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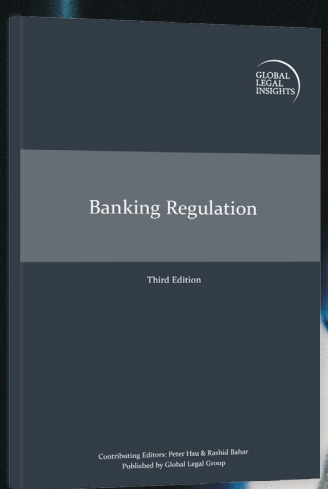
Global Legal Insights

Banking Regulation - Third Edition



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Contributing Editors: Peter Hsu & Rashid Bahar
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GLOBAL LEGAL INSIGHTS - BANKING REGULATION

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Introduction

Banks in Canada have been continuously recognised as amongst the soundest and safest across the globe. During the global financial crisis, while a number of banks in other countries became insolvent, failed or received taxpayer bailouts, Canadian banks remained well-capitalised, well-managed and out of the danger zone. Notwithstanding, the global financial crisis has led to a series of significant regulatory changes (most significantly in the areas of liquidity and capital) designed to reduce the risk of another global financial crisis occurring, of which Canadian banks are already or will become subject, to ensure that they will continue to be well-positioned for any risks going forward.

Regulatory architecture: overview of banking regulators and key regulations

Banking in Canada falls under federal jurisdiction such that the Parliament of Canada has legislative authority over "Banking, Incorporation of Banks, and the Issue of Paper Money". The primary piece of legislation that governs banking in Canada is the *Bank Act* and its regulations.

Banks in Canada are supervised by multiple regulators, with the Office of the Superintendent of Financial Institutions (OSFI) responsible for prudential regulation, and the Financial Consumer Agency of Canada (FCAC) responsible for consumer protection. OSFI regulates and supervises all banks under its supervisory framework, develops and interprets legislation, and issues guidelines. The FCAC ensures that federally regulated financial institutions comply with consumer protection measures, and helps to keep consumers informed. FCAC's Compliance and Enforcement branch investigates and evaluates possible concerns, and has the power to enforce compliance.

Several other regulatory bodies are also involved in regulating banks in Canada. The Department of Finance helps the government develop and implement financial sector policy and legislation. The Bank of Canada, which is owned by the federal government, helps to keep inflation low, promotes efficient banking systems, is responsible for currency, and is a fiscal agent for the government. The Canadian Payments Association (CPA) runs the national clearing and settlement system in Canada. The Canada Deposit Insurance Corporation (CDIC) provides deposit insurance to all member institutions (which includes all major Canadian banks) against the loss of eligible deposits in the event of failure. The Financial Transactions and Reports Analysis Centre of Canada (FINTRAC) helps to protect Canada's financial system by detecting and deterring money laundering and terrorist financing under the *Proceeds of Crime (Money Laundering) and Terrorist Financing Act*[1] *and its regulations*. The Ombudsman for Banking Services and Investments (OBSI) is an independent and impartial body that resolves disputes between banks and their customers when a bank is not able to resolve the dispute internally. The Canadian Bankers Association helps to ensure Canada has a successful banking system by advocating for effective policies and working with banks and law enforcement to protect Canadians against financial crimes. Banks in Canada also need to ensure compliance with privacy legislation which is enforced by the Office of the Privacy Commissioner of Canada who has the power to investigate complaints, conduct audits, and pursue court action. Finally, the Financial Institutions Supervisory Committee, whose membership consists of OSFI, the Bank of Canada, the Department of Finance, CDIC and FCAC meets to discuss, coordinate, and advise the federal government on issues related to the Canadian financial system.

There are also three supranational regulatory bodies that are influential in Canadian banking. The Bank for International Settlements (BIS), of which the Bank of Canada is a member, leads global regulatory work on financial systems across the globe. The Basel Committee on Banking Supervision (Basel Committee) is made up of BIS members, and sets out to strengthen worldwide banking through the release of recommendations aimed at enhancing financial stability. OSFI is a Basel Committee member and is committed to implementing its recommendations. Lastly, the Financial Stability Board (FSB), which consists of G20 countries, monitors and makes recommendations related to the global financial system.

Restrictions on activities

The *Bank Act* imposes ownership requirements on banks in Canada. For instance, the *Bank Act* prohibits a person from being a major shareholder of a bank with equity of $12bn or more. Banks with equity of more than $2bn but less than $12bn must have at least 35% of their shares with voting rights listed and posted on a recognised stock exchange and they must not be owned by a major shareholder.

Pursuant to the *Bank Act*, banks are only permitted to carry on the "business of banking" which includes activities such as providing financial services, acting as a financial agent, providing investment counselling, issuing payment, credit, or charge cards, etc. Except when permitted by the *Bank Act*, banks may not "deal in goods, wares or merchandise or engage in any trade or other business".

The *Bank Act* also includes restrictions on undertaking fiduciary activities, guarantees of payment or repayment, dealing in securities, engaging in the insurance business, undertaking personal property leasing activities, and entering into partnerships. Moreover, banks have restrictions on the types of investments they can make and are prohibited from investing in an entity that carries on some activities listed above or entitles that deal in securities, except in certain circumstances. Banks may invest in securities, but are restricted from making substantial investments (e.g. acquiring more than 10 per cent interest in a non-bank entity) or in controlling certain types of entities. Under s.468(1) of the *Bank Act*, banks may acquire control of, or make a substantial investment in other banks, trust or loan companies, insurance companies, cooperative credit societies and entities primarily engaged in dealing in securities. However, certain investments nonetheless require the approval of OSFI or the Minister of Finance.

Banks are prohibited from imposing any undue pressure or coercion to obtain a product or service on any person. Subject to certain exceptions, a bank cannot make a loan that contains conditions which prohibit the prepayment of the loan prior to the due date, nor require an initial minimum deposit or the maintenance of a minimum balance with respect to a retail account of an individual who meets certain prescribed conditions.

Banks are also prohibited from entering into related party transactions, except as otherwise permitted under the *Bank Act* (for instance, if the value is "nominal or immaterial to the bank").

Recent, impending or proposed changes to the regulatory architecture

The banking architecture in Canada has continued to change to strengthen financial security and to incorporate international standards. For example, in July 2015, the *Regulations Amending Certain Regulations Made Under the Proceeds of Crime (Money Laundering) and Terrorist Financing Act, 2015* were proposed in order to update and strengthen the legislation to combat money laundering and terrorist financing activities, strengthen due diligence requirements regarding customers, close gaps in Canada's regime, improve compliance, monitoring and enforcement efforts, strengthen information sharing and address technical issues.[2]

The CPA launched an initiative to modernise Canada's payment structure by introducing a new internationally recognised payment standard, the ISO 20022. Implementation of the new standard is part of a five-year strategic plan. Some of the main benefits of the ISO 20022 include additional remittance information which will in turn support automated reconciliation and straight-through processing and greater interoperability for cross-border payments. Implementation of the new standard will also mean moving away from the use of multiple standards and their associated costs.

A Memorandum of Understanding (MOU) designed to strengthen cross-border cooperation in the event of bank failure was signed by CDIC and the UK Prudential Regulation Authority in 2015. Cooperation between countries to assist banks with cross-border activities has been identified by the FSB as one of the essential features of effective resolution regimes for large financial institutions. This MOU follows similar arrangements CDIC has established with the U.S. Federal Deposit Insurance Corporation, Mexico's Instituto para la Protección al Ahorro Bancario, the Deposit Insurance Corporation of Japan and Taiwan's Central Deposit Insurance Corporation. CDIC will continue to work with international counterparts to strengthen relationships and improve cross-border cooperation and coordination.

In 2015, the Minister of Finance approved OBSI and ADR Chambers Banking Ombuds Office (both of which are regulated by FCAC) as bodies corporate dealing with complaints made by persons having requested or received products or services from its member financial institutions, pursuant to subsection 455.01 of the *Bank Act*.

On January 9, 2015, OSFI issued the final version of its advisory with respect to the early adoption of IFRS 9 for Domestic Systemically Important Banks (D-SIBs) (i.e., the six largest banks in Canada) requiring that D-SIBs adopt IFRS 9 for the annual period beginning on November 1, 2017. Smaller, less systemic Federally Regulated Entities (FREs) with annual periods ending October 31, 2017 can choose to adopt the standard on November 1, 2017 or wait until January 1, 2018 when all FREs with annual periods beginning January 1, 2018 are required to adopt the standard. IFRS 9 is a forward-looking approach which aims to improve issues arising from the method of accounting for financial instruments, simplify the existing rules and enhance investor confidence in the financial system in Canada.

OSFI has introduced several other changes and proposed changes recently. In January 2016, OSFI released draft guidelines clarifying its expectations regarding domestic implementation by Canadian banks of the *Revised Pillar 3 Disclosure Requirements* issued by the Basel Committee in January of 2015.[3] OSFI also: posted new instructions for corporate returns in November, 2015; released a revised advisory clarifying the implementation of annual policy disclosure requirements as set out in the Basel Committee document *Global systemically important banks: updated assessment methodology and the higher loss absorbency requirement* (G-SIB Framework); released a draft guideline entitled *Operational Risk Management* setting out OSFI's expectations for the management of operational risk based on the size, ownership structure, nature, scope and complexity of operations, corporate strategy and risk profile of each bank; revised the guidelines for incorporating banks under the *Bank Act* (along with federally regulated trust and loan companies); revised its transaction instructions for related-party asset transactions with a financial institution; reduced the number of OSFI guidance documents to ensure that OSFI guidance remains current and accessible; and released an advisory outlining how OSFI administers and interprets the substantial investment regimes set out in several statutes, including the *Bank Act*.

Recent regulatory themes and key regulatory developments in Canada

Canadian banks are subject to the regulatory oversight of OSFI. OSFI has publicly affirmed its commitment to participating in the development of international financial standards, and has been proactive in the adoption and implementation of the Basel III framework of the Basel Committee. It is expected that the theme of principle-based regulation and individual institution oversight will continue in Canada as well as the implementation of resolution regimes.

Capital conservation buffer

To avoid breaches of minimum capital requirements, banks in Canada are now required to hold a capital conservation buffer.[4] These changes were set out in OSFI's 2014 *Capital Adequacy Requirements* and implementation of the capital conservation buffer began at the beginning of 2016. This process will continue until 2019 at which time the capital conservation buffer will be equal to 2.5% of a bank's risk-weighted assets. Currently, banks in Canada are advised to maintain the minimum Common Equity Tier 1 capital ratio, Tier 1 capital ratio and Total capital ratio plus the capital conservation buffer.

Common Equity Tier 1 Surcharge

Consistent with the Basel Committee's Basel III framework,[5] and as described above in the section "Recent, Impending or Proposed Changes to the Regulatory Architecture", OSFI has designated six Canadian institutions as D-SIBs: Bank of Montreal; Bank of Nova Scotia; Canadian Imperial Bank of Commerce; National Bank of Canada; Royal Bank of Canada; and Toronto-Dominion Bank of Canada. These six D-SIBs account for approximately 90% of the total assets of Canada's federally regulated deposit-taking institutions[6] and must achieve compliance with heightened regulatory requirements. The imposition of such requirements may offset the potential negative impact of any one D-SIB's failure.

As of January 1, 2016, D-SIBs are subject to a Common Equity Tier 1 Surcharge (CET1) equivalent to 1% of the D-SIB's risk-weighted assets. This CET1 surcharge is implemented through the extension of the capital conservation buffer. D-SIBs will be restricted in their ability to make distributions such as dividends in the event they do not satisfy their relevant capital conservation ratio.

Bank governance and internal controls

The legislative requirements for the governance of banks are found in the *Bank Act* which prescribes the form and degree of governance required.[7] The *Bank Act* sets out that Canadian banks must have a minimum of seven directors; if the bank is a subsidiary of a foreign bank at least half of its directors must be resident Canadians, and if the bank is a domestic bank a majority of its directors must be resident Canadians. Banks are prohibited from having more than two-thirds of their directors qualifying as 'affiliated' with the bank which includes, but is not limited to, the following relationship with the bank: ownership of a significant interest in a class of shares; being a significant borrower; or acting as officer.[8] Directors are legally obligated to discharge their duties honestly and in good faith with a view to the best interests of the bank, and are required to exercise the care, diligence and skill set that a reasonably prudent person would exercise in comparable circumstances. Directors must also establish an audit committee, a conduct review committee, a committee to monitor compliance with public disclosure requirements and a committee to monitor the resolution of conflicts of interest. The CEO of a Canadian bank must be a director of the bank as well as a resident of Canada. A significant feature of the *Bank Act* is the reservation of the power in the shareholders to remove a bank's directors. A bank's board of directors (Board) is responsible for ensuring that the compensation of employees, senior management (Management) and the Board is aligned with the bank's long-term interests.[9] Compensation for all employees is to be consistent with the FSB's *Principles for Sound Compensation* guideline and related *Implementation Standards*.

Corporate governance – the role of the board and management

Although the legislative regime of the *Bank Act* is fulsome, OSFI publishes guidance documents which detail the practical mechanisms of compliance in the Canadian banking industry. OSFI released a 'Corporate Governance' guideline in January 2013 (Governance Guideline) to communicate OSFI's expectations with respect to corporate governance of banks and to complement the *Bank Act* and the applicable *Supervisory Framework and Assessment Criteria*.[10] The Governance Guideline does not apply to the branch operations of foreign banks and foreign insurance companies. The Governance Guideline highlights the distinction between the decision-making role of a bank's Board and the decision-implementing role of its Management and sets out that a Board should be independent of Management. Apart from the critical separation of the roles of Board Chair and CEO, the Governance Guideline does not prescribe any single Board structure as guaranteeing independence.

The Governance Guideline sets out that the Board plays a crucial role in the success of a financial institution through its approval of overall strategy and risk appetite as well as oversight of Management and internal controls. The Governance Guideline sets out that the primary functions of a bank's Board should include approving the following:

- Short- and long-term business objectives and strategies including a Risk Appetite Framework (RAF) detailing the aggregate level, type and limits of risk acceptable to the bank to achieve its objectives.
- Significant strategic initiatives such as mergers and acquisitions.
- Appointment, performance review and compensation of the bank's CEO and other senior Management, where appropriate, as well as succession planning regarding the Board, CEO and other members of senior Management, where appropriate.

- Prompt notification of regulators when the bank is faced with substantive issues.
- External audit plan.
- Internal control framework.

Management of a bank should be responsible for, among other things, a review of the following:

- Significant operational and business policies.
- Business and financial performance relative to the strategy and Risk Appetite Framework approved by the Board, as per above.
- Implementation and effectiveness of internal controls.
- Regular interaction with regulators regarding the overall operations of the bank.
- Organisational structure.
- Compliance with relevant laws, regulations and guidelines.

Both Board and Management have significant duties beyond those expressly found in the *Bank Act*. The structure of the bank itself may impose some further duties on a Board. For example, a parent company's Board should implement sufficient oversight of a subsidiary's activities to ensure that the parent Board is able to discharge all of its responsibilities to the parent company. The interaction between Management and the Board should occur primarily through the CEO. The Board should supervise the oversight functions of the bank through the engagement of the relevant committee, such as the audit committee. The heads of the oversight functions should have sufficient authority and autonomy from Management. They should have unfettered and direct access to the Board or the relevant Board committee for reporting purposes.

Risk governance

One focal element of the Governance Guideline is the concept of risk governance. As risk is a necessary part of conducting business as a financial institution, OSFI characterises risk governance as a distinct and crucial element of corporate governance in Canada. Banks should be in a position to identify the important risks they face, assess the potential impact of such risks and have policies and controls in place to effectively manage them. Risk governance includes, but is not limited to, liquidity, credit, market, insurance, and operational risks. As stated above, a bank's Board should establish an RAF that is "enterprise-wide and tailored to its domestic and international business activities and operations". The RAF should include the goals, benchmarks, parameters and limits that the bank considers appropriate, and should establish mechanisms to control risk as well as a process to ensure the effectiveness of such controls.

Measures endorsed in the Governance Guideline include the creation of a Board Risk Committee and the appointment of a Chief Risk Officer. The Chief Risk Officer should have the necessary stature and authority within the bank and should be independent from operational management. The Chief Risk Officer should not be directly involved in revenue-generation and their compensation should not be linked to the bank's performance of specific business lines. OSFI sets out that the Chief Risk Officer should have unfettered access to and a direct reporting line to the Board or Risk Committee.

The role of the audit committee

The Governance Guideline also expands upon the relevant duties of the Audit Committee as mandated by the *Bank Act*.[11] The Audit Committee, not Management, should recommend to the shareholders the appointment of the external auditor for the bank. The Audit Committee should satisfy itself of the skills, resources and independence of the external auditor prior to reaching an agreement to engage the auditor and should put in place a process to address any concerns raised by OSFI or other stakeholders regarding the independence of the external auditor selected. The Audit Committee should discuss with Management and the external auditor the overall results of the audit, including, but not limited to, a review of the following:

- Key areas at risk of material misstatement within the financial statements.
- Areas of material auditor judgment, including accounting policies and estimates.
- Opinion of the external auditor on the nature of the estimates/models (for example, whether the estimates/models are aggressive or conservative), and, if there are options, the reasoning that led to the final valuation decision including a consideration of industry practice.

- Deficiencies in the bank's internal control.
- Areas for improvement in financial statement disclosures.

The Audit Committee should report to the Board on the effectiveness of the external auditor on an annual basis.

Outsourcing banking functions

Technology, specialisation, cost and competition continually and dynamically shape the market for Canadian banks both domestically and abroad. Banks may consider outsourcing certain activities in response to such shifts in the market. Following the 2008 global financial crisis, OSFI revised its guideline on 'Outsourcing of Business Activities, Functions and Processes' (the "Outsourcing Guideline") in March 2009. A central premise of the Outsourcing Guideline is that although regulatory flexibility is afforded in order to ensure the commercial viability of Canadian banks, banks remain responsible for all outsourced activities.[12] In light of this responsibility, a bank's Board should periodically approve and review outsourcing policies and relationships. Management should communicate with the Board regarding material outsourcing risks, develop outsourcing policies for Board approval, implement such outsourcing policies upon approval and periodically review their effectiveness.

It is expected that banks will assess the materiality of their outsourcing arrangements, developing and maintaining a Risk Management Program for all material outsourcing arrangements. A list of sample questions is provided in the Outsourcing Guideline to aid banks in their assessment of the materiality of a particular outsourcing arrangement. A bank should maintain a centralised list of all outsourcing arrangements identified as material as part of its Risk Management Program. A template for such a centralised list is annexed to the Outsourcing Guideline. OSFI recommends the use of a table to capture the nature of the arrangement, the jurisdiction from which the service is being provided, the expiry and renewal dates applicable to the arrangement, the estimated cost of the arrangement and the estimated value of the contract.

Bank capital requirements

Part X of the *Bank Act* deals with adequacy of capital and liquidity for Canadian banks and requires that banks maintain adequate capital and adequate and appropriate forms of liquidity. Bank capital consists of "Tier 1" capital, consisting of Common Equity Tier 1 capital and Additional Tier 1 capital, and Tier 2 capital.

OSFI is authorised under the *Bank Act* to establish guidelines (and has issued guidelines) respecting both the maintenance of adequate capital and adequate and appropriate forms of liquidity. The Capital Adequacy Guideline implements the related Basel III capital rules without significant deviation, other than a more accelerated timeline than required under Basel III. All Canadian financial institutions (regardless of the size) have been required to adhere to the Basel III BCBS Disclosure Rules since the beginning of Q3 2013.

Canada has also adopted the Basel III leverage ratio and disclosure requirements which came into effect beginning in Q1 2015, requiring all Canadian banks to maintain a leverage ratio that meets or exceeds 3% at all times. OSFI also has the power to prescribed leverage ratio requirements for specific institutions at a greater level than 3% on the basis of a number of factors, including the institution's risk-based capital ratios compared to internal targets and OSFI targets, the adequacy of capital and liquidity management processes and procedures and the institution's risk profile and business lines. The authorised leverage ratio for individual institutions is not publicly disclosed.

As part of compliance and monitoring requirements, financial institutions provide OSFI with quarterly Basel Capital Adequacy Reporting (BCAR). If reporting indicates deteriorating capital, the financial institution can be subject to escalating stages of intervention, starting with additional reporting requirements and continuing to specific temporary restrictions on the business lines of the financial institution. Additionally, OSFI has the authority to direct a financial institution to increase its capital if it determines that a financial institution is undercapitalised. Similarly, in severe cases, OSFI has the authority to take control of the assets of the financial institution or take control of the financial institution if it determines that the bank is experiencing severe financial difficulties.

Rules governing banks' relationships with their customers and other third parties

The *Bank Act* and specific regulations thereunder have detailed provisions relating to consumer protection issues. Among other things, the *Bank Act* and related regulations contain requirements for the simplified disclosure to customers of the cost of borrowing and interest rates.

The FCAC has the mandate of administering consumer protection provisions of the *Bank Act*. Pursuant to the *Financial Consumer Agency of Canada Act*, the FCAC's mandate includes, among other things: supervision of federally regulated financial institutions to ensure that they comply with federal consumer protection measures; promotion of policies and procedures, voluntary codes of conduct, and financial institutions' public commitments designed to implement consumer protection measures; monitoring compliance with such codes of conduct, policies and procedures; supervision of payment card network operators; and promotion of related consumer financial awareness. The FCAC also monitors and evaluates trends and emerging issues in consumer financial services and promotes public awareness about the consumer protection obligations of financial institutions and payment card network operators. The FCAC has the power to impose monetary penalties, impose criminal sanctions or take other actions as are necessary. However, in most cases of minor oversights the FCAC will work with financial institutions to rectify any issues.

The CDIC, a statutory corporation, provides deposit insurance on certain types of small deposits. The CDIC is funded through premiums charged to member institutions. The CDIC insures up to $100,000 per customer per financial institution per insured category of deposits for certain eligible Canadian dollar-denominated deposits (including savings accounts, chequing accounts and term deposits with an original term to maturity of five years or less).

With respect to customer information and privacy, Canadian banks must comply with the *Personal Information Protection and Electronics Documents Act* (PIPEDA). In addition, all banks in Canada have a common law duty of confidentiality in their dealings with customers and in customer identification. PIPEDA provides a regulatory regime in respect of collection, use and sharing of personal information in the context of commercial activities, and requires that institutions obtain an individual's consent prior to using such personal information. Canadian banks have a positive duty to safeguard personal information that has been collected and to abide by the limits on the retention of personal information as set out in PIPEDA.

Banks are also required to comply with the federal statute known as Canada's Anti-spam Legislation (CASL) which regulates unsolicited commercial electronic communications sent by commercial enterprises to individuals. CASL applies to all electronic messages and requires the prior consent (express or implied) of the recipient before any such message can be sent. CASL includes mechanisms for civil recourse as well as monetary penalties and criminal charges for non-compliance.

* * *

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