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RE-REGULATING THE CANADIAN FINANCIAL SECTOR:

THE OWNERSHIP DIMENSION

On December 18, 1986, the Honourable Tom Hockin, Minister of State for Finance, released New Directions For the Financial Sector (henceforth referred to as "New Directions" or the Hockin paper) the long-awaited federal blueprint for regulating financial services. The public's reaction thus far to the underlying thrust of the position paper have been very favourable, and appropriately so. "New Directions" responds to the international trend toward the integration across both institutions and markets by proposing an open, flexible and creative regulatory environment that would appear on the surface to enable Canadians and their institutions to participate fully in the global financial revolution. However, as is increasingly evident in the public discussion flowing from the position paper, there is one area that is beginning to cast a pall over the initial exuberance, namely the very restrictive provisions relating to ownership of financial institutions and in particular to the prohibition of any link between commercial and financial interests. It is, of course, true that those who are expressing concern are those who are most affected by the policy (e.g., the commercially-linked narrowly-held institutions). However, it is also true that the concerns they raise touch upon the very core of, and rationale for, the federal policy, e.g., that "New Directions" may well stifle the very competition it was designed to promote and that in the final analysis the financial sector may become more, not less, concentrated. At the very least, such claims ought to, and will be, subjected to detailed evaluation and analysis.

It is important to recognize that this emerging controversy relates not to the underlying policy principles with respect to ownership but rather to

the manner in which "New Directions" chooses to implement these principles. Indeed, the underlying principles in "New Directions" with respect to ownership could hardly be more clearly enunciated:

> "The government does not believe that it is appropriate to adopt a broad general ownership policy for uniform application to all financial institutions, particularly in view of the differing ownership circumstances that have developed over time and now exist in the Canadian financial services industry. In a dynamic and competitive financial system, there is room for both widely-held and majority-controlled financial institutions. Each form brings its own strengths, both now exist and have served Canadians well: neither is inherently better than the other." (p. 15)

By way of policy intent, "New Directions" then states:

> "The government proposes to retain the ownership distinction between banks and non-banks that now exists and reflects the Canadian reality." (p.15)

These principles clearly applied to the original federal Green Paper (1985). They also apply to the existing Quebec legislation and to the proposed Ontario legislation for both trust companies and the securities industry. Ironically enough, however, they would not appear to apply to the provisions of the federal paper itself. Indeed, of the various reports on the financial system over the past few years, "New Directions" is probably the most restrictive when it comes to the issue of tolerating anything other than widely-held ownership.

One of the reasons why the ownership controversy took so long to surface relates to the fact that many of the palyers confidently assumed that the rather sketchy narrative of "New Directions" (i.e., 40 pages of text which, by one estimate, will convert into close to 1,000 pages of legislation) would,

when fleshed out by further elaboration and interpretation, fall back in line with the underlying principles with respect to ownership. While the detailed legislation has not as yet been tabled, there is now little doubt that the federal government's intent is to follow through with its restrictive ownership provisions.

Thus, the purpose of this paper is to review and assess the arguments with respect to the ownership of financial institutions. Part II of the paper focuses in more detail on the federal and provincial proposals as they relate to the ownership of financial institutions. Part III highlights the possibilities for jurisdictional confrontation and outlines the underlying economic issues. Part IV contains the heart of the analysis. It focuses in detail on the pros and cons of wide and narrow ownership. Much of the material for this section is adopted from the recent hearings on ownership and concentration conducted by the Standing Committee on Finance and Economic Affairs of the Ontario Legislature. Indeed, whenever possible the analysis is conducted in the words of the interested parties. Part V is devoted to internal corporate governance and, in particular, to the role of business conduct review committees (BCRCs) as a means for policing abusive self-dealing. Part VI contains a summary of the analysis followed by two compromise approaches that address the issues raised in the paper. A short conclusion completes the paper.

At the outset, it is important that I reveal my own bias. In my view, "New Directions" has come down far too hard in terms of restricting ownership. More importantly, the implications of this approach are likely to be very far-reaching. Among other things, the paper will argue that on broad economic grounds, the issue is whether the wide ownership provision will

become effectively a barrier to entry and, therefore, inhibit market contestability. On broad pragmatic grounds, the issue is whether wide ownership is the only way to ensure against abusive self-dealing and against the concerns that arise from the co-mingling of the commercial and financial sectors. On jurisdictional grounds, the issue on the domestic front is whether Canada's "big bang" in the financial services area will become a federal-provincial shoot-out. On the international front, the issue is whether domestic capital is being forced off-shore and foreign capital is being given preferential access. My overall conclusion is that, in terms of ownership, "New Directions" in itself is in need of new directions. Specifically, the detailed provisions relating to ownership should conform much more closely to "New Directions" own enunciated principles.

II: OWNERSHIP PROVISIONS

A: FEDERAL PROPOSALS

"New Directions" responds to recent global trends toward the internationalization of markets, toward the integration of the pillars and toward the securitization of loans by allowing ownership integration across the traditional four pillars -- banks, trusts, insurance and securities. However, as noted above, it does so in a manner that favours widely held institutions. Since this is not very evident from a straightforward reading of the federal position paper, the purpose of this section is to elaborate on this theme, focusing first on the regulations pertaining to narrowly-held ownership with commercial linkages.

1. Commercial Linkages

As of December 18, 1986, approval for the incorporation of new banks, trust companies and insurance companies will no longer be granted for applicants with significant commercial interests. The definition of a "significant commercial interest" has two dimensions. First, the individual or corporation must have more than 10% of the shares of the financial institution, i.e., the owner must qualify as a majority or significant shareholder. Second, a majority shareholder of a financial institution will be defined as "commercially linked" if he/she owns more than 10% of the shares of a commercial company (Weir, 1987), This definition of a commercial link will be subject to a de minimus test designed to "ensure that significant shareholders of financial institutions whose total commercial interests are small relative to their financial interests do not serve to bring their financial institutions within the purview of the foregoing ownership rules" (Weir, 1987, p. 20). Total commercial interests will be measured as the aggregate of book value of all ownership interests involving holdings of 10% or more in commercial corporations. The de minimus test will exempt shareholders whose commercial interests are 5% or less of their total interests in regulated financial institutions. More on the implications of this de minimus exemption later.

Of more interest are the provisions relating to the existing commercially-linked, majority-held financial institutions, e.g., Power Financial, Trilon, Imasco (Canada Trust). "New Directions" dictates that "commercially-linked trust, loan and insurance companies with more than $50 million in capital will be required to have at least 35 per cent of their voting shares publicly traded and widely held by December 31, 1991, or within

5 years of reaching the $50 million capital threshold" (p. 17). Moreover, from December 18, 1986 onward no significant shareholder will be allowed to increase his/her percentage holdings. In effect, this provision "grandfathers" these firms, but only in their existing range of institutions. Even if they meet the 35 per cent widely-held requirements, they are still deemed to be commercially linked and hence bound by the previous requirement prohibiting any new incorporations or acquisitions.

2. Majority-Held Institutions Without Commercial Links

The provisions relating to narrowly-held or majority ownership without commercial linkages are much more lenient. Narrowly held trust, loan, or insurance companies where the owners have no commercial links can remain narrowly held (even wholly owned) provided the amount of capital is less than $750 million. Once this capital threshold is passed, the 35 per cent requirement will become operative, again with a five-year period for compliance. What applies beyond the $750 capital threshold is not fully evident from the federal document. My interpretation is that meeting the 35 per cent requirement would grandfather the firm in its current range of activities: to embark on any new ventures (incorporations or acquisitions) would require getting down to 10 per cent ownership.

There is an important further provision relating to all narrowly-held institutions, namely that in reducing ownership levels shares cannot be sold to other significant (over 10 per cent) shareholders. This implies that as significant shareholders sell out, ownership must move in the direction of being widely held.

Needless to say, the banks, mutuals, and the credit unions and caisses

populaires, are not affected (at least directly) by any of these provisions since they are either widely held or deemed to be. However, as will be pointed out later, even some of the mutuals have expressed concerns about the restrictions on ownership and commercial linkages.

3. Mergers and Acquisitions

The Minister of Finance will retain discretionary power to approve the acquisition of one financial institution by another financial institution. There are two guidelines in aiding the Minister in exercising this discretionary power. First, large financial institutions will not, except fot the securities industry, be allowed to acquire other large financial institutions. Second, the announced preference for expansion to new areas is to build rather than to buy. More later on the implications of these provisions.

4. Securities Firms

"New Directions" appears to allow all federally chartered financial institutions to incorporate securities firms or to acquire existing securities firms. Presumably this provision is designed to accommodate the Quebec, Ontario, and other provinces' regulations which do not place any ownership requirements on securities firms.

5. Corporate Governance and Self-Dealing Bans

Finally, it is important to note that "New Directions" also incorporate provisions relating to self-dealing bans and internal corporate governance. These proposals are closely related to the policy on ownership since they

represent alternative ways to monitor non-arms'-length transactions, henceforth referred to as NALTs. Later sections of this paper will highlight these provisions, particularly the role and scope of corporate self-governance.

B: PROVINCIAL PROPOSALS

Quebec's recent legislation for the insurance and securities sectors contains no ownership provisions. Nor does Bill 116, the proposed legislation for Ontario trust companies, or the recent regulations pertaining to the Ontario securities sector (except for a one-year staged entry for foreign acquisitions of domestic securities firms). Ontario, in particular, has accompanied its trust company legislation with very restrictive self-dealing bans. Neither Ontario nor Quebec requires that financial institutions embark upon internal corporate governance procedures.

With this institutional information as backdrop, it is now appropriate to focus on the likely implications of these differing ownership provisions for the evolution of the Canadian financial services sector. The next section deals first with the potential federal-provincial jurisdictional consequences focuses on some of the economic implications of the federal proposals.

III: JURISDICTIONAL AND ECONOMIC ISSUES

A: LOOMING JURISDICTIONAL BATTLES

It would come as a surprise indeed if the narrowly-held, commercially-linked, federally-regulated financial institutions were not

seriously contemplating either (a) incorporating new, or purchasing existing, provincially-regulated financial institutions, or (b) rechartering provincially. It would also come as a surprise if the federal government were not anticipating and "guarding against" such moves. Although I am not a constitutional lawyer, my hunch is that Ottawa might hold sway here, as long as the institution involved is federally regulated. It is far less clear that Ottawa has, at present, much influence over the behavior of financial holding companies, even those that have federally regulated institutions as subsidiaries. The Supreme Court could well be the final arbiter.

However, where Ottawa may not have the upper hand is in the following hypothetical, but not unrealistic, scenario. Suppose, for illustrative purposes, that Bell Enterprises decides to purchase or establish an Ontario or Quebec securities firm. Suppose, further, that Bell then decides to purchase or establish provincial trust and/or insurance companies. To this point, there would appear to be no problem, although no doubt there would be substantial concern on the part of the federal authorities. Now suppose, however, that the trust company applies for access to the payments system and for a "money" card.

It is clear that this could be viewed as an end run around the intent of the federal proposals, since a commercially-linked, narrowly-held financial institution is now requesting access to the payments system. (Note that this was perfectly acceptable prior to December 18, 1986, and continues to be acceptable for the grandfathered institutions.) One can hazard a guess that the federal government would attempt to deny Bell access to the payments system. If Ottawa did not take this approach, it would be putting itself in a situation where it would be difficult to deny the other end runs elaborated

earlier, namely federally-regulated financial institutions rechartering provincially or acquiring provincially-regulated financial institutions.

The constitutional implications of all of this are far from evident. First of all, to have any case at all, it would seem that the federal government would have to bring in legislation to the effect that access to the payments system is what banking is all about. However, such legislation does not now exist and although the payments system resulted from federal legislation it is more akin to a "national" system than a "federal" system since provincially-regulated institutions also have access. Second, the jurisdictional dispute arises because of what Ottawa has done, not because of what the provinces have done. To take a specific example, consider the situation of the stock insurance companies. Under "New Directions", Ottawa has granted them essentially full banking powers on the asset side of their balance sheets. However, they did not request such powers and are not likley to make full use of them. "New Directions" has also decreed that if they want to take full advantage of the new proposals they must become widely held, again something the insurance companies did not ask for. Throughout all of this, the Ontario and Quebec legislation with respect to insurance companies has not changed in any significant way. In other words, it is the federal legislation that has precipitated the jurisdictional problems. Thus it is not at all evident that the courts will come down on the federal side. But what is also evident is that the federal government will likely not accept the situation where one of the principal implications of "New Directions" is that existing and de novo financial institutions will seek refuge in provincial jurisdictions. Again, we are probably headed for the courts on this issue.

B: ECONOMIC IMPLICATIONS

On first reading, "New Directions" gets high marks for enhancing competition. The proposals do respond to the globalization of markets and to the integration of pillars. Allowing financial institutions to enter the securities industry recognizes the current trend toward disintermediation (i.e., securitization). Moreover, the granting of additional powers to trust and insurance companies and the enhancing of the banks in-house powers in the securities area will also enhance competition. However, it is also the case that "New Directions" carves out a new power balance across existing institutions: widely-held institutions will find their powers significantly enhanced in absolute terms and relative to narrowly-held firms, especially those with commercial linkages. The up side is that several mutual life companies and banks are already taking advantage of these new powers and flexibility. But there is a down side as well. In my view, the Achilles heel of "New Directions" is new entry or, in economic jargon, ensuring that financial markets remain contestable. It is instructive to review the federal proposals from this perspective.

First of all, "New Directions" prohibits any new commercial institutions from entering the financial sector either directly or via mergers and acquisitions. Second, the existing commercially-linked majority-held institutions are also locked out of new incorporations and acquisitions unless they commit themselves to becoming widely held. Interestingly enough, these institutions may also be "locked in" to the financial sector since they can only sell their shares in accordance with wide ownership precepts. Given that such institutions may find themselves at a decided competitive disadvantage

relative to the banks, mutuals, credit unions and other widely-held institutions (if such exist), it may be difficult to sell these shares except at a capital loss. Note that any resulting capital losses will also impact upon minority shareholders of these institutions. Hence, Ottawa may well have a political as well as an economic problem on its hands.

The _de minimus_ rule for defining a commercially-linked shareholder also works against new entry. If I own $10 million of equity in, say, a brewery I cannot incorporate a new, small, federal financial institution. However, if I happen to already wholly own a federal financial institution that has, say, $205 million in capital I will then be viewed as "financial" (i.e., not commercially linked) since my commercial holdings in the brewery are less than 5% of my financial holdings. Indeed, I am entitled to accumulate $750 million in financial capital before even the 35 per cent rule applies. This seems clearly perverse in terms of catering to new entry concerns.

The federal government will presumably claim that new entry concerns are satisfied by the provision whereby financially-linked majority ownership can accumulate $750 million of capital before triggering the 35 per cent requirement. But who falls in this category? The word from the street is that the _de minimus_ rule might imply that the Empire Life group qualifies. This is a questionable example, since some significant institutions in the E-L Financial empire tend to be chartered provincially, not federally. My own view is that in terms of domestic financial institutions, this category is close to being an empty set and likely to remain so, although one has to admit the possibility that some existing financial conglomerates may qualify by spinning off their commercial holdings to _de minimus_ levels.

The prospect for new entry by widely-held institutions also appears

bleak. Most of the score of new widely-held banks that emerged as a result of the 1967 Bank Act provisions have either failed or merged, so that this route for ensuring contestability appears weak or non-existent.

This leaves one further avenue -- entry by foreign financial institutions. "New Directions" is not entirely clear in terms of its proposals for these institutions. Temporarily, at least, the status quo prevails. Over time, however, it appears clear that institutions such as the schedule B banks will be brought into the proposals. The recent federally-approved takeovers (Continental by Lloyds and Bank of British Columbia by the Hong Kong Bank of Canada, a wholly-owned subsidiary of the Hong Kong and Shanghai Banking Corporation) point in the direction of treating schedule B's as <u>financially-linked</u> majority-held institutions. In turn, this would imply that they could accumulate $750 of capital prior to being affected by the federal ownership proposals. This would clearly help out in terms of ensuring entry, but it does so in a manner that is likely to generate considerable political and jurisdictional friction. In the limit, this approach would suggest that Deutsche Bank Canada, whose parent not only has downstream commercial linkages, but has effective control over several of Germany's top 100 commercial corporations (Marfels, 1987), will be free to maneuver in the domestic financial market in a way that is not open to Power Corporation or Trilon. Moreover, such a preference on the part of the federal government for foreign commercially-linked institutions over domestic commercially-linked institutions would surely compromise any federal constitutional challenge with respect to provincial ownership provisions.

C: RECAPITULATION

This, then, is the descriptive backdrop to the ownership controversy. As these various proposals reach committee stage the debate is sure to intensify. Indeed, the debate is already in full swing. The CBA (1987) has argued that "New Directions" ownership rules do not go far enough in the direction of ensuring wide ownership. The conglomerates are also beginning to make their views public (Howlett, 1987). Jacques Parizeau (1987) has recently attempted to resurrect the Blenkarn proposal on grounds that "New Directions" is weak in terms of promoting domestic new entrants into the financial sector. And so on.

At this juncture it is instructive to step back a bit and focus on some of the underlying economic dynamics. First of all, the financial services sector is one of the fastest growing industries worldwide. It is at the leading edge of the technological revolution, both in terms of computational and telecommunications developments. Not surprisingly, therefore, capital is being attracted from all parts of the economy to the financial services sector. Some of the attraction is simply portfolio diversification. Some is probably related to exploiting expertise in either or both of telecommunications or computer technology. (There is a rumour that IBM is attempting to buy Merrill Lynch and it cannot be long before Bell Enterprises thinks seriously about a securities subsidiary.) Some is surely motivated by the potential for synergy in terms of offering an integrated range of financial products. And some may be driven by the horizontal integration gains that may arise from co-mingling the real and financial sectors. Underlying all these motives, however, is the quest for the higher returns

that are available in the financial sector.

Second, world class financial services firms require enormous amounts of capital. Constraining Canadian financial institutions from raising capital from commercial organizations will put them at a serious disadvantage relative to foreign firms which do not face such constraints.

Third, restrictive Canadian regulatory provisions with respect to ownership of financial institutions will obviously not alter the relative attraction of financial services investment internationally, and perhaps not even in Canada. But they do have the potential for altering the structure of the Canadian financial sector. By limiting the ability of commercially-linked capital to flow into the financial sector, the predictable results will be (a) to encourage foreign capital to take up the resulting slack, (b) to enhance the degree of domestic financial concentration among the existing players, and (c) to encourage Canadian capital to go offshore in search of investment in the financial sector. In terms of this latter point, I am sure that institutions like Imasco, Power Financial and Royal Trust are already casting their sights offshore in the event that they are frozen out domestically. Indeed, some of the possibilities are intriguing. For example, might Power Financial not increase both its international and domestic flexibility by relocating its head office to, say, Belgium, and then seeking reentry into Canada as a Schedule B bank?

To be sure, this is a highly unlikely scenario. However, the fact that such a scenario can be contemplated, theoretically or practically, surely highlights the core issue in all of this. Why is the federal government proposing these ownership restrictions? What are the benefits that will accrue to the financial sector from widely-held ownership? Do these benefits

exceed the costs generated by restricting entry? Are there alternative approaches available which are less extreme than Ontario's and Quebec's very permissive proposals on the one hand and Ottawa's very restrictive ones or the other? Or does the federal position simply reflect an overriding public policy concern, regardless of potential economic consequences?

To attempt to get to the heart of this issue is the purpose of the remainder of this paper.

IV: NARROW VS. WIDE OWNERSHIP: A SURVEY OF THE ISSUES

A: THE BURDEN OF PROOF

There is no question that concerns relating to narrow ownership, and in particular commercially-linked narrow ownership, rose to the fore in the wake of what Jacques Parizeau refers to as the "trust musketeers" (Crown, Greymac, and Seaway). The later failures of the CCB and Northland Bank, both of which were widely held, served to diffuse the concerns somewhat, at least to the extent that self-dealing problems were now also associated with management and boards of directors. Moreover, the bank failures, more so than the Crown-Seaway-Greymac debacle, directed attention to the inadequacy of the system of supervision. All of these factors, in addition to a rethinking of the powers appropriate for the various financial institutions, were the focus of parliamentary committees in both the House of Commons and the Senate.

It is probably fair to say that one of the critical turning points in terms of both public and legislative awareness of the potential problems associated with narrowly-held ownership of financial institutions was the

testimony before the Blenkarn Committee in September, 1985, by Bernard Ghert, the president of Cadillac-Fairview Corporation. The timing and substance of the testimony as well as Ghert's apparent, if not real, impartiality with respect to the issue served to lend substantially greater focus and credibility to the view that widely-held ownership is the only acceptable policy for the financial sector. More recently, this view has been popularized by Diane Francis (1986) in her book, Controlling Interest.

As a result the burden of proof in the debate appears to have shifted rather dramatically: the banks can now assert, almost self-righteously, that commercially-linked, narrowly-held ownership of financial institutions is virtually synonymous with abusive self-dealing and it is left to the trusts, stock insurance companies and financial conglomerates to plead that the historical tradition of majority ownership of financial institutions has contributed enough to Canadian society that it be allowed to continue. The extent of this change of attitude is reflected by the fact that the Green Paper contained no limitations on majority-held ownership of financial institutions whereas "New Directions" can, as noted above, be viewed as embodying the principle of 10 per cent ownership.

In order to broach the debate, it seems appropriate to focus first on the views of Bernard Ghert (1985). Basically Ghert fears the consequences of undue concentrations of economic power in huge conglomerates, particularly the exercise of financial power by non-financial companies through financial holding companies. At one level, his concerns relate chiefly to the evils of concentration:

> "Potential adverse consequences of this concentration are:
>
> i. ability to misallocate resources by restricting output and raising prices;

ii. redistribution of income from the firm's customers to its owners;
iii. firms with excessive power can become inefficient and wasteful;
iv. a high level of concentration reduces the number and diversity of decision makers in the economy.
v. large concentrations may be unresponsive to regulatory agencies and have the ability to influence public policy;
vi. corporate concentration may stimulate greater government intervention as a countervailing power" (1985, p.68A:5).

In principle these concerns apply to all concentration, whether widely or narrowly held. But applying these consequences to commercial and financial intermingling leads Ghert to be very concerned about self-dealing and conflicts of interest "when a financial institution has both a debt and equity interest in a non-financial corporation" (p.68A:6). Noting that the difficulty in experimenting with higher levels of concentration of power is that they may not be reversible (since governments may be unwilling or unable to dismantle mega-groups once they are established), Ghert concludes that "public policy must not facilitate any increase in the concentration of ownership of financial institutions or more importantly in the trend to unification of control of financial and industrial corporations" (p.68A:6).

His main concern would appear to be the implications for "macro-level concentration" that would arise from the levering of the commercial and financial. One example of this relates to the ability of a commercially-linked, narrowly-held financial institution to discriminate against its owners' real-side competitors:

> "The public record has many examples of economic power being used in ways that are not always in our best interests in this country. As an example, I know of an instance where, if witnesses were required to testify under oath, they would tell you of a financial institution which

had instructions from senior executives of the parent non-financial company to refuse loans to one of its competitors" (p.68A:6).

Not surprisingly, the Canadian Bankers Association (henceforth referred to as the CBA) included this quotation to buttress wide ownership in their testimony before the Ontario Standing Committee on Finance and Economic Affairs (CBA, 1986).

Ghert's ultimate concern, however, is the accretion of macro-level power to the point where it may take on overtones of political influence:

> "Power is the ability to produce intended effects on others; it can also mean the exercise of discretion in decision-making. Another attribute of power is the ability to pursue non-economic objectives, even at the expense of economic considerations. The greater the concentration of power, particularly the exercise of financial power by non-financial companies through financial holding companies, the greater the risk of abuse, either directly or through informal networks and spheres of influence in the business community" (p.68A:6).

and

> "By further concentrating the control of business enterprises, conglomerates [particularly those that unify the control of financial and industrial corporations] may have a greater impact on government policy making. Certainly, a large conglomerate enterprise is likely to "interface" with government in more places than a giant firm whose activities are concentrated in a single industry" (p.68A:22).

As an overall summary of Ghert's concerns, it is useful to reproduce his response before the Ontario Standing Committee to the question of whether or not concentration or largeness is necessary to compete effectively in the world markets:

> "You can have largeness in a sense. Canada needs large financial institutions. Canada needs large steel companies. Canada needs large brewing companies, large merchandisers, large forestry companies, large petroleum companies, mining companies, if those companies are going to have the capital and the management to compete in international markets. But it is when you put those together, large steel companies with large mining companies with large trust companies, into one bag, that I have the concern about the potential for the impact on our economy and our institutions.
>
> ...if you have a big pool of financial assets you can have a major impact on the marketplace. You can have a major impact on getting people to do things that you want them to do" (1986, p. F.7 and F.26 respectively).

This, then, is a brief overview of Bernard Ghert's views on concentration. While most of his points are not particularly novel, the timing and eloquence of his testimony and evidence surely played a major role in the ownership conversion from the Green paper to the Hockin paper.

Thus far, these concerns have been reproduced without comment or analysis. In many cases, such comment is warranted. For example, Ghert's premise that power is the ability to pursue non-economic objectives, even at the expense of economic considerations, would probably argue against "management-controlled" institutions where the ability exists to ignore the interests of the shareholders. However, the approach I have adopted is to use Ghert's views as backdrop to the more detailed focus on the pros and cons of alternative ownership arrangements. Not surprisingly, many of the issues touched upon derive from the above concerns raised by Ghert.

B: ARGUMENTS FOR WIDE OWNERSHIP

1. Market Concentration

Setting aside for the time being the so-called macro-level concentration concerns, the issue at hand is whether or not there are policy implications for wide ownership that derive from concerns relating to the concentration of financial markets. There are several aspects that merit attention.

Dealing first with individual product markets, Table 1 presents aggregate data relating to product market shares by type of financial institutions. The chartered banks (As and Bs) dominate the consumer and commercial loan markets but have a much smaller influence in the market for mortgage loans. Note that by opening up commercial and consumer loans to the trust and insurance companies, "New Directions" will serve to increase the competition and lessen institutional concentration in these markets. However, two traditional measures of concentration (i.e., the percentage accounted for by the four largest companies and the number of companies needed to account for 80 per cent of the market) indicate that concentration is already decreasing in these markets. This is apparent from Table 2. Interestingly enough, the evidence shows that the degree of concentration is increasing in the mortgage market, even though it remains by a considerable margin the least concentrated of the markets in Table 2. Some of the reduced concentration in the consumer and commercial lending markets is presumably due to the advent of the schedule B banks. One would expect that the impact of "New Directions" would be to decrease the four-company concentration ratio. It is not clear what will happen to the second index (the number of companies needed to account for 80 per cent of total assets). My best guess is that it will rise

TABLE 1

Financial Institutions' Market Share - 1984

(Expressed as %)

	Ch'd Banks (A&B)	Trust Co.	Life Co.	Credit Unions	Other
Assets	56	8	11	7	18
Deposits	65	18	-	15	2
Commercial Loans	84	2	-	4	10
Consumer Loans	71	5	6	14	4
Mortgage Loans	31	27	16	17	9

Source: Royal Trustco (1986, p. 8).

TABLE 2

Concentration in Selected Markets among Major Groups of Financial Institutions,[1] Canada, 1979 and 1984

	Percentage of activities represented by the four largest companies			Number of companies needed to account for 80 per cent of the market[2]		
	Mortgages	Domestic deposits	Domestic personal and commercial loans	Mortgages	Domestic deposits	Domestic personal and commercial loans
1979	29.9	53.8	70.0	23	9	5
1984	32.6	47.7	62.7	20	12	7

1 Full ownership links and holding groups are taken into account.

2 In a study by the Department of Consumer and Corporate Affairs, the degree of concentration is determined by the number of companies that account for 80 per cent of the output or employment of an industry. The degree of concentration is "very high" when that number is four or fewer; "high" with five to eight; "relatively high", with nine to 20 companies; "relative low," with 21 to 50 companies; and "low," with more than 50 companies.

Source: Economic Council of Canada (1987), Table 3-4.

(i.e., the number of companies will fall), given the ability to integrate ownership across the pillars and the generally recognized proposition that to be viable in the 1990s financial institutions will have to be large and diversified (except for the niche players). More importantly, this likely increase in concentration will be more pronounced if commercially-linked capital is held at bay, since the number of large-scale diversified institutions will be reduced.

A second approach to concentration of the financial sector is to focus on the size of institutions with respect to the overall financial sector. Here one rapidly becomes involved in a battle of the balance sheets. Before the Ontario Standing Committee, Empire Life's Jackman (1986) argued that, according to Financial Post data, the amount of assets under control (i.e., excluding assets under management such as Estate, Trust and Agency (ETA) assets) of closely-held shareholding groupings are relatively small compared to the total assets in the system. Table 3, reproduced from Jackman's submission indicates that domestic narrowly-held financial conglomerates account for only 7.8 per cent of the total financial assets of the 100 largest financial institutions in Canada. Indeed, he notes that "according to the figures supplied by the Financial Post, all of the closely-held shareholder controlled companies when added together do not equal the assets of any single one of Canada's five largest national banks" (1986, pp. 3-4). Thus implicit, if not explicit, in the Jackman message is that power in the Canadian financial sector is concentrated in the hands of a few large banks. But he goes much further:

> "Large banks have tended to mean large loans to a few large borrowers and may have contributed to the concentration of corporate power in the non-financial sector of this country" (p. 4).

TABLE 3

Financial Post Survey

100 Largest Financial Institutions
(December 31, 1985)

	# of Institutions		Amount of Assets ($ billions)	
Canadian Owned & Widely Held	12	(12%)	413.0	(67.4%)
Foreign Controlled	44	(44%)	62.9	(10.3%)
Government Owned (Fed. & Provincial)	8	(8%)	55.5	(9.1%)
Co-operatives & Credit Unions	18	(18%)	33.5	(5.5%)
Canadian Owned (with an identifiable significant shareholder interest)	18	(19%)	48.0	(7.8%)
	100	(100%)	$612.9	(100.0%)

Source: Jackman (1986), p. 2.

Moreover, in Jackman's view the perceived feeling that regional interests have not been well served by large banks with their headquarters in Montreal and Toronto has led to the rapid growth of the credit union and cooperative movement, which is much stronger in Canada than in the U.S. where the degree and location of bank concentration is much more diverse. Similar concerns have led to the proliferation of the trust and loan companies, most of which are provincially chartered. One can extend this line of argument to suggest that the emergence of narrowly-held financial trust and insurance companies is in large measure a response to the concentration of existing financial power in the hands of the chartered banks. Jackman concludes:

> "Therefore any discussion of concentration of power in the financial services industry must be related to the question of being able to form viable competitive entities which will be able to take on the banks on their own turf without sacrificing the primary requirement of ensuring solvency. Therefore combinations of non-bank financial institutions which have the effect of increasing competition should be encouraged...fully automated on-line systems, automatic tellers and the requirements of providing full service to customers demand a certain size to be fully competitive with the largest of our institutions" (p. 5).

As an interesting aside, Jackman's contentions appear deserving of further research. In effect, his hypothesis is that the concentration of financial power in the hands of a few national banks has contributed in turn to (a) the concentration in the commercial sector, and (b) to the development of regional trusts, credit unions and eventually large financial conglomerates. Thus, in his view the emergence of conglomerates is a direct result of the powerful position of the banks and, hence, is serving to diffuse concentration.

The CBA view (1986) of all of this is poles apart from the Jackman

view. Table 4 presents the CBA approach. While the two tables differ in their coverage (the top 10 in Table 3 vs. all financial institutions in Table 4) and in the manner in which they classify institutions, it is very evident that Table 4 reveals a substantially decreased percentage for chartered banks and a dramatic increase for the combination of trust and life companies. Most of the trust company assets and a substantial portion of the life insurance assets would fall under the Table 3 category of "Canadian owned with an identifiable significant shareholder interest." The principal differences between Tables 3 and 4 are the following:

- Table 3 focuses on all assets, domestic and foreign, of Canadian financial institutions whereas Table 4 focuses only on the Canadian assets (except for some foreign assets of trust companies which are not segregated out in their balance sheets).
- Table 3 deletes the ETA (estates, trust and agency) assets and segregated fund assets on grounds that they are not under the "control" of the trust companies. Table 4 includes 1/2 of these ETA assets as well as 1/2 of segregated fund assets.

Both these modifications are dramatic -- chartered bank foreign assets as of June 30, 1985 were $190 billion and ETA funds were in the same range.

The CBA paper then presents a comparison of the six largest banks and the six largest conglomerates, based on the Table 4 methodology. The comparison is reproduced as Table 5. The data indicate that Trilon and Genstar Financial (now Imasco/Canada Trust) each have financial assts which exceed the domestic operations, as measured by Canadian currency assets, of the T-D Bank, the Bank of Nova Scotia and the National Bank of Canada. [However, if we made the comparison in terms of total assets of the banks, the

TABLE 4

Adjusted Canadian Currency Assets of Financial Institutions
(June 30, 1985)

	($ millions)	(% total)
Chartered Banks[1]	$230,195	42.1%
Trust/Mortgage Loan Companies[2]	134,680	24.6
Life Insurance Companies[3]	67,302	12.3
Credit Unions/Caisses Populaires[4]	42,904	7.8
Property/Casualty Insurance Companies[5]	16,545	3.0
Financial Corporations[6]	15,302	2.8
Investment Dealers[7]	12,021	2.2
Quebec Savings Banks[8]	5,940	1.1
Investment Funds[9]	7,377	1.3
Other[10]	15,051	2.8
Total	$547,317	100.0%

1 Total Canadian dollar assets of all Schedule A and B banks including assets of banks' mortgage loan subsidiaries - Bank of Canada Review Table C-3.

2 Includes Canadian dollar intermediary assets as in Appendix II as well as one-half of E,T&A assets (Statistics Canada 61-006 Table 23) and retirement savings funds (Statistics Canada Table 88) adjusted, where data available, to include Canadian assets only.

3 Includes Canadian dollar assets as in Appendix II as well as one-half of segregated funds (Statistics Canada Table 100).

4 Statistics Canada 61-006 Table 33.

5 Statistics Canada 61-006 Table 114.

6 Statistics Canada 61-006 Table 45.

7 Statistics Canada 61-006 Table 119 (this figure is understated as information was not available on funds under administration by investment dealers).

8 Bank of Canada Review - Chart D-5.

9 Statistics Canada 61-006 Table 73.

10 Includes financial leasing corporations, business financing corporations, real estate investment trusts (REITs), closed-end funds, and accident/sickness branches of life insurance companies in Statistics Canada 61-006 Tables 56, 60, 64, 68 and 110 (this figure is understated as it does not include Alberta Treasury Branches, Province of Ontario Savings Offices, etc.).

Source: CBA (1986), Appendix VI.

TABLE 5

Banks and Financial Conglomerates: Corporate Data - 1985

Banks	($ billions)	Conglomerates	($ billions)
RBC	$53.9	Trilon Financial	$40.1
CIBC	48.8	Genstar Financial	35.3
BOM	44.1	Desjardins Group	29.7
TD	32.4	Power Financial	26.1
BNS	25.7	E-L Financial	19.6
NBC	16.1	Traders Group	6.4

Source: CBA (1986).

bank figures as of December 1985 would be: RBC ($96 billion); Montreal ($82 billion); CIBC ($76 billion); BNS ($61 billion); T-D Bank ($50 billion); National Bank ($23 billion).] The thrust of the CBA brief is two-fold -- to argue that banks do not have as large a market share as is commonly believed and, relatedly, to emphasize that the conglomerates are much larger than they are typically perceived to be.

In a companion paper in the present volume, R.S. Khemani (1987) compares the top five banks with the top five conglomerates. Focusing first on both domestic and foreign assets but excluding ETA funds, the top five banks account for 45.9% of total financial sector assets in 1985. The top five holding companies (one of which, Desjardins, is widely held) account for 11.7%. If ETA assets are included, the percentages are 36.7% and 22.0% respectively.

Finally, Table 6 focuses on the size of institutions in terms of the two concentration ratios. Regards of whether the comparison is in terms of domestic or foreign assets or including or excluding ETA funds, concentration has decreased slightly over the 1979-84 period.

Recapitulation

Rather than becoming involved in picking sides in this definitional battle, I prefer to focus on some of the implications as they relate to ownership and concentration. First of all, markets tend to become concentrated in the Canadian context whenever entry is difficult or the border is closed, or both. Historically, both of these conditions prevailed and they account for the current dominance of the big five banks. Easing domestic chartering under the provisions of the 1967 Bank Act led to a score of new

TABLE 6

Concentration of Assets among Major Groups of Financial Institutions,[1] Canada, 1979 and 1984

	Percentage of total assets represented by the four largest companies				Number of companies needed to account for 80 per cent of assets[2]			
	Total assets		Domestic assets		Total assets		Domestic assets	
	Without ETA	With ETA	Without ETA	With ETA	Without ETA	With ETA	Without ETA	With ETA
1979	53.1	45.0	47.7	39.4	13	14	16	17
1984	50.4	41.0	42.2	35.7	16	15	21	19

1 Full ownership links and holding groups are taken into account.
2 See footnote 2 of Table 2.

Source: Economic Council of Canada (1987), Table 3.3.

chartered banks but, as noted above, most have now either failed or merged with the larger banks. Opening the border under the provisions of the 1980 Bank Act has proved to be a more effective challenge to the major banks, particularly at the wholesale end of their business.

Secondly, the rise of trust companies and credit unions has contributed substantially to enhancing competition at the retail end of financial services. This is clearly evident in terms of hours of service, but it is equally apparent in the increased range of financial products and services.

Thirdly, it is true that the conglomerates have, through mergers and internal growth, made some inroads on the dominant position of the major banks. Some of this has been due to the fact that the banks have been widening spreads between lending and borrowing at the retail end in response to their off-shore and oil-patch losses and that the majority held trusts have been able to capitalize on this spread. Some is no doubt due to the fact that the trusts (and credit unions) are not required to hold non-interest-bearing required reserves with the Bank of Canada. However, the greatest impetus to conglomerate growth has been that they have (until "New Directions") enjoyed far greater powers relating to cross-pillar activity than have the chartered banks.

The fourth point is that "New Directions" will alter rather dramatically the powers available to banks and to conglomerates. Because they are widely held, the banks can now roam acquisitively across the pillars. The conglomerates are stopped dead in their tracks. In my view, even if there were no ownership requirements embodied in "New Directions," the fact that the powers of the banks are unleashed would guarantee that they would more than hold their own in any market showdown with the conglomerates. However,

because the conglomerates' ability to maneuver has been reduced under "New Directions," the spectre of greater chartered-bank domination, and enhanced concentration, of the financial sector looms as the almost inevitable result.

It is true that there may be some important counterweights. "New Directions" has also unleashed the latent power of the mutual life companies and some of them are already flexing their new-found financial muscle. The other counterweight to the banks may be found in opening up the border. If the thrust of "New Directions" is to treat schedule B's as financially linked (rather than commercially linked) entities, then they will offer considerable competition to the banks, at least at the wholesale level.

The fifth point also relates to the new federal proposals. "New Directions" embodies a preference for de novo institutions rather than acquisitions. This clearly favours the major banks, all of which have at some point benefitted substantially from mergers. Few of the banks potential competitors have nationwide coverage. To shut off the merger or takeover route to these firms, whether mutuals or conglomerates, is to entrench the established position of the banks. More generally, the takeover route is an integral part of ensuring new entrants (although as noted earlier "New Directions" shuts this avenue off on two scores -- commercial linkages and the preference for building over buying). Moreover, there is an obvious and critically important relationship between new entry and acquisitions, or more generally between primary and secondary markets: if the acquisition or merger route is fettered, this will surely discourage new entrants. Setting aside the ownership concerns for the moment, it simply does not make economic sense to prevent Canada Trust, for example, from entering the Quebec retail market via the merger or takeover route.

In summary, therefore, "New Directions" may, ironically, serve to entrench the already dominant position of the chartered banks (Jackman, 1987). There may well be sound reasons for inhibiting new entry of commercial enterprises into the financial sector and for curtailing the powers of existing commercially linked conglomerates, but concern over the concentration of financial markets is not one of them. Indeed, curtailing the powers of commercially linked enterprises will serve to increase financial market concentration.

2. <u>Concentration of Economic/Political Power</u>

The CBA brief (1986) argues that narrowly-held ownership can lead to a concentration of economic/political power, which it summarizes as follows:

> "As fewer people gain control of more of the Canadian economy, their ability to influence and distort the political process grows. In addition, with the growth of large, multi-sector holding companies, the failure of one company in a group can have spin-off effects on other affiliates and the entire Canadian economy. This may weaken the ability of legislators to exercise regulatory control."

Again, there are several aspects to this concern.

One relates to the exercise of raw political powers or its obverse, namely that firms become so big or important that regulatory response to them is circumscribed. This situation can, of course, arise under any sort of ownership structure. However, Ghert's concern, reproduced above -- that commercially-linked financial conglomerates may enhance the exercise of this power since such institutions would have many more opportunities to "interface" with government -- is probably à propos here. Nonetheless, it is a bit ironic that the CBA should raise this issue. Surely it is axiomatic

that the government will not allow one of the big banks to fail. Indeed, the banks have become so influential that rescue attempts typically have to be disguised in order to maintain public confidence in the banking system. In the view of many, this is what the Dome bailout was all about.

Recently, Hal Jackman (1987) goes much further by expressing concern that the federal government has essentially tailored "New Directions" as a sophisticated and cleverly disguised bailout of the banks. With some $3 1/2 billion of loan losses last year and some $9 1/2 billion of non-performing loans, and with the trend toward investment banking rather than commercial banking, Jackman sympathesizes with the predicament of the banks, but he believes that the totality of provisions in "New Directions" are skewed much too far in favour of the banks.

Moreover, in terms of influencing decision-making, I am sure that the financial conglomerates wish that they had just some of the influence of the banks, given the remarkable transition from the Green Paper (which was essentially a paper about how the rest of the system, conglomerates included, could get into banking), to the Hockin Paper (which is essentially a paper about whether any other players deserve the new powers that the banks have been granted).

To the extent that the concern here is not so much sheer size as the potential for levering the commercial and financial, one solution may be the resort to selective self-dealing bans. More attention will be addressed to self-dealing bans in the later context of controlling certain types of non-arm's-length transactions. In the present context the point is simply that, given a sufficiently stringent set of self-dealing bans, any commercial investment in the financial sector will become akin to a "portfolio"

investment than a hands-on direct investment.

A second aspect embodied in the above quotation relates to the possibility that a failure on the commercial side could spread to the financial side. This, too, is a genuine concern and it is precisely for this reason that the Murray (Senate) Report (1986), for example, recommended that there be a financial holding company between the commercial and financial institutions. The more recent reports of the Economic Council of Canada (1986, 1987) are especially insistent on the use of financial holding companies as a buffer between the real and financial sectors.

A third possibility is that the underlying issue here is really the concentration of assets in the hands of a few families. In large measure this is the thrust of Francis' Controlling Interest: Who Owns Canada (1986), i.e., from the jacket of the book: "who are the 32 families who, along with five conglomerates, control one-third of Canada's assets?" To the extent that this is a problem (after allowing for the fact that her statement is way-off base unless one utilizes an extremely narrow definition of just what constitutes "Canada's assets"), it affects all sectors and not only the financial services sector. Hence, the range of solutions should also be generic rather than industry specific. Here, I agree with several of Francis' recommendations, e.g.:

- the application of succession duties or preferably accession duties to mitigate the perpetuation of family wealth across generations; and
- reform of the laws relating to merger activity so as to ensure that mergers are market-driven rather than tax-driven.

In summary, therefore, there is probably more substance to ownership

concerns arising from the economic/political aspect of concentration than there is from the market power aspect. Nonetheless, I find the argument neither compelling nor one that would let the big widely-held banks off the hook. Moreover, both of these concentration arguments have to be placed in the context of the on-going globalization of financial services. It was not too long ago when several of the Canadian chartered banks made the top 20 list of banks internationally. This is no longer the case. In the most recent Euromoney rankings (February 1987), the market value of the Royal Bank is less than 10 per cent of each of the top seven ranked banks and its overall ranking is 55th. In terms of assets, however, it fares much better -- 27th. But even here its assets are only 40% of those of top-ranking Citicorp.

3. Credit Deprivation

The CBA brief (1986) lists "credit deprivation" as a further reason for eliminating the link between the commercial and financial: "a financial firm, giving preferential rates to its industrial affiliate, or refusing credit to competitors of related non-financial companies, distorts the credit allocation process and leads to economic efficiency) (p. i).[1] The CBA elaborates as follows:

> "The problem with such a situation lies not only in the fact that the company which was refused credit must spend the time and effort to seek funds elsewhere. An even greater concern is that the information that the company in question was refused credit will become known in the marketplace and could affect the reputation of the borrowing company....Furthermore, the financial institution which turned down the loan would have information about the competitor which would be of use to its related non-financial company" (p. 5).

In my view the correct response to this concern is contained in the

Genstar brief (March 1986). In the quotation that follows Genstar is, of necessity, reponding to Bernard Ghert's claims and not to those of the CBA, since the CBA position paper was released only in the fall of 1986. However, given that the CBA comments rather faithfully reproduce Ghert's arguments, the Genstar position applies equally well to the CBA's concern:

> "The Cadillac Fairview Corporation, a major real estate developer not affiliated through ownership with any financial conglomerate, expressed a concern in a brief on the Green Paper that the mixture of commercial and financial power could limit the availability of funds to certain borrowers which compete with the affiliates of financial institutions and which have no such affiliation of their own. In a competitive environment, there is no advantage to be gained by the arbitrary refusal of a financial institution to lend to the competitor of an affiliated commercial enterprise. Any such refusal would only be to the financial disadvantage of the lender because the refused borrower would be easily able to obtain financing from a competitive source.
>
> There are enough competitors currently operating in the financial services industry that Cadillac Fairview's concern is unfounded. If its concern ever became a problem, that problem is more appropriately solved by measures to increase competition, such as expanding the commercial lending powers for loan and trust companies, or by specific competition legislation, such as 'refusal to deal' prohibitions, than by indirectly attempting a solution through domestic ownership limitations."
> (1986, p. 24)

By enhancing the commercial lending powers of trusts and insurance comapnies "New Directions" has increased competition in the market for loans, thereby minimizing this aspect of the concern with respect to narrowly-held ownership.

Sometimes this "credit deprivation" argument is phrased in terms of "credit bias". Canadians should have confidence that their financial institutions extend credit in an unbiased manner. It is hard to disagree with this. However, the implicit assumption here is that majority-owned financial institutions will be perceived by the public to give preferential loan

treatment to their owners. Not only do I believe that there is not much evidence to support this contention (indeed, federal legislation prohibits trust and loan companies making loans to owners) but, more importantly, as a matter of public perception the opposite is surely closer to the truth. The public would be far more likely to express a concern that it is the chartered banks that have a lending bias -- in favour of their large customers, which would in turn convert this concern into a board-of-directors bias, given the tendency for large customers to find their way onto bank boards. "Tell me which bank had Jack Gallagher as a director and I'll show you a bank that's overextended in the oil patch" is a familiar refrain.

Since lending to trust company directors is much more restrictive (relative to what is allowed for chartered banks), this concern about lending bias does not generate much in the way of a broadside against majority-held institutions.

4. Self-Dealing Concerns

We now come to what I believe is the heart of the issue. Concerns relating to self-dealing and conflicts of interest are typically front and centre in any debate over widely-held or narrowly-held ownership. The first part of this section focuses on self-dealing concerns arising from a comingling of industrial-financial relationships. The second part is devoted to potential self-dealing arising from boards of directors that are not "independent". Finally, the section concludes with the CBA reaction to the ownership provisions in "New Directions". The ensuing discussion of self-dealing is not intended to be exhaustive. For example, one of the implications that derives from the analysis is that there are alternative

ways, such as corporate governance, to attempt to limit the potential for abusive self-dealing. A description and evaluation of corporate governance appears as a later section of the paper.

Following upon the pattern established earlier, quotations from the interested parties themselves provide most of the analysis.

(a) Commercial/Financial Comingling

Once again, it appears appropriate to let the CBA (1986) set the stage:

> "Unlike non-financial companies, financial institutions use public deposits, as well as shareholder investment, in their operations. When one or a small group of investors controls a financial institution, there is an opportunity for owners to channel these deposits for personal use. Because financial institutions are highly leveraged, the cost of failure to participants is significantly higher than for non-financial institutions. With an average leverage of 20 times deposits to capital in financial institutions, there is much more at risk for depositors than for owners; the high degree of leverage implies that a dishonest owner could bilk depositors of far more than his cost of acquiring the depository. While bad management can occur in any organization, there is little possibility for owners of widely-held financial institutions, such as Canada's banks, to divert funds to themselves.
>
> Common ownership by one or a few individuals of both financial and non-financial institutions produces an added risk. Even with strict laws against self-dealing, the temptation to try to save, for example, a troubled real-estate affiliate by "borrowing" from the financial associate could compel an owner to circumvent regulatory authority." (p. i)

The CBA (1986) brief (pp. 2-3) buttresses these arguments by several pieces of evidence. First, it notes that according to a U.S. congressional survey, 61 per cent of FDIC-insured commercial bank failures in the United States from June, 1980 to June, 1983 can be attributed to insider dealings and major shareholdings misusing their position. Second, the CBA refers to a brief

presented to the Blenkarn Committee by the Regional Trust Company in September of 1985 which argued that between December 31, 1982 and mid-1985, 86.9 per cent of the loss provisions of the CDIC related to institutions where material self-dealing is either alleged or demonstrated. (Actually, these two points are somewhat misleading in terms of what they imply about shareholder self-dealing. With respect to the first point, both Jackman (1986) and McFetridge (1987) refer to the same data. McFetridge laments the fact that there is not sufficient detail given with respect to "insider dealings" to be able to distinguish between shareholder dealings on the one hand and management/director dealings on the other. A later quotation from Jackman will indicate that some of these companies were mutuals, where there are no shareholders. In terms of the second point, the CBA is also on questionable grounds in light of the substantial CDIC losses after mid-1985 in connection with the failures of the Northland and the CCB (both widely held), particularly since these losses were apparent before the CBA brief was presented.) Finally, the CBA provides an appendix that focuses on the details of ten international cases of abusive, or suspected abusive, self-dealing. Three of the ten cases are Canadian (Crown/Greymac/Seaway, Fidelity, and Astra Trust/Remor).

The underlying CBA position is that the only effective way of eliminating the potential for abusive self-dealing is to ensure that all financial institutions are widely-held. Therefore, even in the case of Bill 116 (Ontario's proposals for the trust industry) with its very restrictive self-dealing bans, the CBA recommendation is that the proposed legislation be amended to require a separation of industrial and financial business and to require that financial institutions be widely held.

In Controlling Interest..., Diane Francis takes much the same approach:

> "The easiest way to prevent self-dealing is to impose ownership limits on any lending institution taking deposits from the public and insured under the Canada Deposit Insurance Corp. Federal laws now limit bank ownership to 10 per cent, and this limit should also apply to provincially-chartered trust companies. Unfortunately, controlling interest in all trust companies is already held by individuals or conglomerates. Even so, they should be forced to divest over a ten-to-fifteen-year period" (1986, p. 328).

However, Francis adds: "if laws fail to disallow owning both types of assets [commercial and financial], self-dealing rules should be enacted to forbid financial companies from conducting any transactions with their real economy cousins" (Ibid., p. 330).

Professor Stefan Dupré, Chairman of the Ontario Task Force on Financial Institutions (1985), echoes this concern about the role that ownership provisions can play in minimizing self-dealing. After describing himself as a "regulatory pluralist", by which he means that self-dealing bans, enhanced supervision, audit committees and business conduct review committees all have an important role to play, Dupré (1986) offers the following conclusions before the Ontario Legislative Committee:

> "...in my respectful view, all the so-called business conduct review committees in the world and all the regulators that can be imagined are not proof against the abuses of self-dealing. In the words of my task force report, assurance that self-dealing will not arise in situations of closely-held ownership requires two acts of faith: the first, in the integrity of controlling owners and the second, in the capacity of regulators to ensure that self-dealing prohibitions are in fact enforced. More than enough incidents have yielded more than enough evidence to tell us that these acts of faith rest on foundations that are anything but robust" (1986, p. F.31).

This, then, is the case for the likelihood of abusive self-dealing in situations where there is majority ownership and a comingling of the real and financial. There is clearly something to these concerns.

For their part, the conglomerates and narrowly-held institutions recognize the problems with abusive self-dealing, but they obviously do not share the above analysis or solutions. Again, the Genstar brief is probably the most effective in terms of of presenting an alternative viewpoint and approach:

> "Self-dealing is not a danger which only exists in, or because of, closely-held institutions. Every corporation has dominant individuals who exercise effective or significant control over its activities, whether it is closely or widely held. A closely-held corporation is ultimately subject to effective control by a major shareholder or its representatives, while a widely-held corporation may be effectively controlled by its senior management or some combination of management and directors" (1986, p. 12).

Not surprisingly, one aspect of the conglomerates counter-attack is to focus on examples of self-dealing involving management and directors of widely-held institutions. Although the following section focuses in more detail on directors, it is instructive to reproduce some of Genstar's concerns in the present context:

> "A 1977 study by the Conference Board in Canada found that the directors of banks (the quintessential widely-held financial institution) felt they received their appointments to directorships because:
>
> > 'banks have traditionally reserved the seats on their boards for top executives (or representatives of wealthy families) in the expectation of attracting or keeping them as customers, and in the hope that their names will serve as prestigious advertisements and they themselves as ambassadors for the bank, and thereby attract further business.'

In 1978, the Royal Commission on Corporate Concentration found that this disposition to appoint directors for the purpose of attracting business led to a type of self-dealing. It stated, respecting bank boards, that:

> 'These boards are composed largely of the chief executives of major corporations that are customers of the bank (though not necessarily of only that bank), and that will usually borrow from that bank. Another element of the board is usually composed of leading members of legal firms who serve the bank in various parts of Canada. To some degree, therefore, most members of the board have important business relations with the bank in addition to their fiduciary duties as directors. Inevitably this creates the possibility of a conflict of interest, collective as well as individual, where the directors' obligations to the bank may clash with their duties elsewhere.'"

Not to be outdone by the CBA brief, Genstar also details briefly several examples of self-dealing by widely-held institutions -- the takeover of Union Enterprises Ltd., the Standard Investments Limited case, and the CCB (pp. 13-15).

Hal Jackman (1986) of Empire Life takes this argument somewhat further:

> "The proposition that concentrated ownership is a primary cause of failure of a financial institution is a most unusual view and only in Canada does this extraordinary thesis gain some currency. In the United States and other western countries, a strong shareholder presence has always been encouraged as an added protection for depositors and as a means to ensure management accountability. In fact in our neighbour to the south 'mutual' savings banks which are owned by their depositors are being encouraged by government to become 'stock' companies for these very reasons.
>
> Although, as many studies in the U.S. have pointed out, 'self-dealing' by directors and management have contributed to an alarmingly large number of failures, no correlation can be shown between those failures caused by improper managers and directors and those with significant shareholder interest. In fact many of the failures attributed to 'self-dealing' involved mutual companies where there were no shareholders at all.
>
> In Canada, the evidence to support the view that shareholders are a primary cause of failure is far from convincing.

> The Federal Superintendent of Insurance, Mr. Robert Hammond, in his 1985 testimony before the House of Commons Finance Committee, outlined the causes for failure of 11 federal financial institutions since 1980. Only in the Greymac-Seaway fiasco was self-dealing by owners the cause of the default. A report prepared for the Chairman of the Economic Council of Canada expanded the list to include provincial failures. Of the 21 companies named, only in the Greymac-Seaway group of companies and the Continental Trust could self-dealing by owners be considered the cause of the failure although in a number of other cases, self-dealing by officers and directors, but not shareholders, could be considered the proximate cause of default. To this list we must add the two widely held western banks which failed and where director self-dealing was in evidence.
>
> Similarly as Mr. Justice Hughes pointed out in his excellent report on the Atlantic acceptance and British mortgage failures in the 1960's, self-dealing by officers and directors, not shareholders, was the cause of the failure of those two companies.
>
> In summary, the whole subject of widely held versus closely held is not capable of sweeping generalizations as it affects solvency. Of course there may be weak owners as we have seen in the Crown Trust-Greymac affair of a few years ago. However there can equally be self-dealing by directors and management in the absence of control by strong shareholders. It is simply impossible to state what shareholder configuration is appropriate in every case." (pp. 5-7)

The conglomerates' bottom line on ownership and self-dealing is probably effectively captured by the summary position of Genstar:

> "To believe that self-dealing will be eliminated by domestic ownership limitations is illusory. Self-dealing can be controlled more effectively and at a lower cost by alternative means. These alternative means include statutory prohibitions [i.e., self-dealing bans], improved supervisory powers for regulators, enhanced public disclosure, improved internal control mechanisms, increased standards of care owed to a financial institution by its directors, and increased responsibilities for third-party advisors to monitor and report instances of self-dealing" (1986, p. 11).

To this list of alternative approaches many advocates of the position that

there should be no ownership requirements would require that the regulators apply a "reputation" test to any potential owners. However, short of focusing on objective criteria, like the existence of a criminal record, it is not clear how such a test would be, or could be, applied.

(b) Directors and Self-Dealing

From the Jackman brief to the Ontario Legislature Committee:

> "The term self-dealing or 'related party transactions' is commonly used to refer to transactions between a deposit taking institution and its shareholders. However it is much broader than that and refers to transactions involving the use of depositors' funds with any person, whether he be a major shareholder, officer or director of employee who has a fiduciary responsibility in respect to those funds....
>
> Unfortunately, at present there are no meaningful self-dealing provisions in the Bank Act. Loans to directors or banks are so commonplace that it is generally conceded that the prime requirement for membership on a bank board is the fact that he or she is affiliated with a substantial customer. [Note that the existing trust legislation does not allow directors to be significant customers of the institution -- T.J.C.]
>
> I am not suggesting for one moment that the directors of large banks are in any way dishonest. However a director of any deposit taking institution must take an 'even handed' view in determining his responsibilities to both depositors and borrowers. This may not always be an easy task. For a depositor is interested in the highest possible return consistent with safety. The borrower, on the other hand, is interested in receiving the greatest amount of money at the lowest possible rate. These views are prima facie in conflict. It is therefore the responsibility of the director to take an even hand in assessing his responsibilities. If you have a banking system where the board of directors are almost entirely made up of management and large borrowers, without any shareholder or depositor accountability, it becomes difficult to ensure that depositor protection may not be sacrificed to imprudent lending. This is what has happened in Canada with director-related loans such as Dome Petroleum and Massey-Ferguson.
>
> This issue goes to the root of governance and control of any financial institution. How can a director effectively judge management if he is beholden to

> management for a loan? Similarly how can management refuse a loan to a person who is in a position to judge his performance? If self-dealing and conflict of interest rules are appropriate for the trust companies, surely they should also be for the banks.
>
> One further point on the matter of directors' loans. I have outlined the danger that exists when a large financial institution's board of directors is dominated by large corporate borrowers. Not only does the lending institution risk favouring the borrower over the depositor, but the presence of these men may very well have an effect on how credit is allocated among the various parties who compete for loans. [This relates to the issue of "bias", discussed earlier -- T.J.C.]
>
> It is difficult for a small businessman in a small town in Ontario to understand why huge amounts of money are lent to conglomerates to help finance takeover bids, when his own line of credit is limited to financing receivables and inventory. Trust commpanies, loan companies and credit unions do not finance takeover bids. Nor do they make loans to South American governments. The trust and loan industry therefore desires expanded commercial lending powers from the Province of Ontario and from Ottawa so that it can fill the gap in this allocation of credit." (1986, pp. 9-11)

What the reader is probably intended to conclude from Jackman's comments is that the trust companies, even if they are narrowly held, are by the nature of their business <u>and</u> their boards of directors more sensitive to the needs of their depositors and borrowers. But these are my words, not Jackman's.

"New Directions" responds to these concerns by requiring that at least one-third of the directors of financial institutions meet stringent criteria establishing their independence of the financial institution.[2] Moreover, the audit and corporate governance committees must consist solely of these independent directors. However, in what can only be described as an aberration, "New Directions" requires cumulative voting for directors only for narrowly-held institutions. (With cumulative voting for 25 directors, a shareholding of 4 per cent would be ensured of electing one director. Note that such directors might well qualify as independent directors.) On this

issue I support Diane Francis:

> "Cumulative voting should be required....Currently, dissatisfied shareholders are powerless to secure representation on a board unless they put up a complete slate of their own and undertake an expensive proxy fight. Bank boards...should not include the bank's largest customers" (1986, pp. 325-26).

Despite this concession, the CBA reaction to "New Directions" as it relates to independent directors appears to be extremely negative. Their recent document evaluating "New Directions" states (1987, p. 30) that the proposals relating to independent directors are a "source of major concern" to the banking industry and that a more detailed evaluation of their concerns will shortly be communicated to the federal government. Now that reference has been made to the CBA reaction to "New Directions", it is convenient to focus on three other CBA concerns relating to the ownership provisions of the federal position paper.

(c) <u>The CBA and Ownership</u>

In general the CBA welcomes the initiatives in "New Directions" that move the system toward wide ownership. However, the CBA's view is that in at least three areas these initiatives do not go far enough.

The first relates to the provision whereby commercial interests will not necessarily be precluded from acquiring or increasing positions in existing trust, loan and insurance companies with capital below $50 million ("New Directions", p. 17). Although the CBA recognizes that the intent here was to introduce this exception only for emergency situations (e.g., to save a faltering institution), the CBA recommends that this provision be removed (1987, p. 25).

The second relates to the grandfathering provisions for narrowly-held, commercially-linked firms. Under the current interpretation, it appears that if a commercial shareholder has 50 per cent of the shares of a financial institution, such a shareholder could maintain this proportion, i.e., take 50 per cent of any new share issue. The CBA preference would be to preclude majority shareholders from acquiring _any_ additional shares until the ownership level falls to 10 per cent. Actually, the CBA goes much further here, repeating its earlier position that the government pursue a policy of active divestiture over a five-year period for any majority shareholdings in financial institutions. According to its estimates, this would require unloading $3.5 billion in shares -- less than 6 per cent of TSE equity trading in 1986 and roughly one per cent if spread out over five years (1987, p. 27).

The CBA's third point relates to the provision whereby narrowly-held ownership without financial links will be allowed up to a capital threshold of $750 million (or roughly $15 billion of assets). While the CBA believes that it is appropriate to be more lenient with respect to non-commercially-linked narrow ownership, it also believes that the $750 million capital threshold should be dropped to $250 million. Basically the argument has to do with the interaction between narrow ownership and deposit insurance. With full insurance up to $60,000 there is an incentive for owners of a financial institution to take excessive risk. If the venture fails, the depositors are bailed out by the CDIC. If the gamble pays off, then the majority shareholder pockets the winnings. To minimize such incentives, the CBA recommends (a) lowering the capital threshold from $750 to $250 million, (b) introducing some element of co-insurance in the operations of the CDIC, and (c) establishing separate CDIC "pools". Note that these latter two recommendations were

embodied in the Murray (Senate) Report on Deposit Insurance (1985). In order to protect fully the small unsophisticated depositors and at the same time not to unduly inhibit new entry, the Senate's proposal involved full insurance for the first $25,000 and then 20 per cent co-insurance (i.e., 80 per cent CDIC insurance) thereafter up to a total of $75,000. The idea behind the concept of pools (one for the banks, one for the trusts, and one for each of the credit unions and the insurance companies if they wished to be covered by CDIC) was that losses in any of the pools would have to be financed by other institutions in the same pool. In this way, there would be an enhanced incentive for all trust companies, for example, to encourage greater industry self-monitoring, because all trust would be saddled with covering any CDIC losses arising from a trust company failure.

In general, I believe that the CBA is correct when it asserts that the interaction of narrow ownership up to $750 capital and full CDIC coverage up to $60,000 does provide an incentive for excessive risk-taking, if not self-dealing. The question that arises, however, is whether the fact that the authorities refuse to alter CDIC implies that narrow ownership must be sharply curtailed. Actually, the real incentive for taking advantage of the CDIC arises when the institution is <u>already</u> in trouble so that there is little or no equity left. Here excessive risk-taking is costless (unless it involves fraud, etc.) since the value of the equity is already zero. It is precisely for the reason that the Wyman report (1985), the Blenkarn Report (1985), the Murray Reports (1985, 1986), the Dupré Report (1985), and the Economic Council of Canada (1987) all argued for an "early warning system" that would alert the regulators on a timely basis to any problems besetting the institution. The ECC report suggests a series of components that might be included in such an

early warning system, e.g., items relating to capital adequacy, liquidity, asset quality, profitability and management performance (1987, Figure 4.2). To this list I would add that there be a careful monitoring of the level of, and rates paid for, brokered deposits which have tended to be a leading indicator of impending financial institution trouble. Unfortunately, "New Directions" does not appear to place much emphasis on the development of an early warning system. However, one hopes that the regulators themselves will find it appropriate to implement such a system.

Nonetheless, some aspects of the CBA concern here will be reflected in the compromise proposals in the concluding section of this paper.

(d) Recapitulation

The potential for abusive self-dealing is present in virtually all financial institutions and is a a valid concern. There is no question that widely-held ownership can effectively eliminate both the ability of, and incentive for, owners to self-deal. However, there is also no question that with dispersed or widely-held ownership, an incentive is generated for officer- or director-related self-dealing. This is the point of much of Jackman's comments. In a recent paper, McFetridge (1987) makes a similar point:

> "In the case of dispersed ownership, excessively risky loans may be made to officers and directors. The latter benefit if the investments so financed succeed. If they fail, the losses are imposed on the shareholders and, if the losses are sufficient, on depositors, deposit insurance and other creditors" (1987, p. 7).

Hence, it is hard to escape the conclusion that the combination of independent directors, corporate governance procedures, cumulative voting and, in general,

the application of trust-company-type restrictions on directors are appropriate for all financial institutions. And in order to control owner-related self-dealing some combination of ownership restrictions and self-dealing bans are also desirable.

In his paper McFetridge proposes a further method for controlling the potential for damaging self-dealing, namely reducing the maximum leverage ratio:

> "The essential point is that, from the standpoint of depositors safety, a closely held or concentrated majority intermediary may be equivalent to a widely-held intermediary with a higher maximum leverage ratio. Indeed, this thinking appears to be reflected in the array of leverage ratios presently imposed on deposit-taking intermediaries. Banks which are widely-held are generally allowed higher leverage ratios (between 20:1 and 30:1) than trust companies (12 1/2:1, higher with permission)" (1987, p. 11).

McFetridge adds, however, that for widely-held institutions this would have to be accompanied by some prohibitions on the transactions between the intermediary on the one hand and officers and directors on the other, since altered gearing ratios do not affect the incentives for management self-dealing (pp. 10-11).

To conclude this section it seems appropriate to refer yet again to the excellent paper by McFetridge. The issue in question relates to the role that a 35 per cent minority shareholding (widely held) can have on the behaviour of a financial institution. The rationale in the Murray Report (1986) for a 35 per cent widely-held float included the following:

- it is in principle sufficient to prevent a restructuring of the corporation that would be inimical to the minority shareholders, since 2/3 of shareholders must agree to any restructuring under the

Canada Business Corporations Act.

- it would enhance disclosure and would represent a significant enough float to attract attention from investment analysts.
- it would enhance in the operations of internal corporate governance, particularly if cumulative voting for directors were required.
- it would allow Canadians to own equity in their financial institutions.

McFetridge adds a further point with respect to a 35 per cent float:

> "The question is whether a compromise such as the proposed requirement that trust, loan and insurance companies have at least 35 per cent of their voting shares widely held has any merit. An initial reaction is that it does not reduce either the incentive or the ability of the controlling (inside) interest to self-deal. Indeed it increases it. Insiders have even greater leverage being able to impose their losses on depositors, deposit insurance, other creditors and on the outside minority.
>
> In anticipation of this, however, the demand price for minority shares will involve a considerable discount from their value to the majority. Thus, the cost of insider self-dealing is effectively internalized. Insiders will take whatever steps they can to assure the potential outside minority that it will not be among the victims of insider self-dealing. It will be in the interest of insiders to push this guarantee process up to the point at which the cost of the guarantees provided is just equal to the increase in the price which outsiders are willing to offer for a minority interest. Of course, protection for the outside minority is also protection for depositors and shareholders. Thus, the requirement that closely held intermediaries sell a minority interest to outsiders effectively forces the majority interest to take additional measures at its own expense to protect depositors and other creditors" (1987, pp. 18-19).

Therefore, from my vantage point the bottom line to all of this is the following. If there were no costs to limiting ownership, then the concern over self-dealing might justify the imposition of a 10 per cent ownership

provision. But the thrust of this paper is that there are very substantial costs. Hence, alternative approaches must be found to prevent abusive self-dealing. Not only do such alternative approaches exist, they are also likely to be very effective. Nonetheless, it is my view that, for reasons outlined above, some degree of public float is also warranted.

5. The Federal Reserve (Corrigan) Approach

If one engages in a discussion of "New Directions" with a representative of a chartered bank, the conversation will not get very far along before the "Corrigan Report" comes up. This is the recent position paper Financial Market Structure: A Longer View authored by E. Gerald Corrigan, President of the Federal Reserve Bank of New York. It is a wide ranging document on the future of U.S. banking regulation and it presumably has the approval of Federal Reserve Chairman, Paul Volker. What appeals to Canadian chartered bankers is the document's approach to the intermingling of commerce and banking. Essentially, The Longer View argues in favour of "moving in the direction of a more uniform and integrated approach to the operation of the banking and financial system [i.e., integration of the pillars] while still preserving the distinction between "banking and the remainder of the economy" (1987, p. 22).

The core of the argument is two-fold. First,

> "If there are substantial economic benefits from linking banking and commercial enterprises, then efforts to achieve that separation by regulation would, almost certainly, fail or, if somewhat successful, would remove the very economic incentives for such combinations in the first instance." (p. 25)

Implicitly, if not explicitly, this suggests that the commercial side is

interested in the financial side <u>only</u> because of what it can gain from such things as concentration of assets, market power, self-dealing and the like. Hence, it would appear to rule out or ignore other reasons, such as seeking a higher rate of return on capital, portfolio diversification, arm's-length networking and synergy, and even comparative advantage, defined for example by a computer firm having an ownership stake in a financial institution in order to obtain hands-on knowledge and information relating to emerging computational needs and developments in the financial sector. Nonetheless, the Corrigan approach is probably the correct one if regulators are unable to prevent the abusive self-dealing that can arise from a comingling of the commercial and financial.

Corrigan's second point is that it is difficult to see how the financial part of such a commercial-financial entity can have a call on official sources of liquidity and capital unless, at the very least, the authorities have some supervisory influence over the entity as a whole. Corrigan elaborates:

> "the affiliates find it difficult to disavow each other or their parents and vice-versa in times of stress. This tendency seems to reflect at least two major considerations. First, when one part of a financial entity has problems, the marketplace generally attributes those problems to the entity as a whole; and, second, when the great intangible -- public confidence -- is so central to the "going concern" value of the enterprise, overt decisions to "cut and run" simply do not come easily. Strength surely begets strength, but weakness even more surely begets weakness" (p. 25).

This is not a new point since it has been raised earlier in the analysis, but it has been stated here with more effect. The earlier comment that part of the answer is to ensure that there is a financial holding company between the commercial and financial side has presumably been found wanting by the

New York Fed. More precisely, it has not been addressed.

Corrigan concludes by noting that the entire issue "really comes down to a debate as to what kind of risks do we, as a nation, want to incur as a matter of public policy" (p. 27).

An "official" response was not long in coming. Representative Doug Barnard (Democrat, Georgia), Chairman of the House Subcommittee on Commerce, Consumer and Monetary Affairs challenges Corrigan's views on the separation of banking and commerce. (Predictably, the title of his "op ed" piece in The Wall Street Journal is "Wrong-Way Corrigan"!) Barnard (1987) makes several points. The first is probably the most important, namely that while Corrigan position paper is generally excellent, his view on ownership is the one element that "appears to be derived more from customary Federal Reserve doctrine than from fresh creative thought".

Second, Barnard challenges the blueprint's claim that there is no feasible scheme of legal constraints and/or regulation that can effectively insulate an insured bank or thrift institution from financial abuse if it is owned by a commercial/industrial firm. Without going into detail, Barnard's conclusion here is that "if we want tough regulation of financial holding companies, we can get it, no matter who owns them."

Barnard's next point is more telling. Noting that the integration of the pillars (i.e., the striking down of Glass-Steagall) will open up situations where bad loans on the books of banks will provide an incentive to off-load these via an underwriting of securities, Barnard asks if the provisions that will be put in place to control this type of activity are not very similar to those that would also be required to control the commercial/financial linkage. It should be noted in passing that this issue

has really not been addressed in the various briefs that serve as the "raw material" for the analysis in this paper. In large measure this is a result of the fact that it was not until December, 1986, that both Ontario and Ottawa opened up the securities industry to 100 per cent ownership by Canadian financial institutions. Two comments appear relevant. First, it seems apparent at first blush that the potential conflicts of interest or self-dealing problems of a Molson's owning a securities firm are much more easily kept in check than the problems that would arise with a dominant financial institution with an extensive loan portfolio owning a securities firm. This point has recently been effectively made by OSC Chairman, Stanley Beck (1987). Second, I think that Barnard is basically correct in suggesting (albeit indirectly) that effectively policing this latter conflict of interest is going to be every bit as difficult as policing the commercial-financial overlap. In the Canadian context, it is worthwhile noting that so far several conglomerates have decided not to enter the securities core, whereas all major banks appear to be moving in.

The final substantive argument in the Barnard piece is that it is not possible to draw a clean line between commerce and banking in light of the proliferation of financial instruments in recent years. Keeping the commercial/industrial firms out of the banking club will simply mean that they will offer their quasi-banking services in other ways. It is highly unlikely that the clock will be turned back on the development of "in-house" or corporate banking. There are two main areas where even medium-sized corporations can take on a banking role:

> "First, they can develop the expertise and systems to replace financial advice previously bought from the banks, and deal with those banks on a more equal footing. Second, asset and liability management can be turned into a profitable activity" (Crabbe, 1986, p. 28).

Moreover, the big corporations are major players in the world's financial markets. B.P. Financial raised nearly a billion dollars in the Eurobond market in 1985, utilizing a sophisticated range of financial instruments and currencies. GMAC is one of the leaders in the securitization of car loans, although to date it does this through a securities firm. General Electric Credit Corporation eliminated this securities link by recently acquiring Kidder Peabody. These activities are presumably not as well developed in most large Canadian corporations, but it is only a matter of time before they will emerge. One domestic development that merits attention, however, is the networking between Provigo and the National Bank to install "debit cards" in Provigo stores. These are effectively money cards since a customer can debit his account for $100 for a $65 grocery bill and take the $35 in change. Is PetroCan next? We are just beginning to see the explosion of such financial activities in the commercial sector. The underlying thrust of the Corrigan Report, and "New Directions" for that matter, to the effect that we can hive off financial activities into a few institutions and generate a complete break between financial and commercial ignores the existing, let along the emerging, reality. In Barnard's view, it is preferable to encourage the commercial/industrial firms with financial expertise and ambitions to pursue these ambitions as banking-system insiders (and, hence, regulated) rather than as outsiders. Hence he concludes that the qualifications for bank ownership "ought to be set in functional and operational terms (sufficient capital, capable management, etc) rather than in terms of the prospective owner's 'parentage'" (ibid.).

Thus, while chartered bankers may take comfort from the views of the Federal Reserve Bank of New York, about the most that can be said on this

issue is that the U.S. is also undergoing a rethinking of ownership provisions -- except, of course, that it is Congress and not the Fed that will do the legislating!

This completes the survey of some of the principal arguments in favour of widely-held ownership of financial institutions. Although the counterarguments from the narrowly-held perspective were generally included in the above analysis, there also exists a set of propositions that are frequently offered to buttress the position that financial institutions should be allowed to be majority held. To these I now turn.

C: ARGUMENTS FOR NARROW OWNERSHIP

1. Historically and Competition-Wise, Majority-Held Institutions Have Served Canada Well

"New Directions" itself recognizes this: "each form [of ownership] brings its own strengths, both now exist and have served Canadians well: Neither is inherently better than the other" (p. 15). This is particularly the case in recent years. Not only have the non-bank, deposit-taking institutions, many of which are majority held, been the source of much of the innovation in both service and financial instruments but Canadians have sufficient confidence in them that they have grown more quickly than the banks. Unless one wants to entertain the notion that Canadian consumers are somehow dumb or being misled, it seems to me that this is evidence enough that narrowly-held institutions are meeting the needs and desires of Canadians.

2. <u>Wide Ownership was Designed to Ensure Canadian Control of Banks, Not to Deter Self-Dealing</u>

Until well into the post-war period, there were no ownership limitations on Canadian financial institutions. Indeed, it is instructive to recall that the introduction of the provision whereby banks were required to be widely held had little or nothing to do with minimizing conflicts of interest or abusive self-dealing. Rather, the rationale was to counter the possibility that foreign banks, particularly U.S. banks, might attempt to gain control of the chartered banks. The combination of the 10 per cent rule and the requirement that in the aggregate foreigners could not hold more than 25 per cent of bank shares (i.e., the so-called 10/25 provision) ensured that the banks would remain in Canadian hands. Indeed, the policy in favour of mutualizing insurance companies arose for the same reasons.

In this light, it is more than a little ironic that the Lloyds takeover of Continental and the Hong Kong and Shanghai Bank takeover of the Bank of British Columbia received Ottawa's blessing. Presumably what prevented Canadian financial institutions (except perhaps for the mutuals) from qualifying as eligible purchasers were the domestic ownership provision relating to banking. Moreover, the government's acceptance of Lloyds as a purchaser lends credence to the earlier suggestion that the schedule B's will eventually be viewed as "financially linked" rather than "commercially linked", so that their capital threshold for triggering the 35 per cent publicly traded float is $750 million rather than $50 million. <u>In other words, while the introduction of the 10 per cent rule was designed to prevent foreign ownership of banks, in the current context of dealing with troubled banks it is serving to preclude domestic ownership!</u> Personally, I find this

unacceptable -- not the fact that Hong-Kong and Shanghai should take over the Bank of British Columbia but rather that many Canadian-owned financial institutions were deemed to be ineligible suitors.

Obviously, the fact that the original rationale for wide ownership was not related directly to self-dealing concerns need not diminish the force of such an argument in the current time frame. Nonetheless, it is important in this debate to remember why wide ownership was introduced in the first place.

3. Ownership Provisions World-Wide are Not the Norm

A further point that merits emphasis is that the absence of ownership restrictions on non-bank financial intermediaries is the norm across the industrializaed world. Indeed, in a recent CLHIA questionnaire sent to various foreign jurisdictions, none of the jurisdictions that have responded thus far have in place ownership limitations of the sort proposed by "New Directions". The preliminary results of this questionnaire appear as Appendix A to this paper.

One can imagine many areas where what the rest of the world is doing may be quite irrelevant. However, the financial services sector is surely not one of these areas if the principal implication is to reduce the inflow of domestic capital to this key sector.

4. Majority-Owned Firms are Better Directed

Time and again the issue that seemed to consume the members of the Ontario Standing Committee on Finance and Economic Affairs related to the impact of a major shareholder on boards of directors. What does a major shareholder bring to a board? Leadership? Entrepreneurship?

Accountability? Sheer power? Beyond some initial observations that tended to emphasize the merits of having majority shareholders on these boards, the representatives of narrowly-held institutions found this to be a delicate question. They had no desire to impugn the boards of widely-held institutions, but at the same time they were groping for ways to impress the committee of the merits of majority ownership. The following excerpt from the remarks of Allen Lambert, Chairman of Trilon Financial Corporation, is probably typical:

> "[In Canada the boards of most big corporations] are drawn from across the country with wide geographic representation, and that is as it certainly should be. But that also means that it is a fairly loose association. They are not seeing each other on a regular basis, other than perhaps...at board meeting times...I have worked with the board of a bank, and it was a very good board and a board of 40-plus at times, but from all parts of Canada, and there was not much leadership amongst the board as such.
>
> I think a major shareholder brings some leadership to the board. He probably (and the representatives of the major shareholder) would be in the minority, but nevertheless if they sense something is going wrong, they would be the catalyst to start to take some action with the other directors.
>
> I think it is like a caucus. You have got to have some group that is really going to get things moving,...I think we all know of instances of widely held corporations where change was clearly needed but it took a while for the board to really come to grips with it. And that is understandable because no one wants to really be the initiator of something unpleasant, and we tend to often go along with these things; whereas a major shareholder is so much at risk himself that he is less inclined to go along with something that is not right or that is unpleasant. And so he will be the catalyst to bring it to the attention of the whole board and, through the whole board, work for change" (1986, p. F.11).

In his prepared remarks, however, Lambert effectively proposes an alternative way to compare the performance of financial institutions:

> "When evaluating financial institutions, overall performance should, I think, also come into play. Not one Canadian bank ranks among the top 50 banks around the world in terms of return on assets and return on equity, two important performance measurements. Royal Trust, by comparison, achieved in 1985 a return on assets higher than any Canadian bank, and second highest among all North American banks and trust companies, and had the highest return on equity" (p. F.4).

Brascan's Trevor Eyton takes this point one stage further:

> "Royal Trustco shares traded in the market at about three times book value. Five or six of the chartered banks in Canada -- we are now talking about the major banks -- trade at less than book value. I will ask you a question. Why is it that Royal Trustco shares trade at something like three times the basic price of the share of the chartered banks? I think one of the reasons is our concern for shareholder values, and with it implications for ongoing good financial health for our financial institutions" (1986, p. F.6).

One can, of course, read too much into these and other similar statements by representatives of majority-owned firms. Nonetheless, it does seem evident that majority-owner representation in boards of directors can have a substantial positive impact on an institution's performance. Certainly, there is nothing here that would lead to the conclusion that the boards of widely-held institutions are preferable and, therefore, nothing in the way of an argument for forcing financial institutions to be widely held. Indeed, just the opposite.

I now turn to a closely related issue, the market for corporate control.

5. The Market for Corporate Control

From the Genstar brief:

> "The market for corporate control, or the possibility that a widely-held corporation may be acquired by a major shareholder, exerts a strong disciplinary influence on the management of widely-held corporations. If management becomes inefficient or begins appropriating corporate assets to itself, the corporation will become an enticing target for take-over. The new owner could replace incumbent management and realize a significant increase in returns.
>
> Domestic ownership limitations on Canadian financial institutions would eliminate the market for corporate control and remove an important check on the activities of the management of widely-held financial institutions" (1986, p. 29).

This point is supported by Calvin Goldman, Director of Investigation and Research, Competition Act, of Consumer and Corporate Affairs Canada:

> "While implementation of a Bank Act model requiring widely-held or dispersed ownership may be effective in preventing self-dealing abuses arising from non-arm's-length transactions, it does eliminate one very important mechanism for ensuring the efficient operation of financial institutions, namely the market for corporate control. The potential for change in shareholder control of a corporation may act as an effective incentive for efficient managerial behavior and as a removal mechanism for inefficient management" (1986, p. 21).

As an important aside, Goldman argues that both traditional approaches to controlling abusive NALTs, namely wide ownership and rigid bans on self-dealing, are too extreme and that "further work is required to explore viable alternatives" (Ibid, p. 22). I concur and shall return to this point in the concluding section.

Back to the central issue. In the historical industrial organization literature relating to the development of the "modern" corporation (i.e., the separation of ownership from management), the market for corporate control represented the principal avenue by which this development was tied to market efficiency. The market for takeovers or more generally the ability to acquire

sufficient equity so as to discipline management was viewed as the key to reconciling what in modern jargon is called the "principal-agent" problem. However, mandatory ownership limits eliminate this possibility and, in terms of market efficiency, effectively undermine the rationale for widely-held institutions.

It is important to note, however, that Canadians can still send a message of sorts to their chartered banks by unloading bank shares. But even this avenue is precluded for the mutuals.

The issue can be addressed from a different vantage point: how many heads have rolled as a result of the banks' enormous loan losses and non-performing loans? Canadians can be excused for being somewhat cynical of their banks when they see their neighbour foreclosed and at the same time witness the pomp and circumstance by which one generation of bankers annoints the next. Paraphrasing Trevor Eyton only slightly (1986, p.F.4): "it is clear that 10 per cent ownership limits are fantastic for bankers; it is far from clear that they are good for banks!"

6. Conflict of Cultures: Commercial vs. Investment Banking

As the Canadian securities industry prepares for the "big bang", the street talk has tended to centre around the question of whether one of the big banks will purchase a major securities firm. Actually, the issue is frequently put the other way around -- will a major securities firm be willing to associate itself with a large bank? While there are many variables that enter this equation, the "cultural clash" is one of the most prominent. In the extreme, the commercial banking culture is passive, hierarchical and surely fits well within the traditional "management culture" of Canadian

chartered banks. Again in the extreme, investment banking culture is pro-active, entrepreneurial and more consistent with the partnership (non-hierarchical) approach of many of the securities firms. More importantly, the clear trend, world-wide, is away from commercial banking and toward investment banking.

The Naisbitt Group, of Megatrends fame and among the world's leading trend analysts, confirms this view:

> "As more companies aggressively work both sides of the balance sheet in combinations of debt and equity, they will come to require fewer services of commercial banks" (1986, p. 30).

and

> "Commercial banks may be hindered by their operating culture. 'Qualities that make you a good commercial banker, such as caution, conservative decision making, and unwillingness to deviate from concensus, would make a failure of an investment banker,' comments James Rawlings II, Managing Director, Drexel Burnham Lambert, Inc. Moreover, corporate clients perceive commercial bankers as a source of funds rather than confidential advice. Most corporate financial officers view commercial banks as too conservative in an age of aggressive financial innovation. Anthony de George, Chief Financial Officer of Grace Geothermal Corporation, states that his company uses commercial banks 'only for checking, money market accounts, and temporary deposits for excess cash. For our long-term financing needs, we turn to investment banks...the level of competence [of commercial banks] and the way they are structured makes them less attractive than investment banks'" (1986, p. 22).

The point here is not to come down against the chartered banks. Indeed, in recent articles I have argued that the banks must be allowed to enter the securities core (1986, 1986a). Moreover, I am confident that they can make the transition and accommodate any differences in corporate cultures: they

have no choice if they want to follow their customers.

Rather, the point is to question why Canada is on the verge of precluding the very corporate form that would appear to be most suited to the trend toward investment banking. The issue here is not so much one of whether Power Financial should have the same freedom to maneuver as the banks. It probably has more to do with allowing new entrants to move into the financial sector to market new products or to exploit profitable niches.

Quite frankly, I am concerned about the longer-term future of the Canadian financial services industry if the domestic participants are required to be management-driven (widely-held institutions plus the mutuals) leaving the foreigners to be the source of owner- or entrepreneur-driven institutions.

7. <u>Market Contestability</u>

Finally, the analysis has come full circle. The rationale for re-assessing the ownership controversy derived from the fact that "New Directions" does not score well in terms of new entry, at least for domestic institutions. One of the arguments in favour of more liberal regulations pertaining to majority ownership is to facilitate new entry and, hence, market contestability.

Surprisingly, the Genstar brief is one of the few that focuses on this critical issue, although in the wake of "New Directions" this will surely change. The brief notes:

> "Contestability of financial service markets is determined by barriers to entry (and exit) in the industry. The potential of entry helps to ensure competition, increase efficiency and prevent any competitive abuses that could result from market power. Competition from abroad also serves to enhance the degree of competition in Canadian financial markets...

> Barriers to entry may be structural or regulatory....The Director[3] convincingly argued that 'the onus should be on regulators to clearly demonstrate the need for maintaining regulations which restrain contestability of markets...'
>
> Domestic ownership limitations will reduce contestability further. Achievement of optimal size, either by new entry or by acquisition will be made more difficult if concentrated shareholdings are not permitted" (1986, pp. 22-23).

The Blenkarn Committee also recognized the role that majority ownership can play in the new entry process. I shall have more to say about the details of the Blenkarn recommendations on ownership later. For now, the following passage is relevant:

> "This risk of self-dealing, however, has to be offset against the benefit of having a strong major shareholder that could provide financial support to a financial institution during its initial formative period and on an ongoing basis especially during periods of economic adversity. A widely-held ownership structure makes it difficult for new or small financial institutions to raise capital under these conditions. Perhaps less restrictive ownership limits in the banking sector could have alleviated the recent difficulties experienced by small regional banks in Canada. Indeed, evidence presented before the Committee favouring closely-held ownership cited the benefits of this type of ownership structure in the formation of 'de novo' institutions and during the initial growth period for institutions when a widely-held ownership structure could otherwise make it difficult for a small and developing institution to raise additional capital for expansion. It was pointed out, for example by Atlantic Trust, that a major shareholder could have a greater interest and ability to provide additional capital for a fledgling institution especially during periods of adversity" (1985, p. 53).

In his (somewhat surprising) appearance before the Ontario Standing Committee, Blenkarn carries this notion further. In the passage that follows, he is responding to a question about the importance of self-dealing in many of the recent failures. After making the point that bad management was probably more

important than self-dealing he notes:

> "I think the banks' suggestion that it was totally a matter of self-dealing is an effort to maintain the 10 per cent rule of ownership, which I do not think has served us well in small institutions. In very large institutions it is important that there be widespread ownership, but small institutions need a godfather to look after them.
>
> That was particularly so, as pointed out to us, with respect to Atlantic Trust in the Maritimes in the course of collapse. The Misener family has a major interest in that trust company and has managed to turn it around. It is now profitable...Why? They own pretty well the whole thing. They can afford to put in a chunk of fresh capital to get it straightened around.
>
> In our view a small institution is well served by a major shareholder who has something to gain by its success and is, therefore, prepared to do more than normal to make it grow. I suspect that the problems we had with the Northland and the CCB would not have been there had those banks had major shareholders. They would not have got into some of the bad deals and they would not have expanded as rapidly as they did. I am not at all convinced that the 10 per cent rule is important for self dealing" (1986, p.F.15).

As will be detailed later, the Blenkarn Committee's compromise was to allow wholly-owned financial institutions up to a threshold of $10 billion in assets and thereafter to require gradual dilution according a sliding scale which would generate 10 per cent ownership after $40 billion in assets. From Blenkarn's above comment, however, it would appear that the rational for the sliding scale has more to do with concentration, writ large, than with concerns about self-dealing.

This completes our analysis of the pros and cons of the ownership controversy. Prior to moving to the concluding section and some compromise proposals, it is important to focus in more detail on internal corporate governance and its potential for controlling abusive self-dealing.

V: INTERNAL CORPORATE GOVERNANCE

The Blenkarn Report (1985), The Murray (Senate) Report (1986) and "New Directions" all place considerable emphasis on internal corporate governance as an essential ingredient in monitoring NALTs. Focusing for the present on the Murray Report recommendations (because I am more familiar with them), the proposal for monitoring NALTs consisted of three tiers. The first is a selective ban on certain NALTS which, by their very nature, can be solvency threatening. The second tier is an internal "Business Conduct Review Committee" (BCRC), composed of independent directors, that will pre-screen all NALTs and allow to proceed only those which by objective criteria are undertaken at market (arm's-length) prices. The third tier is pre-clearance by the regulator for certain types of transactions, e.g., those which exceed a certain size threshold, those for which it is difficult to ascertain the equivalent arm's-length prices, and those which appear to be passable but in tandem with previous NALTs exceed a cumulative threshold level so that regulatory oversight is warranted. Both the Blenkarn and Murray Reports recommend that for _de novo_ institutions and for mergers or takeovers, all NALTs must, for a period, be regulator-approved, until the regulators are satisfied that the appropriate internal monitoring procedures have been put in place.

Nonetheless, I think that it is fair to say that our legislators and their advisors at both levels of government, as well as may analysts, do not feel very confident with this mechanism. My own view is precisely the opposite. Effective internal corporate governance is the only way to detect and deflect potentially abusive NALTs on a timely basis, whether the NALTs are

owner or management/director related. Regulators become apprized only after the fact. Thus, the question becomes: can the concept of a BCRC be established in a manner that sensitizes the entire upper echelons of the financial institution to the self-dealing issue?

Given my obvious biases on this issue, I was pleased to note that, in some quarters at least, the role assigned to internal corporate governance is being enhanced rather dramatically. In his appearance before the Ontario Standing Committee, Trevor Eyton traces briefly the history of Royal Trustco's business conduct review committee and indicates that it will be introduced into all of Trilon's companies:

> "The business conduct review committee looks at all related-party transactions; that is its responsibility. All its members are independent. They have their own legal counsel. They have direct access to the auditors of the company at call. They have the same kind of access to all the senior managers. They have the same kind of access to all the records of the company.
>
> There are mechanisms within the company, including a mechanism in the investment committee, such that all transactions which fall within their purview are automatically referred there. They make their decision. As I say, it is an independent one. They can do it with people present or not. Ordinarily, no one else is; it is just the members of the committee. Their decision cannot be appealed. That is it; it is gone.
>
> We are going beyond that. Next year in our annual reports we are including a section that is going to feature the business conduct review committee. We are going to picture them so they will be even more aware of their responsibility. We are going to include their charter; that is, what their function is. We are going to include a report on how they have discharged their responsibility and their functions for the year in question, and they are going to sign it off. In that sense, what we are doing is the same process I talked about before. We are forcing them to consider their independence and their responsibility.
>
> More recently, and in answer to some of the queries and concerns of regulators, we have said -- there was never any reservation about it on our part -- that regulators could and should have direct access and perhaps direct

> reporting between business conduct review committees and the regulators. It seems sensible and doable.
>
> We see no reason that the regulators could not in some way confirm or approve membership on the business conduct review committees. We see no reason that a regulator, at will, on a regular or random basis, could not sit in and listen to the deliberations and the decision-making of those committees. We see no reason that those committees should not, as a matter of course, provide minutes of their meetings to regulators so there is an ongoing information exchange, and we see no reason that those committees could not file those deliberations in some public place so they are open for public scrutiny and inspection.
>
> I can report that the few regulators I have talked to about it have seen it as a positive from two points of view. First, they see the business conduct review committee and the members as a kind of addendum to their own office, one that is operating without public expense and does not cut into their budget. Second, they recognize that there are always limits to what regulators can do. You cannot have enough regulators with enough budget and enough time to cover every conceivable transaction, and the system I was describing of strict and tough self-governance was one that fitted nicely, as long as they were informed and had an opportunity to speak directly to members of the business conduct review committees.
>
> It is working well at Royal Trustco, but it is not perfect yet. We are working on it. It is still a new concept. It was a concept that was specifically blessed by the Senate banking committee in its report. It has been blessed by a number of the regulators I have talked to who have seen it as a way in which they can reconcile an ongoing major shareholder, which is a historic fact today, with the benefits that brings and the balance of independent directors and mechanisms where the independent directors could express themselves and monitor the related-party dealings that might occur within a group" (1986, pp.F-7-8).

As I noted above, internal corporate governance structured along these lines would seem to offer effective and timely monitoring to ensure that "all third parties and regulators will have a high degree of assurance that any and all self-dealing transactions are in the best interests of the institution, its shareholders, and its customers and are being carried out at prices that would fairly reflect those which occur in arm's length or market transactions" (Murray Report, 1986, p. 34).

VI: SUMMARY AND ALTERNATIVES

This final substantive section of the paper will focus in turn on some summary observations and some policy options.

A: SUMMARY OBSERVATIONS

- By allowing for ownership integration across the pillars and opening up the Canadian financial services sector to international competition, "New Directions" gets high marks for responding to global financial developments.
- However, the federal position paper accomplishes this in a manner which may result in a rather dramatic reduction in the potential inflow of domestic capital into Canadian financial services. World-wide, capital is being attracted to financial services. The prohibition of new commercial-financial linkages will arrest this trend domestically. As a result, new and existing commercially-linked capital will be enticed to charter provincially or, if this avenue is blocked, to go offshore.
- Under this scenario, markets may remain contestable if the border becomes sufficiently open. In turn, however, this has the potential for generating preferential treatment for foreign over domestic narrowly-held (and commercially-linked) institutions.
- In addition to these concerns relating to domestic entry, "New Directions" is likely to increase rather than decrease concentration in financial markets. The recent decrease in

financial market concentration may well be reversed if the conglomerates are prevented from competing head-on with the banks. While the big-should-not-buy-big approach to mergers is probably warranted, the build-not-buy proposal will only serve to entrench the position of the banks by preventing their competitors the ability to develop nationwide networks. Moreover, takeovers provide a valuable avenue for entry. Now that we finally have in place a competition policy with teeth, it seems appropriate to allow its provisions to monitor merger and takeover activity in the financial sector.

- Recent conglomerate growth is a function of a variety of factors. Part of it relates to the fact that the banks have fallen on hard times as a result of their oil-patch losses and third-world loans. This aspect of conglomerate growth surely enhances competition and benefits all Canadians. Part of the growth may relate to inappropriate incentives encouraging mergers and takeovers. These incentives, which apply to all sectors and not just the financial sector, require legislation to ensure that mergers become market-driven rather than tax-driven. Finally, part of conglomerate growth reflects regulatory barriers: the conglomerates could do what the banks could not, at least until "New Directions" appeared. In my view, even if there were no ownership restrictions in "New Directions", there would be no threat of a conglomerate "takeover" of the financial services area: the banks and mutuals will more than hold their own. However, with its prohibition against commercially-linked financial

institutions, new and existing, "New Directions" may well foster the very concentration among domestic institutions that it purports to combat.

- Concentration of assets in the hands of a few families may be viewed as a problem, but it is not peculiar to the financial sector. Indeed, it is best viewed as a symptom of the fact that markets have not been sufficiently contestable and that mergers have been tax driven. If, after adopting appropriate measures on these fronts, there is still perceived to be a problem the appropriate solution is a generic one, like the imposition of succession or accession duties, rather than interfering only with the operations of financial markets.
- Concentration in terms of accumulating "political" power as a result of the comingling of commercial and financial interests may also be a factor motivating ownership limits. The suggestion here would be that the Royal Bank would have less political clout in the corridors of power than a commercial/financial conglomerate of the same asset size. As long as there are precedures in place to prevent abusive NALTs and there is a financial holding company between the commercial and the real, I have trouble seeing why this should be the case. This is particularly so if the banks themselves engage in both commercial lending and the underwriting/distribution of securities. However, I recognize that this aspect of concentration does worry some Canadians and it, rather than any concern about self-dealing, appears to have been the motivating force underlying the Blenkarn formula.

- Concerns relating to potential abuses of self-dealing can also motivate ownership restrictions. However, this is too narrow a view of the self-dealing issue. As one moves towards wide ownership, the ability for owner-related self-dealing diminishes while the ability/incentive for management- and director-related self dealing increases. Extreme solutions are of course possible -- wide ownership and outright bans on all shareholder/management/director self dealing -- but the costs of banning all NALTs in order to be sure to capture those that may be abusive effectively emasculates the synergy potential unleased by "New Directions". It appears to me that a more even-handed approach working across a range of fronts is both more flexible and more effective. As outlined above, the combination of limited ownership provisions, selective self-dealing bans, internal corporate governance and cumulative voting for independent directors is likely to complement the remainder of the regulatory process in providing an effective deterrant to abusive NALTs as well as the assurance that those that are allowed to proceed are undertaken at market or arm's-length prices. Moreover, even without enhanced legislative powers, it is surely the case that the regulatory agencies and auditors will, as a result of the recent failures, be far more vigilant in their line of duty.
- "New Directions" appears to be operating under the assumption that one can forge a clean separation between activities that are financial and those that are commercial. In fact, this distinction is becoming increasingly blurred with the rapid growth of in-house

or corporate banking and joint ventures like the National-Provigo debit card. Submitting these activities to regulatory overview is more appropriate than ignoring them under the pretext that they are non-financial. It is increasingly difficult to distinguish General Electric Credit Corporation's credit activities, only 5 per cent of which are allocated to the financing of G.E. products (McFetridge, 1987), from those of a financial institution. Moreover, the real/commercial overlap will likely intensify. For example, now that deregulation in Ottawa and Ontario has neutralized the lead that Quebec enjoyed in financial deregulation, my hunch is that this province's next move will be to encourage its financial sector to take an active role (along Japanese or perhaps even German lines) in Quebec-based commercial enterprises, with a view to facilitating export penetration.

- In addition to enhancing entry and, therefore, contestability and competition, a relaxation of "New Directions" ownership limitations would also provide other benefits. Perhaps "maintaining existing benefits" is the more appropriate phrasing, since by virtually any criteria one cares to apply (service, innovation, rate of return, acceptability by the public) the likes of Empire Life, Royal Trust, Great West Life, Montreal Trust, London Life, etc. are serving Canada well. In this light, it seems incredible that the recent entry of Barclays Bank (Kohut, 1987) into the provision of agricultural leasing (via a takeover of Massey Ferguson Finance Corp. of Canada Ltd. to form Barclays Bank Agricultural Finance Corp.) may well be the sort of initiative that "New Directions"

would deny to the above-enumerated institutions, let alone to potential commercially-linked domestic capital in search of investment opportunities. And if it is O.K. for Barclays, it is presumable also O.K. for commercially-linked Deutsche Bank. What is there about Barclays that makes it preferable to Empire Life? At least we can regulate Empire Life! This would be a questionable policy even for a sector in secular decline. However, to contemplate such an approach for the world's fastest growing, most innovative and probably most high-tech sector is surely inappropriate. The issue here is not one of preferring large widely-held banks or mutuals to large narrowly-held conglomerates. Neither is likely to be highly innovative. Rather, it is to allow free entry of new capital to the financial sector to capitalize on profitable market niches, to market new instruments, to exploit new technology and to deploy enterpreneurship consistent with the trend toward the investment banking culture. Under "New Directions", I fear that we are inviting the foreign financial institutions to play this role. The economic arguments for altering this aspect of "New Directions" appear overwhelming, but failing this, "economic nationalism" is surely a last resort. (I never thought I would ever say this in public!)

- Thus far, the quotations in this paper have essentially pitted the views of representatives of narrowly-held institutions against those of widely-held institutions. Self-interest probably dictates that the debate will involve in this direction. However, what is really at issue is the future of the Canadian financial services

industry. In this context, it is significant that the Laurential Group (a mutual) has added its voice to those who fear that the ownership provisions of "New Directions" are not in Canada's long-term interest:

> "While the Minister recognizes the need to give businesses the means to develop in the new context of international financial markets, some people still persist in ignoring this trend, as they continue to raise the specter of a concentration of power. However, there is no evidence, not a single fact, that points to any real problem....
>
> The new policy is intended to prevent financial institutions from becoming tied to non-financial or commercial business through shareholding. However, as yet, no country has felt it was necessary to introduce legislation along these lines....
>
> When we compare the size of Canadian companies to the large corporations with international operations -- the largest Canadian financial institution, the Royal Bank, ranks 54th -- we see that the real problem is the competitive capacity of our companies, and not their concentration. It is urgent that something be done now, not tomorrow. To illustrate the scope of the problem, the newspapers last month reported that the powerful Nippon Life had just acquired a 15% interest in the no less powerful American Express-Shearson group, and that the two companies were planning to conquer new markets together. Not only are the big players on the international stage bigger than us, but they're making alliances to boot! In any case, if you look at the problems that we have faced in Canada in the past few years -- failures of banks, insurance companies and trust companies -- you can see that these were small firms that were undercapitalized or badly managed!
>
> Some government officials and commentators also seem to be obsessed by the question of conflicts of interest and the dangers inherent in transactions between companies within a single group. However, the self-regulation system developed by many companies over the years has proved it can cope with this. With a few improvements, such as the presence of outside members on the Board of Directors in sufficient number and the creation of committees made up of outsiders with a mandate to examine transactions between cohabiting instititutions, this system will surely be worth preserving. Some people still continue to advocate prohibiting any transactions between

> cohabiting institutions and erecting watertight walls between them. But we know it's not the institutions that practice this kind of deception. So in order to protect against a few individuals who are likely to practice fraud, some people are prepared to paralyze the institutions and our entire system!
>
> Based on what we've seen, we fear that the federal legislation is being drawn up on the principle that all businesses and their executives are inclined to cheat or engage in doubtful practices....The Asians -- especially the Japanese, who are fast becoming our most serious competitors -- have understood the dynamic of their companies. It is worth noting that their legislation governing financial services proceeds from the principle that institutions and their executives are generally honest citizens." (Castonguay, 1987, pp. 11-15)

Castonguay does not elaborate as to the reasons why, from the Laurentian Group's standpoint, the ownership provisions in "New Directions" are viewed so negatively. My hunch is that somewhere in their impressive plans for expansion one or more of their domestic and/or international downstream holding companies are going to require capital from outsiders in larger-than-10% tranches. Thus, "New Directions" could seriously interfere with their expansion plans.

- To conclude this summary I want to draw upon an overrriding principle of the Murray (Senate) Report (1986, p.15), which in turn was borrowed from the Green Paper (1985, p.1) -- "in a fast changing financial world, regulatory policy should avoid as much as possible the imposition of a preconceived structure on the financial system". In my view, to puruse ownership restrictions beyond the limits that are required (for example, for adequately controlling self dealing) is to straightjacket the system. Wide ownership may well be appropriate, but the market, rather than the regulators, should decide this.

My view of the above analysis and summary is that it indicates that the Hockin Paper is itself in need of new directions in terms of its ownership and entry provisions. Accordingly, the present paper concludes with two alternative approaches. The first of these, referred to as the "Modified Blenkarn" approach, rectifies some of the market contestability concerns while at the same time endorses the "New Directions" principle of widely-held ownership for large financial institutions. The second, referred to as the "Modified Murray" approach, is more consistent with the above analysis in the sense that while it requires that there be some widely-held ownership it does not go as far as endorsing the notion that there is something sacrosanct about 10 per cent ownership.

The obvious other alternative -- no ownership limits at all -- seems to be a non-starter in the current environment, whatever its potential merits.

B: NEW DIRECTIONS ON OWNERSHIP

1. Modified Blenkarn

As noted above, Jacques Parizeau (1987) has recently argued that the Blenkarn proposal be resurrected as the appropriate way to approach the ownership of Canadian financial institutions. Under Blenkarn, financial institutions could be wholly owned until they reached $10 billion in assets. Between $10 and $20 billion majority shareholders could hold 75 per cent of the shares, between $20 and $30 billion, 50 per cent, between $30 and $40 billion 25 per cent, and the 10 per cent rule would apply beyond the $40 billion assets threshold. These assets limits would exclude foreign assets,

ETA assets, and segregated funds assets. In addition to rectifying the above concerns with respect to new entry (both in terms of de novo entry and via acquisitions, which Parizeau would allow), such a proposal would place foreign and domestic financial institutions on a more equal footing.

Since these asset thresholds would presumably be indexed for inflation, one way for "New Directions" to incorporate the Blenkarn-type sliding scale would be to eliminate all reference to "commercially-linked" financial institutions. In other words, the 35 per cent rule could be implemented at the $750 million capital threshold (e.g., roughly $15 billion in assets), with, say, 50 per cent widely held coming in at $25 billion, 75 per cent widely held at $35 billion and a maximum 10 per cent ownership stake at $45 billion. If one wanted to be flexible with these limits, instead of requiring divestiture the institutions could be required to ensure that all <u>new</u> equity issues be widely placed if the ownership limits are binding. Moreover, the presumption would be that the issue of mergers and acquisitions would fall under the Competition Act, with perhaps an overriding requirement that big should not buy big.

One further advantage of such a proposal is that the Minister of State for Finance would not be involved as much in the day-to-day decision making of financial institutions. Under "New Directions", the spectre arises of a steady stream of queries to the Minister of State for Finance, e.g., Are we commercially linked? Do our real side investments exceed the <u>de minimus</u> level? Is the institution we would like to acquire a big institution, a medium-sized institution or a small one? Can we be exempted from the build vs. buy preference? And so on. Under modified Blenkarn the corporate boardroom will make all these decisions and recognize their implications.

2. Modified Murray

The Blenkarn alternative, like "New Directions" itself, embodies the 10 per cent principle as the ideal for large financial institutions. My interpretation of the above analysis is that there is precious little in the way of solid argument for the presumption that widely-held institutions are to be preferred. Hence, I would opt for a version of the Murray (Senate) Report.

As it stands, the Murray Report essentially requires all financial institutions operating in more than one pillar (and all commercially-linked financial institutions even if their operations are confined to one pillar) to be 35 per cent widely held. There is no asset threshold level which would trigger this requirement, so that even relatively small financial institutions, if commercially linked or operating in more than one pillar, would be required to have a 35 per cent public float. This recognizes the CBA concern that the $750 million threshold for capital is far too high, particularly given the present workings of deposit insurance. Moreover, it also recognizes the fact that most if not all of the narrowly-held financial institutions that have failed (and where there was evidence of self-dealing) were below this $750 million capital limit.

Now there is nothing special about the 35 per cent level, except that, under the CBCA provisions, it is sufficient to block a capital reorganization that might be inimical to minority shareholders. (Indeed, the recent ECC report (1987) would not allow a minority shareholding of less than 35 per cent for precisely this reason.) Therefore, it is also possible to implement a sliding scale under Modified Murray, e.g., 35 per cent widely held up to, say, $750 million in capital and 45 per cent or even 50 per cent thereafter.

Included in such a proposal would be the full range of regulatory

provisions to prevent abusive self-dealing -- independent directors, cumulative voting, internal corporate governance à la Eyton and an early warning system of monitoring. Obviously, nothing would prevent firms from becoming widely held under this scheme and one would expect them to move in this direction if there are gains to be had from wide ownership.

Ontario's proposals (no ownership limits, no corporate governance and very strict self-dealing provisions) would still be offside vis-à-vis Ottawa, but the attraction of chartering provincially would be reduced significantly. First of all, most conglomerates welcome some public shareholding. Second, most holding companies (whether widely held or narrowly held) would probably prefer to institute internal corporate governance procedures rather than be subjected to air-tight self-dealing bans. Thus, while it would be preferable, under the modified Murray approach, for Ontario to adopt similar ownership and self-dealing provisions, failure to do so would not result in the incentive for rechartering or acquiring provincially chartered institutions that currently exist under "New Directions" or would exist under the Blenkarn-type approach.

My overall assessment, therefore, is that some version of the Murray apporach to ownership is the ideal compromise. While it represents a rather dramatic departure from the status quo, it trades off the various political and economic concerns with respect to ownership in a manner that at the same time instills greater public confidence in Canada's financial services sector yet allows it sufficient flexibility and ability to respond to the domestic and international challenges of the rapid evolution in global finance.

VII: CONCLUSION: MAINTAINING PERSPECTIVE

For many Canadians the issue of wide ownership has taken on overtones of an "overriding public policy concern". My plea is for legislators and legislation to maintain perspective on this issue and, in particular, to weigh the costs, present and future, to Canada and to Canadians of such an approach. One aspect of maintaining perspective is reflected in the comments of OSC Chairman, Stanley Beck, before the Ontario Standing Committee (1986, pp.F.14-15)

> "A lot of nonsense has been talked about the mix between he real and the financial and the concerns about self-dealing. After all, the great Canadian concern has always been about shortage of capital to develop our Canadian institutions. Now we are saying to elements of the financial industry, 'You cannot have access to pools of Canadian capital' because somehow there is a danger in having access to Bell Canada's capital or CPR's capital. That is an argument I do not buy. But I am probably in a minority these days, because it has become an emotional sort of argument. It needs a good deal of analysis...
>
> But it is no different here from what has happened in the United States, or in the United Kingdom with the Lloyds' scandal. Every country will always have its dramatic financial frauds. But you should not set broad, national economic policy on the basis of a single fraud or on the basis of anecdotal evidence. I worry that this is happening too much in the country today."

The earlier quotation from Claude Castonguay expressed similar concerns. Indeed, even Bernard Ghert (1985, p. 68:12) shares some of these concerns:

> "You have to make your laws and regulations and supervision based on the assumption that you are dealing with honest, well-intentioned people, unless you are prepared to accept a police state where you have a policeman looking over everyone's shoulder all of the time."

A second aspect of maintaining the appropriate perspective relates to

the fact that the "burden of proof" in the ownership controversy has come to rest on the wrong shoulders. Surely, the dictum of Peter Dey (Stanley Beck's predecessor at the OSC) is appropriate: "the presumption is that any action is permissable unless it can be demonstrated to be contrary to the public interest" (OSC, 1983, p. 16). However, in the current debate those who are in favour of the 10 per cent rule have never really had to argue the full case. Rather, the presumption has developed that majority ownership ought to be prohibited unless it can be demonstrated to be conducive to the public interest. This approach serves to "taint" the genuine benefits to Canadians that have been derived from majority-held financial institutions. Effectively, widely-held ownership is quickly becoming another of our so-called "sacred trusts", essentially outside the realm of reasoned argumentation. Approaching public policy from such a perspective is questionable at the best of times. It may be disastrous for a sector that is as open internationallly and is in as full flight as the financial services sector.

A third and final aspect of maintaining perspective relates to the changing role of the consumer of financial services. Most of the above analysis focused on the dramatic changes in either or both financial instruments and financial institutions. However, an excellent case can be made that the financial services revolution has had its greatest influences at the level of the consumer. He/she now has experienced an increase in information, in access to technology and in the range of available choices of both institutions and instruments that probably exceeds the extre degree of maneuverability associated with the institutions themselves. Thus, the notion that the role for government in the financial services sector is to enact

legislation in order to protect consumers from their own actions is increasingly questionable. Phrased differently, there is valuable information content in the observation that trust companies have been growing more quickly than banks and in the fact that shares of narrowly-held institutions trade at a multiple of book value whereas those of some of the major banks trade at less than book. Markets may not be perfect, but to ignore the information content of financial markets where consumers/shareholders have ample access to information and alternatives (moreso than is the case in most other markets) is, in effect, to undermine the value of markets as a signalling device.

Despite all of this, there may well be a case for widely-held ownership. However, my evaluation of the arugments and evidence relating to the ownership issue is that the case for the 10 per cent rule has not been demonstrated. Indeed, the opposite is probably nearer the truth. Faced with a choice of the 10 per cent rule or the Murray approach, I would opt for the latter, <u>even for the chartered banks</u>. Fortunately, however, we are not faced with this polar choice.

By way of conclusion, therefore, I reiterate my earlier position that, in terms of ownership, "New Directions" is in need of new directions. Actually, this should not really be a tall order. After all, "New Directions" does embody a set of underlying <u>principles</u> with respect to ownership that are indeed admirable. All that is required now is to develop a set of detailed provisions and regulations that will implement these enunciated principles.

APPENDIX A

Commercial Linkages: International Evidence

In response to the Hockin paper, the Canadian Life and Health Insurance Association (CLHIA) asserted that Canada would be virtually alone in restricting the growth of life insurance companies on the basis of any commercial links with non-financial organizations or unregulated financial institutions. To buttress this assertion, the CLHIA undertook a cross-pillar, international poll to see if there were any precedents to the proposals embodied in "New Directions". The following are extracts of responses received thus far:

Association of British Insurers
"I am writing to confirm that there are no legislative restrictions on the ownership, investment, expansion and/or diversification flexibility of financial institutions in this country when they are linked to commercial (non-financial) enterprises."

American Council of Life Insurance
"You asked whether we are aware of any statutory limitations on the ability of a life insurance company to enter into an upstream or downstream affiliation with a non-depository, commercial enterprise. To the best of our knowledge, no such limitations exist in the United States."

The Life Offices' Association of New Zealand Inc.
"In New Zealand there are no restraints affecting the financial institutions, on grounds that they are linked to commercial (non-financial) enterprises in any way."

Swedish Bankers' Associaton
"...concerning restrictions when banks are linked to non financial enterprises I can tell you that there are no such restriction under Swedish law."

Verband de Versicherungsunternehmungen Osterreichs (Austria)
"There is a lot of regulations for financial institutions but most of them apply regardless of any ownership connection with non-financial enterprises."

Association Internationale des Sociétés d'assurance Mutuelle
"We can inform you that, as far as insurance companies are concerned, they are not subject to France to the mentioned restrictions."

The Life Insurance Association of Japan
"In general, Japanese commercial (non-financial) enterprises can establish or acquire financial institutions including a life insurance company."

Swiss Bankers' Association
"...we hereby inform you that the Swiss banking legislation presently in force does not include any provision limiting acquisitions, investments and development of financial institutions legally or economically linked to commercial institutions outside the financial or banking sector."

While further responses are still being received and processed, the CLHIA has issued an interim bulletin which notes:

> Further replies and materials received from various financial services associations in West Germany, Norway, Denmark, Finland, Luxembourg, Belgium, Costa Rica, Sweden, Switzerland and France have reaffirmed the CLHIA statement...that "We are not aware of any country in the world where the growth of a financial firm is constrained because of commercial linkage".

Source: Canadian Life and Health Insurance Association, Quarterly Review, volume 3, number 2, 1987, pp. 7-8, and CLHIA Circular No. 4471F (March 26, 1987).

FOOTNOTES

1. As part of its argument, the CBA brief reproduces the Bernard Ghert quotation (which I have also reproduced above) pertaining to the unnamed narrowly-held financial institution that refused a loan to one of its commercial competitors.

2. The criteria for independent directors include:
   - that they are not officers, employees or significant (10 per cent) shareholders of the financial institutions or companies related to it;
   - that they do not have significant business links with the institutions or companies related to it, directly or indirectly (which includes being a director and/or officer of a signficant borrower);
   - that they do not belong to firms acting as major legal advisers to the institution; and
   - that they are not immediately related by birth or marriage to any person in the above categories.

3. The reference here is to the Director of Investigation and Research, Combines Investigation Act (1985, p. 9).

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