdiction will regulate the foreign bank's capital. As part of the branch approval process, OSFI reviews the regulatory capital standards and requirements of the foreign bank's home jurisdiction to confirm its satisfaction with the foreign bank's regulatory capital requirements.

iv Recovery and resolution

Canada is fortunate in that there have been no failures to date among FRFIs as a result of the economic downturn that persisted from late 2007 to 2012. At present, FRFIs are not required by statute to create an internal plan for their own failure or recovery from failure, although OSFI considers the adoption of living wills as a sensible regulatory initiative. OSFI, in conjunction with the CDIC, the Bank of Canada and the Canadian Department of Finance, has been engaged in a process of assisting FRFIs with disaster recovery plans, and is currently designing a bail-in regime that would result in the mandatory conversion of debt to equity to further bolster the permanent capital of banks that are on the verge of failing. In addition, as stated above, OSFI has designated the six largest Canadian banks as D-SIBs and imposed additional prudential regulatory requirements on such institutions, including a 1 per cent common equity surcharge effective from January 2016. In addition to the capital surcharge, OSFI has enhanced its supervisory framework for D-SIBs to include:

a increased supervision and monitoring;

b more examination by specialists with expertise in credit risk, market risk, operational risk, corporate governance and money laundering compliance;

c enhanced reporting;
d cross-institution reviews;
e selective use of external reviews to benchmark risk control practices;
f stress testing of capital and liquidity requirements; and
g the development of recovery and resolution plans.

Resolution of matters of solvency and regulatory non-compliance, insofar as they relate to the affairs of an FRFI, are directed by OSFI's supervisory process pursuant to a regulatory regime for intervention in the affairs of a non-compliant FRFI or one that may face solvency issues. The objective of the intervention process is to enable OSFI and, where relevant, the CDIC, to identify issues at an early stage and, working collaboratively with the FRFI, to implement a scheme to address the areas at issue with the goal of bringing the FRFI back into full compliance with regulatory requirements and, where relevant, strengthening the FRFI's overall financial position.

This intervention process is divided into four stages of review and action. The first stage is an early-warning stage, and involves assessing the financial condition, operation and performance of the FRFI, and the conduct of meetings between OSFI and the FRFI to raise awareness of the issues. Intervention at this stage may include, *inter alia*, meetings with OSFI, site visits, OSFI's attendance at board meetings, select meetings with key members of management and the board, and the provision by OSFI of supervisory letters outlining the required steps to be taken by the FRFI to address the issues.

The second stage comprises a more active role by OSFI in the monitoring and implementation of corrective measures as concerns increase as to the financial viability or solvency of the FRFI. This stage is characterised by enhanced monitoring, additional supervisory reviews, the mandatory implementation of remedial measures aimed at rectifying issues, external audits of procedures and financial reporting, and the development of contingency plans for full regulatory intervention and control. The third stage anticipates the future failure of an FRFI and involves OSFI working with external specialists and professionals in assessing asset quality, the tightening of business constraints, full-time on-site monitoring of the FRFI's activities and further enhanced planning for full regulatory administration.

When an FRFI reaches the fourth stage, OSFI has determined that the FRFI is no longer viable. At this time, OSFI will either take over the affairs of the FRFI or require the commencement of an insolvency or restructuring proceeding for the FRFI under the Winding-Up and Restructuring Act (Canada); the most likely outcome of such proceeding is often the sale of the FRFI or its assets to another institution approved by the government.

IV CONDUCT OF BUSINESS

i Confidentiality

Canadian law imposes a common law duty of confidentiality on all banks in their dealings with customers and customer information. This is commonly referred to as the banker–client duty of confidentiality.

ii Privacy

All banks carrying on business in Canada are subject to Canadian privacy laws, including the Personal Information Protection and Electronic Documents Act (PIPEDA), a federal statute, and in some provinces, the provincial equivalents of PIPEDA. Compliance with PIPEDA does not obviate provincial and territorial privacy requirements. PIPEDA applies to every 'organisation' in respect of 'personal information' that the organisation collects, uses or discloses in the course of commercial activities. 'Personal information' in PIPEDA means 'information about an identifiable individual, but does not include the name, title, business address or telephone number of an employee of an organisation'. 'Organisation' includes an association, a partnership, a person (both a corporation and a natural person) and a trade union.

Banks must obtain an individual's consent when they collect, use or disclose that individual's 'personal information'. PIPEDA limits the use and disclosure of such personal information, creates a positive duty on banks to safeguard personal information they have collected and places limits on the retention of personal information.

iii Consumer protection

The Bank Act contains a number of regulations focused on consumer protection issues that apply to all Canadian banks and foreign bank branches relating to the disclosure to consumers of the cost of borrowing, the disclosure of charges and the disclosure of interest rates.

In addition, the foregoing institutions are subject to the oversight of the Financial Consumer Agency of Canada (FCAC). FCAC is presided over by the Minister and is responsible for:

a determining whether FRFIs are in compliance with consumer protection provisions of laws and contractual undertakings applicable to them;
b promoting the adoption by such financial institutions of policies and procedures designed to implement such laws and undertakings, as well as voluntary codes of conduct and other public commitments made in the area of consumer protection;
c monitoring the implementation of voluntary codes of conduct designed to protect the interests of customers of such financial institutions;
d promoting consumer awareness about the obligations of financial institutions with respect to their customers;
e fostering an understanding of financial services; and
f monitoring and evaluating trends and emerging issues impacting consumers of financial products and services.

FCAC also supervises payment card network operators, promotes the adoption by such parties of policies and procedures designed to implement pertinent laws and regulations, monitors the implementation of applicable voluntary codes of conduct and promotes public awareness about the obligations of payment card network operators.

iv Money laundering

All financial institutions in Canada are subject to the Proceeds of Crime (Money Laundering) and Terrorist Financing Act (Canada) (PCMLTFA) and to the regulations issued thereunder. In addition, FRFIs are subject to additional guidelines issued by OSFI that are intended to assist FRFIs in identifying and complying with applicable requirements of the foregoing legislation and its regulations and related provisions of the Criminal Code (Canada).

The PCMLTFA is administered by the Financial Transactions and Reports Analysis Centre of Canada (FINTRAC) and by OSFI to the extent any issues relevant to money laundering and terrorist financing affect FRFIs. OSFI and FINTRAC are authorised by law to exchange information. All FRFIs are required to establish reporting channels to senior management and their boards, appoint an individual responsible for compliance with applicable laws and regulations, adopt written policies and procedures to implement such requirements, assess and monitor compliance with such requirements, train personnel with respect to such requirements, and self-assess and test compliance.

V FUNDING

Canadian banks fund their activities through a variety of sources. The largest banks generally have stable deposit bases and issue term deposits, bank deposit notes and bankers' acceptances to augment their funding requirements. Canadian banks also enjoy access to borrowing lines that they maintain with the Bank of Canada for short-term borrowing, overnight funding, daylight loans and liquidity requirements. Foreign bank full-service branches cannot accept retail deposits, but can otherwise access the Canadian deposit and financial markets to fund their activities. Lending branches cannot take any deposits in Canada and have no access to funding in the Canadian capital markets. They must fund their activities through sources available to the foreign bank from outside Canada or borrow money from other financial institutions.

In response to the financial crisis of 2008 and 2009, the federal government created the Canadian Lenders Assurance Facility (CLAF) in October 2008. Originally set to expire in April 2009, the programme was extended until 31 December 2009, but was not extended further. The CLAF was set up as a temporary facility to provide insurance on the wholesale borrowing of federally and eligible provincially regulated deposit-taking institutions. This action was taken to ensure Canadian financial institutions were not placed at a disadvantage with respect to foreign competitors. As the Canadian financial institutions performed well during the financial crisis, the CLAF was never used.

VI CONTROL OF BANKS AND TRANSFERS OF BANKING BUSINESS

i Control regime

The Bank Act contains a set of common restrictions on the acquisition of control or ownership of a Canadian bank, but differentiates within such schemes among banks of differing sizes. The Bank Act distinguishes large banks with an equity capitalisation of C$12 billion or more from medium-sized banks with an equity capitalisation of less than C$12 billion but C$2 billion or more and small banks with an equity capitalisation of less than C$2 billion.

Large banks must be widely held by the public, medium-sized banks must be publicly held by at least 35 per cent (with their stock listed on a recognised Canadian stock exchange) and small banks can be privately wholly owned. All acquisition restrictions apply equally to any acquirer, whether domestic or foreign.

The acquisition by any person of a 'significant interest' in any class of shares, whether voting or non-voting, of any Canadian bank requires the approval of the Minister.[2] A bank that is not a large bank may apply to OSFI to exempt a class of non-voting shares for purposes of this requirement if the class comprises less than 30 per cent of the total equity of the bank. Each subsequent increase in a person's significant interest of the same class would also require the Minister's approval unless such person already controls the bank or, in respect of a bank that is not a large bank, the increase does not result in such person's interest increasing by a further 5 per cent of the relevant class and would not cause the person to acquire control of the bank. Prior to approving a transaction involving a foreign bank controlled by a person that is not a resident of a member country of the World Trade Organization, the Minister must be satisfied that treatment as favourable for Canadian banks exists or will be provided in the jurisdiction in which the foreign bank principally operates (either directly or indirectly through subsidiaries).

Where the Minister grants approval for a person to acquire a significant interest, the Bank Act prohibits any person from acquiring control of or becoming a 'major shareholder' of a large bank.[3] The only exceptions to this limitation apply in instances where a major or controlling shareholder held its interest prior to the bank becoming a large bank, and that shareholder is, or is controlled by, a widely held entity that is a bank, insurance company or other regulated financial institution, whether domestic or foreign. Apart from the need to obtain ministerial approval to acquire a significant interest, there are no restrictions on the ability of a person to acquire all of the shares of a bank that is not a large bank. However, where the bank is a medium bank, not less than 35 per cent of its shares will have to be listed on a recognised Canadian stock exchange within three years of such acquisition, unless the Minister either extends the time frame for the listing of such shares or exempts the bank from such a listing.

2 Under the Bank Act, a person has a 'significant interest' when such person, together with any entity controlled by or acting in concert with such person, acquires or holds a beneficial ownership in more than 10 per cent of a class of shares of a Canadian bank. As the test of ownership is one of beneficial ownership, the Bank Act test looks through intermediate holding companies to the beneficial ownership of the shares of a bank.

3 Under the Bank Act, a 'major shareholder' is a person who (together with all entities controlled by or acting in concert with such a person) beneficially owns more than 20 per cent of the voting shares, or more than 30 per cent of the non-voting shares, of a bank.

The Bank Act further provides that a person controls an entity if, generally speaking, such person beneficially owns more than 50 per cent of the voting securities (in the case of a corporation) of such entity, or if such person has a direct or indirect influence that, if exercised, would result in control in fact of the entity. A person who controls an entity is deemed to control the entities the second entity controls or is deemed to control.

A major shareholder of a Canadian bank may also not hold a substantial investment in an entity that engages in certain personal property leasing activities in Canada that extend beyond commercial finance leasing, such as leasing automobiles or household personal property.[4]

The approval process for the acquisition of a significant interest essentially begins with the filing by the applicant of an application with OSFI for ministerial approval. OSFI has published administrative guidelines with respect to the process for the submission and the contents of application materials. However, any applicant will be required to submit a detailed business plan outlining its intentions in conjunction with any such application.

Once the applicant's application is certified as complete, the Minister must give notice to the applicant either approving the transaction or indicating that the transaction will not be approved within 45 days, subject to extension for an additional 45 days in the case of an acquisition of control, or 30 days in the case of the acquisition or increase of a significant interest. If the application is rejected, the applicant may make representations to the Minister in respect of its application, and the resulting final decision must be rendered by the Minister within similar time periods.

An initial consultative meeting should be held with OSFI prior to submitting any application to identify any potential issues that may delay or inhibit the application process, especially with an application that has the potential to raise policy concerns for the Minister. In addition, regulations issued under the Bank Act contain certain restrictions on disclosure by Canadian banks of specified information about their business and affairs obtained by OSFI in the course of OSFI's supervision of banks. This prohibited information includes the results of supervisory reviews and other assessments conducted by OSFI on banks (including OSFI's ratings of banks and recommended or required remedial action), information regarding enforcement actions taken in respect of banks, and any related correspondence between OSFI and banks. This can have a limiting effect on the regulatory due diligence that may be conducted on Canadian banks. However, there are some techniques that have been agreed between OSFI and Canadian banks to allow an acquirer to manage this risk.

Governments of foreign countries and agencies thereof, and entities controlled by such governments and agencies, cannot incorporate or acquire ownership or a significant interest in, or control of, a Canadian bank unless the entity seeking to incorporate or acquire a significant interest in, or control of, the Canadian bank is itself a foreign bank, a foreign financial institution or a subsidiary thereof.

Given the restrictions in the Bank Act on the ability of any person to acquire a significant interest in a bank without ministerial consent, and the absolute statutory bar on any person being a major shareholder of a large bank unless such person is him or

4 Under the Bank Act, a person has a 'substantial investment' in a corporation if such person (together with all entities controlled by such person) beneficially owns in excess of 10 per cent of the voting shares of such corporation or in excess of 25 per cent of the equity interest in such corporation. A person has a substantial investment in an unincorporated entity where such person (together with all entities controlled by such a person) beneficially owns in excess of 25 per cent of the ownership interests, however divided, in such an unincorporated entity.

herself widely held within the meaning of the Bank Act, without a change in Canadian banking laws, a person may undertake an acquisition of a large Canadian bank only by way of amalgamation (or merger) of the acquirer with the Canadian bank. Any such transaction will be subject to approval by two-thirds of the shareholders of the bank, OSFI and the Minister. The Bank Act prescribes factors that the Minister must take into account in considering such transaction, including, without limitation:

a the sources of continued financial support for the amalgamated bank;

b the opinion of the Superintendent of Financial Institutions (Superintendent) regarding the extent to which the proposed corporate structure of the amalgamated bank and its affiliates may affect the supervision and regulation of the amalgamated bank, having regard to the nature and extent of the proposed activities to be undertaken by it, and the nature and degree of supervision and regulation applying to such proposed activities; and

c whether the transaction is in the best interests of the Canadian financial system.

In addition, the amalgamated bank will still be subject to Canadian regulatory, ownership and control restrictions to the extent that it remains a bank existing under the Bank Act. If the amalgamated bank is organised outside Canada, following the completion of the amalgamation, its activities in Canada will remain subject to the Bank Act. Given the central position played by Canadian domestic banks in the Canadian financial services sector, it is hard to contemplate the successful completion at this time of any transaction by which the government would allow a large Canadian bank to be acquired by a foreign bank, even by way of amalgamation, under circumstances where the amalgamated bank would not continue its existence as a bank under the Bank Act. Further, due to the regulatory restrictions on any person acquiring a significant interest (i.e., in excess of 10 per cent of any class of shares of a bank) without further ministerial consent and the outright statutory bar to anyone becoming a major owner of a bank unless the acquirer is also widely held, within the meaning of the Bank Act, it would be difficult for an acquirer to pledge its equity in a bank in context of financing an amalgamation with the Canadian bank to any significant extent. A bank is permitted to pledge its assets as security for its own obligations, but only to the extent that the grant of such security falls within the bank's internal policies relating to the grant of security, which policies are reviewed regularly by OSFI.

ii Transfers of banking business

The Bank Act contains a statutory regime for the transfer by a Canadian bank of all or substantially all of its assets to another Canadian financial institution or a foreign bank licensed to operate a branch in Canada.

The process requires the purchaser and seller to enter into a formal written agreement, which must be submitted to OSFI prior to the agreement being approved by the shareholders of the selling bank. The consideration for the transfer of such assets must be cash or fully paid securities of the purchasing financial institution or foreign bank, or any other consideration specified in the agreement of purchase and sale. The agreement must then be submitted to the shareholders of the selling bank for approval by special resolution (a resolution approved by not less than two-thirds of the shareholders of the bank entitled to vote on such resolution). Once approved, the agreement must be submitted for approval to the Minister within three months of shareholder approval. Any such agreement is of no force and effect unless and until it is approved by the Minister. The Bank Act does not address any issues relating to customer consent to any such transfer. These issues are generally a matter of contract and would typically be addressed by a bank's contractual arrangements with its customers, giving the bank broad and open-ended contractual rights to alter its customer arrangements and to structure its affairs in the manner that the bank may require.

The Bank Act also provides, subject to a limited set of exceptions, that a Canadian bank cannot transfer more than 10 per cent of the total value of its assets to any single person without the consent of the Superintendent (the head of OSFI).

VII THE YEAR IN REVIEW

OSFI is in the process of implementing a number of regulatory initiatives to further strengthen the capital bases of Canadian banks and to contribute to the stability of Canadian financial institutions. OSFI implemented new capital guidelines meeting the requirements of Basel III as they are to apply to deposit-taking FRFIs in January 2013, with a greatly accelerated phase-in period for the increase in minimum capital standards beyond that required by Basel III. OSFI also designated the six largest domestic Canadian banks as systemically important, issued an advisory detailing additional prudential regulatory requirements for application to such institutions, and instituted newer liquidity requirements and leverage limitations. OSFI also issued new guidelines addressing sound practice in the use of derivatives incorporating G20 commitments and reflecting current market practices, and addressing sound business practices for operational risk management. OSFI is undertaking a review of corporate governance requirements in relation to changes in a bank's board of directors and senior management, current large exposure limits, materiality criteria for related party transactions, cyber risk, mortgage underwriting and mortgage insurance with a view to further tightening Canadian credit standards and protecting the Canadian banking sector from systemic risk. OSFI's projects of improving the disclosure of information, with a focus on enhanced reporting of bank risk exposure and risk management practices, are ongoing. In addition, OSFI is continuing to study issues relating to solo capital requirements in light of new considerations related to D-SIBs, as consideration is being given to these issues in other jurisdictions, and it is considering these issues in the context of the Canadian financial marketplace.

There have been no significant federal pronouncements or actions taken by Canadian regulatory authorities to regulate and increase public reporting of over-the-counter derivatives (OTC) utilised by sophisticated investors. Some Canadian provinces have adopted legislation and regulation addressing the use of OTC derivatives by less sophisticated investors, and Quebec enacted new derivatives legislation in April 2008, which is primarily principles-based regulation. Canadian securities authorities have issued position papers suggesting that all OTC derivatives are securities subject to regulation under provincial and territorial securities laws. Beginning in 2010, the Canadian Securities Administrators (CSA), a body comprising representatives of Canadian provincial and territorial securities regulators began publishing a series of consultation papers on the regulatory treatment of OTC derivatives under which the CSA promoted the benefits of increased disclosure and the use of a central clearing house to clear and close out OTC derivatives. This process has now advanced to the enactment of rules by certain provinces, including Ontario and Manitoba, on product determination, trade repositories and data reporting, and the issuance of additional draft rules for comment on various aspects of the derivatives market, including clearing, settlement and collateralisation of cleared derivatives, essentially mirroring some of the provisions of the US Dodd-Frank Act reporting obligations, counterparty representations, and the collection and dissemination of information relating to OTC derivatives transactions.

The government also continues the process of re-examining the ability of banks to enter into the automobile leasing business. This issue has been under consideration by the government for generations, and it is too soon to tell whether there will be any meaningful change in government policy.

Foreign banks have been active in long-term project finance transactions with Canadian borrowers, including public-private infrastructure transactions and renewable energy (especially solar and wind) development projects, while Canadian banks generally have not been very active in financing facilities with a term of 10 years or more.

The financial downturn in the United States and Europe, and the weaknesses of related financial markets and financial institutions relative to those of Canada, provided an opportunity for Canadian financial institutions, and Canadian banks in particular, to expand into new financial markets, particularly in the United States. The past year has seen Canadian banks benefit strongly from this significant foreign expansion and acquisition, particularly from their US assets. Given the strong position that Canadian banks find themselves in and their high levels of profitability, it is expected that this trend will continue in the near term. However, the government requires FRFIs to obtain Canadian ministerial approval for material foreign acquisitions. Banks with equity of C$2 billion or more will require the consent of the Minister to acquire control of a foreign financial services provider if the assets of the entity over which control is being acquired, when added to the assets of all foreign financial services providers over which control was acquired within 12 months, exceeds 10 per cent of the acquiring banks' consolidated assets, as shown on its last annual statement that was prepared before its first acquisition of a foreign financial services provider within the relevant 12-month period.

VIII OUTLOOK AND CONCLUSIONS

Canadian financial institutions are generally thought to be well capitalised and are profitable. The government has been active through its participation in the G8 and G20 in protecting the interests of the Canadian financial services sector by ensuring equal access to foreign markets and actively working against anticompetitive market practices and proposed taxes on bank balance sheets, all of which would penalise Canadian financial institutions for having been good stewards of their balance sheets and protecting the interests of their shareholders.

Canadian financial markets are strong and active. This past year, Canadian financial markets were characterised by a level of activity that was at or exceeded pre-recession levels. Canadian banks are lending to good corporate customers at spreads equivalent to pre-recession levels last seen in 2007. The Canadian bond market is equally active. Barring some unexpected catastrophic market development, it is expected that this trend will continue through the next year and possibly accelerate.

Appendix 1

ABOUT THE AUTHORS

SCOTT HYMAN

Davies Ward Phillips & Vineberg LLP

Scott Hyman is a partner practising primarily in the banking, project finance and structured finance areas, including merchant banking, secured lending, financial institutions regulation, derivatives and structured products. A large component of his practice in these areas is transactional work, which includes provision of advice in structuring and completion of domestic and cross-border secured and unsecured credit facilities, acquisition finance, structured finance and project finance transactions. He regularly acts for financial institutions and companies, lenders and borrowers in the arrangement and facilitation of acquisition, project, working capital, asset-based, equipment and bridge financings. He has extensive experience in financial institution regulatory matters, and regularly advises Canadian and foreign financial institutions in connection with the regulatory aspects of the transactions in Canada. He was named in *Lexpert* magazine's 'Top 40 Under 40' (2004 and 2006) and is included in *The Lexpert/American Lawyer Guide to the 500 Leading Lawyers in Canada*; *Canadian Legal Lexpert Directory*; C*hambers Global*: *The World's Leading Lawyers for Business*; *IFLR 1000*; *The Best Lawyers in Canada, Expert Guides' Guide to the World's Leading Banking Lawyers*; and *Who's Who Legal: Canada*. He obtained his BA from the University of Toronto, and his LLB and LLM from Osgoode Hall Law School. He was called to the Ontario Bar in 1993.

CAROL PENNYCOOK

Davies Ward Phillips & Vineberg LLP

Carol Pennycook is a partner whose practice includes syndicated loan transactions, infrastructure and project financings, PPP transactions, corporate reorganisations, debt and equity offerings, M&A, derivative products and property development joint ventures. Some of her recent transactions include acting on PPP transactions in Canada for project consortia or their lenders; renewable energy transactions including joint ventures for wind and solar developments and project financing of renewable energy facilities; revolving, term corporate and acquisition credit facilities; and capital markets bond, debenture and MTN offerings in Canada and the United States. She also acted for the successful consortium on the Port of Miami Tunnel project and for a short-listed consortium on the Indiana Ohio River Bridge project. She is a director of P3 Canada, a federal Crown corporation, and was chair of the Committee for Review of the Commodity Futures Act (Ontario). She is a recipient of Lexpert's Zenith Award, and is lauded as a world-class, national leading lawyer by, *inter alia*, *Chambers Global*, *Euromoney*, *Expert Guides' Best of the Best for Banking and Guide to the World's Leading Women in Business*, *IFLR 1000*, *PLC Which Lawyer?*, *Best Lawyers* and *The Lexpert/American Lawyer Guide to the Leading 500 Lawyers in Canada*. She was called to the Bar in Alberta in 1981 and Ontario in 1985.

DEREK VESEY

Davies Ward Phillips & Vineberg LLP

Derek Vesey is a corporate partner in the Toronto office with a broad practice encompassing syndicated loan transactions, infrastructure and payment financing, private equity and general corporate matters. He has played a lead role in numerous major syndicated credit facilities acting for both borrowers and lenders, and is actively involved in the firm's private equity group. He also provides advice to clients involved in public-private infrastructure projects, and has acted on a large number of public and private acquisitions as well as numerous corporate reorganisations. He has been recognised for banking and finance in *Chambers Global: The World's Leading Lawyers for Business* and as a repeatedly recommended lawyer in the areas of corporate mid-market law and project finance in *The Canadian Legal Lexpert Directory*. He obtained his LLB from Osgoode Hall Law School, and was called to the Ontario Bar in 1998.

NICHOLAS WILLIAMS

Davies Ward Phillips & Vineberg LLP

Nick Williams is a partner whose practice focuses on banking and project finance, PPP, infrastructure development, secured lending and private equity. He has acted in numerous project finance, PPP, infrastructure and private equity transactions advising lenders, sponsors, equity investors, developers, operators, purchasers and various levels of government across multiple sectors, including infrastructure, energy and mining. He also has extensive experience in syndicated lending, having acted for lenders and borrowers on syndicated domestic and multi-jurisdictional financing transactions. He is recognised as a leading banking and project finance lawyer by, *inter alia*, *The Lexpert/American Lawyer Guide to the 500 Leading Lawyers in Canada*, *IFLR 1000*, *The Best Lawyers in Canada, Chambers Global: The World's Leading Lawyers for Business* and the *Canadian Legal Lexpert Directory*. He gained his LLB from the University of Western Ontario and was called to the Ontario Bar in 1989.

DAVIES WARD PHILLIPS & VINEBERG LLP
155 Wellington Street West
Toronto, ON M5V 3J7
Canada
Tel: +1 416 863 0900
Fax: +1 416 863 0871
www.dwpv.com