January 1993

Breaking the Logjam: Proposals for Moving Beyond the Equals Approach

Ronald J. Daniels
University of Pennsylvania, president@jhu.edu

Reprinted from *Canadian Business Law Journal*, Volume 22, 1993, pages 132-157.

Breaking the Logjam: Proposals for Moving Beyond the Equals Approach

Abstract
Over the last decade, the structure and performance of Canadian financial institutions has undergone a profound transformation. Propelled by both regulatory changes and market innovations, Canadian financial institutions have found their historically protected markets opened to intense competition from a variety of different sources. The most significant regulatory change has been the piecemeal dismantling of the pillars that have traditionally separated the core activities of banks, insurance companies, loan and trust companies, and securities dealers from encroachment by one another. With lower entry barriers, institutions have scrambled to penetrate each other's markets. This entry has spurred a narrowing of differences in the structure and conduct of Canadian financial institutions.

Another regulatory change that has spurred increased competition is the reduction, (or, in the case of American owned Schedule II banks, outright elimination) of the constraints that have traditionally limited the operations of foreign financial institutions in Canada. Not surprisingly, the reduction of these restrictions has spawned the growth of a highly dynamic foreign financial industry in Canada.

Disciplines
Law

Comments
Reprinted from *Canadian Business Law Journal*, Volume 22, 1993, pages 132-157.

BREAKING THE LOGJAM: PROPOSALS FOR MOVING BEYOND THE EQUALS APPROACH

*Ronald J. Daniels**

Over the last decade, the structure and performance of Canadian financial institutions has undergone a profound transformation. Propelled by both regulatory changes and market innovations, Canadian financial institutions have found their historically protected markets opened to intense competition from a variety of different sources.[1] The most significant regulatory change has been the piecemeal dismantling of the pillars that have traditionally separated the core activities of banks, insurance companies, loan and trust companies, and securities dealers from encroachment by one another. With lower entry barriers, institutions have scrambled to penetrate each other's markets. This entry has spurred a narrowing of differences in the structure and conduct of Canadian financial institutions.

Another regulatory change that has spurred increased competition is the reduction, (or, in the case of American owned Schedule II banks, outright elimination) of the constraints that have traditionally limited the operations of foreign financial institutions in Canada. Not surprisingly, the reduction of these restrictions has spawned the growth of a highly dynamic foreign financial industry in Canada.[2]

---

* Assistant Professor, Faculty of Law, University of Toronto. I would like to thank Michael Andrews, Ray Labrosse and George Triantis for comments on an earlier draft of this article. A special note of gratitude is due to my colleagues, Robert Howse and Jacob Ziegel. This article has been substantially enriched by the ongoing dialogue we have had over the last several years respecting both the possibilities and limits of competitive federalism in Canada. Of course, the usual disclaimer applies.

[1] Many of these trends are discussed in: Economic Council of Canada, *Globalization and Canada's Financial Markets* (Ottawa, Ministry of Supply and Services, 1990). See also: Harvey Lazar, Andrée Mayrand and Keith Patterson, "Global Competition and Canadian Federalism: The Financial Sector" (1991), 20 C.B.L.J. 1. Of course, many of the same trends affecting Canadian financial institutions have also been observed in the United States. A useful overview is provided by Robert Litan, The Revolution in U.S. Finance (Washington, D.C., Brookings Institution, 1991).

[2] Under the Bank Act, the entry of foreign banking institutions is subject to a variety of

But competition has not derived solely from regulatory changes. Market innovations — particularly those offered by *market* intermediaries — have generated new products that have made dramatic inroads into the traditional preserve of financial institutions. This competition has been felt on both the asset (investment) and liability (borrowing) side. On the liability side, pension funds and mutual funds now vie with traditional financial institutions to attract scarce investment dollars. By offering investors a greater diversity of investment products (as measured by their risk and return characteristics), market intermediaries have been able to lure investment dollars away from traditional financial institutions to a broad range of new investment funds. On the asset side, the creation of liquid markets for, among other things, insured residential mortgages, automobile leases, and the commercial paper of triple A credits has lowered the administrative costs of credit, which has, in turn, increased the attractiveness of these products to both retail and commercial borrowers.

There is little doubt that increased competition has conferred very tangible benefits on Canadian investors, borrowers and consumers in the form of an expanded range of price competitive products and services. It is equally clear, however, that this competition has inflicted a price on established financial institutions in the form of reduced profit margins on many of their traditional lending activities. Financial institutions have responded in several ways, both positive and negative, to a tightening of income: by increasing the riskiness of their investment portfolio so as to increase expected returns, by entering into new lines of business (*e.g.*, foreign currency and interest rate risk management), and by aggressively cutting production costs.[3]

In pursuing the last of these aforementioned goals — cost reduction — it is not at all surprising that Canadian financial institutions, as one of the most highly regulated industries in the country, have placed the system of solvency and supervisory regulation that governs their activities under exacting scrutiny.

---

different restrictions, including aggregate size constraints and net benefit tests. However, under chapter 17 of the Canada-U.S. Free Trade Agreement, American institutions are entitled to the spirit of national treatment, which prohibits differential treatment of American and Canadian institutions.

[3] While the last two changes are desirable from a public policy perspective, increased risk-taking is much less so.

Nowhere is concern with regulation more palpable than in the case of the loan and trust industry. Industry attention to regulatory structure derives from the fact that both the federal and provincial governments have asserted jurisdiction over their conduct, subjecting industry members to two or more wholly independent regulatory regimes aimed at the same basic set of regulatory goals.[4] This situation stands in stark contrast to other areas of shared financial federal-provincial jurisdiction, say transportation or product labelling, where different levels of government purport at least to regulate different aspects of the same activity.

Obviously, with multiple sets of regulation, the cost of providing financial services for loan and trusts is raised in comparison to other competitors providing similar services and products, which are subject either to one coherent set of safety and soundness regulations (*e.g.*, banks) or to no regulation at all (*e.g.*, commercial firms like GMAC). In some cases, the costs of compliance with multiple regulation are quite low and are distinguished mainly for their annoyance value.[5] In other cases, however, compliance with multiple regulatory schemes may be extremely expensive or, even more distressing, virtually impossible. This can occur when the regulations of one jurisdiction expressly contradict the regulations of another.

In view of the non-trivial costs inflicted by existing federal arrangements in loan and trust regulation, the industry's plea for ambitious constitutional reordering is predictable.[6] Yet,

---

[4] Both the federal and provincial governments claim jurisdiction under the Constitution Act, 1867 (U.K.), to charter loan and trust corporations. Federal jurisdiction emanates from the federal incorporation power, while provincial jurisdiction derives from authority over property and civil rights in the province (s. 92(13)) and over the incorporation of companies with provincial objectives (s. 92(11)).

The impact of federalism on the regulation of financial institutions has been discussed in a number of different articles. See, for instance: W. Moull, E. Waitzer and J. Ziegel, "The Changing Regulatory Environment for Canadian Financial Institutions: Constitutional Aspects and Federal-Provincial Relations" in J. Ziegel, L. Waverman, and D.W. Conklin, *Canadian Financial Institutions: Changing the Regulatory Environment* (Toronto, Ontario Economic Council, 1985). See also: P. McDonald, "The B.N.A. Act and the Near Banks: A Case Study in Federalism" (1972), 10 Alta. L.R. 155; and J. Chant and J. Dean, "An Approach to the Regulation of Banking Institutions in a Federal State" (1982), 20 Osgoode Hall L.J. 721.

[5] This is so for duplicative regulations that stipulate the separate filing of essentially similar information with each jurisdiction.

[6] Industry criticism of the current regulatory regime is reported by A. Michael Andrews, *Remarks*, The Trust Companies Association of Canada Annual Conference, April 30, 1992.

irrespective of whether the proposed reordering is ambitious (wholesale transfer of jurisdiction of the regulation of loan and trusts to the federal government) or more modest in nature (conclusion of an intergovernmental accord that binds the provinces to a uniform pattern of regulation), industry officials tend to overlook some of the core benefits to be realized from a decentralized scheme of regulation. The dysfunctional nature of the present decentralized regime makes industry hostility to decentralization understandable, though lamentable. As I have argued elsewhere, properly devised decentralized federal arrangements have the capacity to produce responsive and innovative regulatory products.[7]

In the loan and trust setting, it is my belief that a relatively modest set of refinements to the existing regime would greatly increase the likelihood of superior legislation being produced.[8] The challenge for federal and provincial politicians is to effect changes to the current regime that remedy its most perverse features, but without abandoning a core role for lower level governments. One sensible proposal in this direction would be the adoption of a European-style mutual recognition regime. However, for a variety of reasons to be discussed below, agreements among sovereign governments that facilitate and, indeed, foster direct competition among their bureaucratic elites are enormously difficult to conclude. This is a point which has been generally overlooked in the literature on competitive federalism.[9]

---

[7] R. Daniels, "Should Provinces Compete? The Case for a Competitive Corporate Law Market" (1991), 36 McGill L.J. 130.

[8] The value of the competitive federalism model in the financial institutions context has been recognized by a number of different commentators. See, for instance: T. Courchene, *Economic Management and the Division of Powers*, vol. 67 of the background papers for the Royal Commission on the Economic Union and Development Prospects for Canada (Toronto, University of Toronto Press, 1985), at p. 198 (endorsing the value of decentralized competition in the securities area); Canada, *Standing Senate Committee on Banking, Trade and Commerce: Toward a More Competitive Financial Environment* (Ottawa, Senate of Canada, 1986): "multiple jurisdictions may be conducive to greater experimentation and innovation. The costs of an inappropriate expansion of powers may still be serious, but these costs would be localized and thus minimized in comparison to a situation where such an experiment were conducted nation wide" (at p. 63); and Law and Economics Workshop Series, *Regulation of Financial Institutions: Some Notes on Regulatory Competition*, Working Paper No. WS 1989-90-(5), by N. Roy (Toronto, Faculty of Law, 1990) (decentralized competition led by Quebec responsible for modernization of financial institution regulation).

[9] For a recent theoretical review of the competitive federalism literature, see: D. Kenyon and J. Kincaid, eds., *Competition Among States and Local Governments* (Washington, D.C., Urban Institute Press, 1991).

In light of the relatively bleak prospects for multilateral government negotiations to conclude arrangements facilitative of intergovernmental competition, I argue for an enhanced, though well-demarcated, role for federal government unilateralism in creating the framework for effective and durable decentralized arrangements.

TOWARD AN OPTIMAL REGULATORY REGIME FOR LOAN AND TRUSTS

In thinking about which set of distribution of power arrangements are most congenial to creation of an efficient regulatory regime for loan and trust companies, it is important to stress that there are both costs and benefits to every set of distribution of power arrangements and, as a consequence, the choice of any regulatory structure will, inevitably, invite balancing among competing goals. Usually the balancing exercise is guided by a rule of net benefit — policy-makers should opt for the distribution of power arrangements which produces the greatest benefits to society relative to the attendant social costs.

The following functional criteria are frequently invoked by federalism scholars as a way of organizing cost-benefit analysis of both decentralized and centralized schemes of regulation:[10]

> (i) *economies of scale*: does decentralized jurisdiction over the policy area impede the realization of economies of scale in the production of regulation? In the context of financial institutions regulation, does the fact that regulatory supervision is vested in two federal agencies (OSFI and CDIC) and numerous provincial agencies (*e.g.*, Ontario Ministry of Financial Institutions) create duplicative administrative costs? How significant would the administrative cost savings be if the entire system of solvency and supervisory regulation were to be consolidated into one central agency?
>
> (ii) *externalities*: does decentralized provision of regulation impose costs on citizens located in other provinces which are not taken into account by provincial regulators? Concern over external impacts is a central justification for the Equals Approach adopted by Ontario [to be discussed in depth below]. That is, without stringent enforcement of its own distinctive regulatory regime, Ontario has argued that it is concerned about the possible

[10] For a discussion of the various methodologies available to evaluate federal structures, see R. Simeon, "Criteria for Choice in Federal Systems" (1982-1983), 18 Queens L.J. 131; G. Stevenson, "The Division of Powers" in R. Simeon, *Division of Powers and Public Policy*, vol. 61 of Research Studies for the Royal Commission on the Economic Union and Development Prospects for Canada (Toronto, University of Toronto Press, 1985), at p. 71.

abuses that its depositors could suffer from the actions of extra-provincially incorporated institutions.

(iii) *transaction costs*: does decentralized provision of regulation create excessive transaction costs that reduce the operational efficiency of Canadian capital markets? This goes back to the concerns raised by the industry with multijurisdictional compliance costs that were identified earlier.

(iv) *innovation*: does decentralized provision of regulation enhance the degree of successful innovation and experimentation undertaken by regulators in a given policy area? In the financial institutions realm, the lead role played by Ontario in the modernization of its loan and trust legislation — Bill 116 — served as a catalyst which inspired other Canadian jurisdictions, including the federal government, to overhaul their own legislation. The same is true of many of the securities industry reforms introduced by Quebec (*e.g.*, allowing higher foreign ownership of market intermediaries). By allowing single jurisdictions to legislate without having to secure the consent of other jurisdictions, the likelihood of legislative experimentation is increased. Further, such experimentation reduces the costs of widespread legislative mistake. If the innovation is a success, then citizens in other jurisdictions will pressure their own governments into adopting the successful reform.[11] On the other hand, if the innovation proves defective, non-innovating jurisdictions can simply refrain from adopting the legislation, thereby protecting their citizens from the costs of mistaken policy.

(v) *responsiveness and accountability*: does decentralized provision of regulation produce financial regulation that is responsive and accountable to citizen preferences? To the extent that citizen preferences for financial regulation vary within the country, do these preferences coalesce within provincial boundaries? Relatedly, are there gaping holes in the system of regulation owing to various constitutional constraints. For instance, is the structure and stability of the existing system of financial regulation hobbled by the inability of provincial regulators to supervise effectively upstream holding companies? Is the system of regulation so confusing that institutions and depositors are incapable of knowing with certainty which regulator is responsible for which particular regulatory initiative?

(vi) *dynamic adjustment costs*: provisionally assuming that there is a case for shifting jurisdiction from the provincial to the federal level of government, how serious are the adjustment costs occasioned by constitutional reordering?

THE EVALUATIVE CRITERIA AS APPLIED TO THE CURRENT LOAN AND TRUST REGIME

In applying these criteria to the case of loan and trust

[11] This emulation effect explains the diffusion of socialized health insurance schemes across Canada.

regulation, it is clear that the current system is plagued by serious, debilitating defects. Quite simply, it is a system which mixes the worst characteristics of both decentralized and centralized arrangements, with few of the benefits of either. In large part, dysfunctional federalism is attributable to the jurisdictional overlap and duplication created by Ontario's adoption of the Equals Approach in 1987.[12] Stripped to its barest essentials, the Equals Approach stipulates that before any extra-provincially chartered institution (including those that are federally chartered) is given permission to operate within Ontario, it must agree to abide by a wide range of corporate governance and investment limits that are prescribed in Ontario's loan and trust legislation.[13]

The antecedent for the Equals Approach was the notorious Greymac affair, in which several Ontario trust companies failed after a series of high profile self-dealing transactions.[14] The

[12] See Louise Pelly, *Harmonization: A Federal Perspective*, prepared speech at the Institute for International Research Conference on the New Financial Services Regulation, February 25, 1992, at p. 3: "While the trust and loan companies may be the main victims of the lack of uniformity, the principal perpetrator of the injustice is the Loan and Trust Corporations Act (1987) of Ontario". See also J. Chertkow, *Worst Among Equals: An Analysis of Ontario's Equals Approach*, Canadian Institute speech (1989); Jacob Ziegel, *The Regulatory Evolution: Is there Light at the End of the Tunnel*, prepared remarks for Insight Conference on Financial Services Reform, April 7-8, 1992; and Senate Banking Committee, *Canada 1992: Toward a National Market in Financial Services*, Eighth Report of the Standing Committee on Banking, Trade, and Commerce, May 1990.

[13] Under Bill 116 (*The Loan and Trust Corporations Act*, S.O. 1987, c. 33, now R.S.O. 1990, c. L.25), before undertaking activity as a loan and trust corporation within Ontario, an extra-provincially chartered institution must first become registered with the Superintendent of the Loan and Trust Branch of the Ministry of Financial Institutions (s. 213). Section 39(1) of the Act requires that the extra-provincially chartered institution be able to show that it can comply with certain enumerated provisions of the Act. These sections pertain, *inter alia*, to share alienability, board composition and fitness of directors, role of outside directors, and directors' duties and liabilities. To the extent that these provisions contradict comparable provisions in the jurisdiction of incorporation, the Superintendent is able to waive application of the Ontario provisions providing that "depositors will be adequately protected" (s. 39(4)). In addition, however, a range of provisions within the statute apply to extra-provincially chartered institutions because of their application to all regulated (both provincial and extra-provincially chartered) institutions. These provisions relate to information provision and record keeping, conflict of interest transactions, business and investment powers, permissible corporate structures, and various statutory remedies for wrongdoing. Any gaps in this comprehensive regulatory structure are filled by requiring extra-provincially chartered institutions to provide the Superintendent, as a precondition of registration, with a "voluntary" undertaking that the institution will "adhere . . . to the terms, conditions and restrictions, if any, imposed on its registration" (s. 32(1)).

[14] See discussion in B. Cass, remarks for Institute for International Research Conference, *Complying with the New Financial Services Regulations, Identifying Emerging Market Opportunities*, February 25, 1992 at p. 20.

Greymac affair exposed in quite arresting terms the frailties of the existing scheme of regulation. Quite simply, antiquated legislation then in force in Ontario and elsewhere proved to be no match for the contrivances and ingenuity of unscrupulous industry participants. Into this breach stepped the Ontario government, first with the Dupré Report, and second with Bill 116 — an extensive overhaul and modernization of the province's loan and trust legislation. Recognizing that the adoption of Bill 116 would make Ontario the most stringent loan and trust regime in the country, the province used the Equals Approach as a way of tempering the incentive of Ontario institutions to reincorporate in more lenient jurisdictions.[15]

Why has the Equals Approach been so reviled? First, by insisting that extra-provincially incorporated institutions submit to Ontario's jurisdiction, the legislation undermines the vision of equal legitimacy and competence that lies at the very core of the federal idea.

Second, by requiring compliance with its own regime, as well as the regime of the chartering jurisdiction, the Equals Approach generates excessive transaction costs. As mentioned above, these costs can be quite significant particularly when the chartering and host jurisdiction's specify rules that directly contradict one another, requiring the institution to expend time and resources reconciling the two.

A third problem with the Equals Approach is its impact on depositors and institutions chartered outside Ontario. Unless an institution is willing to suffer the expense of segregating its activities into two separate institutions — one that would be governed by the Equals Approach and be confined in its operation to Ontario, and the second which would operate outside Ontario and, therefore, fall outside the ambit of the Equals Approach — an extra-provincially chartered institution will be forced to adhere to Ontario-based standards in many of its core activities, even when those activities are conducted exclusively in provinces other than Ontario. This is particularly so in respect of Bill 116's corporate governance provisions. The fact that non-Ontario

[15] In this vein, Cass, *ibid.*, at p. 20, states that: "As Ontario modernized its legislation, the previous similarity of the Ontario statute to legislation throughout Canada ceased to exist. To ensure equal protection for depositors and a relatively similar competitive environment among industry participants in the Province of Ontario, all corporations operating in Ontario were required to adhere to Ontario's standard."

residents (both depositors and shareholders of extra-provincially incorporated companies) are governed by Ontario legislation poses vexing problems for democratic theories of legislative accountability.

Fourth, by formalizing control over extra-provincial institutions, the Equals Approach obscures regulatory accountability. With multiple regulators supervising industry behaviour, inevitable conflicts in independent schemes of regulation are resolved through *ad hoc* intergovernmental adjustments. Significantly, policy adjustment through intergovernmental negotiation is an exercise that is characterized by scant public consultation and debate, thereby lending further force to the accountability concerns raised earlier.[16] Moreover, with regulation dependent upon the whim and discretion of regulators, industry officials face considerable difficulty in knowing which rules apply to which transaction and to what extent. This uncertainty, of course, increases the cost of transactional activity.

Fifth, because the Equals Approach can be used to trump the regulatory initiatives of another jurisdiction, the most important benefits of decentralized distribution of power arrangements — namely, experimentation and innovation — are thwarted. Under the Equals Approach, any regulatory initiative taken by a province other than Ontario, no matter how dynamic and forward looking, can be squelched if it is deemed to conflict with the provisions of Bill 116. By stifling innovations even before they are tried, the Equals Approach denies citizens in both the chartering jurisdiction and elsewhere the opportunity to obtain welfare gains from improvements in regulatory performance.

Finally, by selectively sterilizing certain aspects of extra-provincial legislation, the Equals Approach may generate incoherent and unprincipled systems of regulation. Many of these concerns were raised in a recent speech by Louise Pelly.[17] Pelly identifies a number of sections contained in the federal government's new loan and trust legislation, Bill C-4,[17a] which, barring a waiver of

---

[16] Donald Smiley was, of course, one of the earliest commentators to point out the democratic process values compromised by executive federalism. See, for instance, D. Smiley, "An Outsider's Observations of Federal-Provincial Relations Among Consenting Adults" in R. Simeon, ed., *Confrontation and Collaboration: Intergovernmental Relations in Canada Today* (Toronto, Institute of Public Administration of Canada, 1979), at p. 105.

[17] Pelly, *supra*, footnote 12.

[17a] S.C. 1991, c. 45, in force June 1, 1992.

compliance with Ontario legislation by the Ontario government, will be sterilized by the Equals Approach. One of the greatest ironies of the Equals Approach is that the initiative, which was at least in part a reaction to a lack of federal leadership, is subverting federal government leadership now that it has decided to act.

RESTORING THE BALANCE: IS THERE ANY CURRENT JUSTIFICATION FOR MAINTENANCE OF THE EQUALS APPROACH?

As previously discussed, the strongest and most frequently invoked rationale in favour of the Equals Approach was the fear of competitive reincorporation. Absent mandatory licensing, irresponsible (or, even worse, opportunistic) chartering jurisdictions could create a regulatory regime that permitted shareholders of loan and trusts to engage in excessive risk-taking. Because of their high levels of financial leverage, shareholders of financial institutions will be naturally inclined to increase the riskiness of the firm's assets, hence the creditors' debt, in order to raise the returns they receive as residual claimants.[18] Although excessive risk-taking by shareholders in commercial companies is controlled by interest rate pricing and myriad contractual restrictions, these techniques are far less effective in the financial institution context and, as a consequence, government regulation is required.

Why can't the creditors (depositors) of financial institutions create optimal contracts without the assistance of the state? The traditional rationale for regulation of financial institutions is based on the inability of small-stakes creditors (*i.e.*, depositors) to negotiate and enforce optimal restrictions on shareholder risk-taking.[19] However, while possessing some force, the small-

[18] The divergence of interest between shareholders and creditors in responding to certain types of transactions is formally known as the agency costs of debt. For a basic introduction to agency theory see: Barnea, Haugen and Senbet, *Agency Problems and Financial Contracting* (Englewood Cliffs, New Jersey, Prentice Hall, 1985), chapters 3 and 4; or Klein and Coffee, *Business Organizations and Finance: Legal and Economic Principles*, 4th ed. (Westbury, N.Y., Foundation Press, 1990), chapter 4.

[19] These problems can be illustrated by simple example. If it is assumed that a financial institution has 1,000 depositors who each deposit $100 in the institution (for a total investment of $100,000) and, further, that $1,000 spent on negotiation and enforcement-related activities will prevent shareholders from squandering $10,000 of depositors' funds, then it is obvious that the funds should be expended on enforcement. Depositors as a group are made better off by $9,000 and, therefore, each depositor should be willing to contribute $10. However, what is rational for a group acting as a whole often becomes

stakes story is not a complete rationale for regulation. While small-stakes investors may not be capable of negotiating tailored debt contracts with the institution, they (or at least marginal depositors) can insist that the corporation increase the rate of return on debt to the point where this return is commensurate with the risks actually assumed. And, if this price is too expensive, then the institution will commit to a conservative course of action, which will lower its costs of debt.[20] As well, private sector bonding agencies may assist passive depositors by certifying insitutions for soundness — again without governmental support.[21]

In light of defects in the depositor apathy rationale for financial institution regulation, other rationales for regulation are implicated. Some draw on government paternalism — the belief that depositors should be prevented from making excessively risky investments.[22] Other rationales draw on the fungible nature of financial assets, and the opportunities they present for undetected insider opportunism.[23] Yet still others view the principal rationale for regulation of financial institutions to be based on the perverse effects of government commitments to certain types of distortionary regulation and the need for some type of corrective or compensatory regulation.[24]

---

irrational from the perspective of each member of the group. Because each member will realize that the $10 she contributes will benefit other depositors as much as herself, she will be loath to part with the funds, and will instead rely ("free ride") on the contributions made by other investors. Nevertheless, the same rationale that makes one depositor apathetic applies with equal force to other depositors, and, as a consequence, the investment that made so much sense to the group will not be made.

[20] This analysis is developed in depth in C. Smith and J. Warner, "On Financial Contracting: An Analysis of Bond Covenants" (1979), 7 J. Financial Econ. 117.

[21] This is not a far-fetched claim. Recently in Canada a private monitoring agency, Trac Industries, has played an important role in evaluating the soundness of the Canadian insurance industry. The company was instrumental in alerting the Canadian public of problems in institutional performance well in advance of any indications of problems from regulating governments.

[22] See discussion in R. Clark, "The Soundness of Financial Intermediaries" (1976), 86 Yale L.J. 1.

[23] See, Clark, *ibid.*

[24] These policies are flat rate based deposit insurance and full compensation for all depositors (including uninsured depositors) upon the failure of an institution. Although these policies are aimed at promoting stability, they inexorably lead to less vigilant depositor monitoring which, in turn, increases the scope for shareholder risk-taking. To temper the effect of these policies, government must implement corrective legislation, which ratchets up the aggregate level of financial regulation. The leading and most vociferous exponent of this view is E. Kane. See, for instance, E. Kane, "Competitive Financial Regulation: An International Perspective" in R. Portes and A. Swoboda, eds., *Threats To International Financial Stability* (Cambridge, Cambridge University Press, 1987), chapter 4.

Evaluation of the Equals Approach requires attention to all these rationales. If the central purpose of regulation is to temper incentives for irresponsible (perhaps even fraudulent) conduct by the insiders (shareholders and managers) of financial institutions, then the obvious question is why won't chartering governments be equal to this task? Why, for instance, can Ontario not assume that the federal government and the remaining provinces are just as committed to sound regulation as it is? To understand Ontario's fear over this issue it is important to acknowledge that those features of the current financial institutional regulatory regime (flat rate based deposit insurance, perverse bank closure policies) which dull incentives for responsible behaviour by institutional insiders will have the same effect on chartering governments. Because the full costs (both political and financial) of the failure of an institution are borne principally by the federal government as deposit insurer, chartering provincial governments will expend less effort supervising institutional behaviour than if they were saddled with all of these costs.

Indeed, one could go further, by arguing that under a regime of externalized responsibility chartering governments will deliberately create incentives for indigenous institutions to skew their investment portfolio in a direction that vindicates parochial provincial industrial policy objectives. To induce shareholders of indigenous institutions to undertake this investment, the chartering government will, either explicitly through portfolio rules or implicitly through their supervisory activities, hold out the carrot of increased risk-taking.[25] In return, for instance, for investing in local real estate or commercial enterprises at levels that would not be observed in a world of vigilant depositor monitoring, shareholders are permitted to increase the risk of their portfolio, but without having to pay additional compensation to depositors.

Nevertheless, if concern over competitive deregulation was legitimate in 1987, the fact that several jurisdictions have since revised their loan and trust legislation in the direction of the standards promulgated in Bill 116 undermines the continued relevance of this rationale. By stimulating the development of

[25] These themes are developed at length in R. Daniels, "Form Over Substance: Bad Policy As a Recipe for Bad Federalism in the Regulation of Canadian Financial Institutions", forthcoming, Osgoode Hall L.J.

modern and responsible systems of regulation, the tonic of the Equals Approach has done the trick, and it is now safe for the initiative to be rescinded. The appropriateness of doing so is further underscored by the tremendous concentration of chartering activity of loan and trusts under federal legislation. Data (from 1989) show that there were 56 trust companies chartered with the federal government, and that the total insured deposits of these companies (a crude proxy for asset size) amounted to 85% of total insured industry deposits, while the figures for Ontario were 17 firms and 10.7% of total industry deposits.[26] Ignoring Quebec, there were only 10 institutions chartered in the remaining provinces (3 in Alberta, 1 in British Columbia, 2 in Manitoba, 1 in Nova Scotia and 2 in Saskatchewan) and the total insured assets of these institutions was 3.4% of the industry's.

These data reveal in quite arresting terms the fact that the brunt of the Equals Approach is being primarily borne by federally chartered institutions and their investors. That is, Ontario, which enjoys the patronage of firms comprising only 10.7% of the total industry's assets — a number which has surely declined in the wake of several recent failures of Ontario-based institutions — is setting the regulatory agenda for the federal government, which enjoys almost eight times that amount. Given the almost exclusive financial responsibility that the federal government bears for the failure of financial institutions, the necessity, indeed, legitimacy, of Ontario intervening to protect depositors (meaning the federal deposit insurance fund) from irresponsible federal legislation is, to say the least, curious.

Although this discussion suggests that the case for imposition of the Equals Approach against federally regulated institutions is weak, it says little about the threat of irresponsible legislation posed by other provincial jurisdictions. Here, the issue is not so much the validity of the rationale for the Equals Approach, but rather the choice of instrument used to vindicate these concerns. That is, if Ontario is concerned with the opportunistic funnelling of Ontario depositors' funds to pet industrial policy projects of other provinces, there are other more appropriate ways to address

[26] Because Quebec deposits are insured with another agency, the QDIB, the figures for Quebec are downward biased. These data were derived from the Canada Deposit Insurance Corporation.

these concerns. One possibility is to place greater emphasis on the disclosure of information which would allow investors to be apprised of the risks of investing in institutions chartered in lenient jurisdictions. Alternatively, if regulators are dubious of the capacity of depositors to respond to, or even understand, such information, then it may be appropriate for the deposit insurer to levy special insurance premiums on institutions operating in notoriously lenient jurisdictions.

Of course, the most obvious mechanism for dealing with the perverse incentives that encourage institutions and governments to behave irresponsibly is, as I have argued elsewhere, to reform the system of regulation so that there are greater incentives for depositor vigilance over the activities of financial institutions.[27] This would require fundamental reform of many of the core features of the current system of financial regulation. Doing so, however, would lessen the likelihood that institutions could escape discipline for irresponsible chartering decisions.

BREAKING THE LOGJAM: MOVING BEYOND THE EQUALS APPROACH

Assuming that the Equals Approach could be dismantled, what type of distribution of powers arrangements would take its place? In considering this issue, I should declare up front my belief that a properly devised system of decentralized regulation can generate valuable contributions for the quality of regulatory product (responsive and innovative legislation) without many of the debilitating transaction cost, externality, and accountability problems that plague the current system. The attractiveness of this option is buttressed further by provinces' intense interest in and commitment to continued regulation in this area. Quite simply, wholesale constitutional reordering in favour of the federal government is unlikely to be achieved without incurring substantial enmity. As a consequence, I consider the strong form centralist option no further.

A far more attractive option involves the rationalization of the current federal scheme along the lines of a European-style mutual recognition regime.[28] Under such a regime, provinces would agree

---

[27] Daniels, *supra*, footnote 25.

[28] A number of commentators have endorsed the value of a mutual recognition model in this context. See, for instance, Chertkow, *supra*, footnote 12, and *Canada 1992, supra*, footnote 12.

to allow extra-provincially chartered institutions free rights of entry to local deposit markets. The chartering (or home) jurisdiction would be vested with primary responsibility for ensuring the safety and soundness of the institutions it charters, while the host jurisdiction would be relegated to a secondary monitoring role. Significantly, however, the secondary monitoring role would be much more limited than that which Ontario currently exercises under the Equals Approach, and would perhaps focus on consumer protection or conduct of business-type regulations. To ensure confidence in the regulatory approach devised by the chartering government, and specifically to guard against the possibility of a debilitating "race to the bottom" in regulatory standards, participating governments would have to agree on a core set of rules that would serve as a floor below which no chartering government's regulations could dip. In this way, host governments would be assured that all institutions would abide by specified minimum regulatory standards, irrespective of where the institution was chartered.

The genius of the mutual recognition regime is the balance that it strikes between the extremes of incoherent decentralization and stultifying centralization. So long as the irreducible core of minimum regulation is restricted from overwhelming the scope for experimentation with distinctive regulatory initiatives, the system would permit many of the benefits of decentralization (increased incentives for experimentation, innovation and accountability) without forgoing the benefits of centralized or co-ordinated distributions of power (reduced externalities and transactions costs). Supplementing its attractiveness on purely functional grounds is the greater consonance of this system with the political factors that make an ongoing role for provincial governments all but certain in the financial institutions area.

ROADBLOCKS TO REFORM

In view of the strong functional and political case in support of a European-style mutual recognition regime, what accounts for the failure of federal and provincial governments to substitute this more streamlined system for the currently dysfunctional federal regime? This question is especially salient in light of the relatively strong endorsement that a mutual recognition regime for loan and trust regulation has received from both academic and govern-

mental commentators over the past several years. Even more perplexing is the fact that a special committee of federal and provincial financial institution regulators (the Interprovincial Conference of Financial Institution Ministers) has been meeting since December 1988 in an effort to define the minimum rules necessary to operationalize a mutual recognition regime. Despite good-faith efforts, the performance of the joint committee has been extremely disappointing. Recently, for instance, provincial members of the joint committee announced agreement on a core set of principles for financial institution regulation, but the federal government refused to endorse the proposed regime for fear of the damage it would inflict on its newly minted loan and trust statute.[29]

There has been little, if any, scholarly analysis that focuses on the transition issues involved in moving from a regime of stable, cartel-like production to a regime of hurly-burly intergovernmental competition. For the most part, scholars have focused their energies on static analysis, debating the question of whether, and if so under what conditions, decentralized federalism constitutes a superior mode of policy delivery to centralized or co-ordinated federalism. However, this type of analysis begs the central issue of which institutional arrangements are most conducive to the creation of competition promoting agreements, and which are not. In other words, while competition among governments in the provision of policy may well be desirable, competition alone cannot create the conditions that facilitate further government competition — inevitably, some degree of co-ordination is necessary.

This issue is placed in sharp relief by some of the comparative work that Roberta Romano has undertaken in the corporate law area. She analyzes the delivery of corporate law products in the United States, Canada and the European Community.[30] Romano finds that when, as in the American case, the judiciary created clear conflict of laws rules that preserved the integrity of each jurisdiction's corporate law product, a lively decentralized compe-

[29] These include: financial reporting, audit and accounts requirements, liquidity, capital based and risk weighting of assets, minimum quality asset rules, commercial loan definition, permissible downstream companies, and quantitative investment rules. *Interprovincial Harmonization of Trust and Loan Company Legislation* (March 28, 1991), draft.

[30] R. Romano, *The Genius of American Corporate Law* (August 10, 1992), draft manuscript on file with the author.

tition naturally ensued. However, in stark contrast, when, as in the process of completing the European market, inter-governmental negotiation was relied on to determine the ground rules governing recognition of corporations chartered by member states, clear constraints on competitive interaction emerged.[31] The central teaching of these comparative data is how hard it is for governments to displace stable, cartel-like systems of legal production with systems based on intense, inter-governmental competition in the absence of third party (*e.g.*, judicial) intervention.

What are the factors impeding the creation of competition promoting regulatory regimes? One possible factor is the fear of post-agreement defection. Fear of defection is a common thread in the literature explaining the failure of negotiating parties to conclude welfare enhancing agreements. This fear is modelled in the prisoner's dilemma model.[32] Although two parties are anxious to consummate an agreement that will improve their lot relative to the status quo, they rationally fear defection from the agreement by the other party because defection will produce gains to the defector that exceed the gains she will realize from adherence. The rub is that while the welfare of the defecting party increases, the welfare of the non-defecting party is actually less than it would have been had there been no agreement. Thus, unless parties are able to secure credible assurances of mutual performance, they will not consummate an agreement in the first place.

In the context of financial institution regulation, the argument that fear of defection has hobbled the consummation of a welfare-enhancing agreement rings hollow. It is true that, in the absence of an ambitious restructuring of the regulatory system, parties will secretly harbour the desire to defect from an agreement, but the persistence of those aspirations is of little moment in explaining the reasons why agreements do not get concluded in the first place. The key is not whether "bad" incentives exist, but whether these incentives can be contained by agreement.

---

[31] This point is confirmed by B. Cheffins, "European Community Company and Securities Law: A Canadian Perspective" (1991), 36 McGill L.J. 1282 at pp. 1293-4. Cheffins notes that European Commission officials were predisposed to centralization of company legislation because they realized that by harmonizing legislation they would remove the incentive for companies to shift jurisdictions to take advantage of regulatory divergences.

[32] R. Hardin, *Collective Action* (Baltimore, John Hopkins University Press for Resources for the Future, 1982), p. 145; M. Taylor, *Anarchy and Cooperation* (New York, John Wiley & Sons, 1976), chapter 5.

Thus, an alternative explanation for the failure of the provinces and the federal government to conclude a mutual recognition regime lies in the inability of the parties to detect and penalize defections from the agreement. Superficially, the claim that the federal and provincial governments are unable to detect and penalize deviations from formal agreements seems strained. Extra-constitutional agreement has been one of the chief ways in which formal distribution of power arrangements have kept up to date with the evolving nature of the Canadian economy and society. And, given the pervasiveness of these agreements, a host of institutions and mechanisms have been devised to monitor performance and, if necessary, discipline breach.

Perhaps concern over the enforceability of the core rules necessary to support a mutual recognition regime in the financial institutions area reflects problems that are distinct to that policy area, namely the difficulties in relying on formal legal rules to constrain institutional risk-taking.[33] Even cursory review of the string of failures in Canada over the last decade shows how imperfect formal rules and restrictions are as instruments for preventing insolvency. Many of these institutions, through inadvertence or otherwise, created quite risky portfolios within the four corners of regulation. While many institutions made sure they had a mix of different assets in their portfolio, they failed to diversify these assets geographically, which made them vulnerable to regional economic downturns.

The implication of this observation is that the competence and dedication of regulatory personnel constitute an important, if not central, component of an effective regulatory regime. If provincial bureaucrats are not truly committed to the spirit of the restrictions that undergird a mutual recognition regime, then it may be possible for them to sidestep the rules through discretionary enforcement activities. However, these problems are not insurmountable. By agreeing to rationalize the *supervisory* activities of chartering governments by, perhaps, delegating supervision to one centralized monitoring agency, the scope for government defection would be confined.

---

[33] A Conference Board of Canada survey of regulatory authorities cited mistrust among regulators as one of the reasons why agreement in this area has proven elusive. See: B. Sutton (with G. Glorieux), "The Changing Structure of the Canadian Financial Services Industry: Volume II, The Perspectives of Regulatory Authorities", The Financial Services Research Program of the Conference Board of Canada, April 1992 Draft, at p. 55.

So far, the impediments to agreement have been pitched at a fairly high level of principle. I do not question in any way the sincerity of the commitment of negotiating governments and their representatives to the enterprise of securing a durable and functional agreement that would support effective intergovernmental competition. But just as firms in the private sector are plagued by endemic accountability or agency problems, so too are institutions in the public sector. In the public case, agency problems emanate from the grant of authority going from citizen-voters to their agents (politicians and bureaucrats). In financial institution regulation, agency problems are related to the fact that it is difficult, if not impossible, for interested citizen-voters (and sometimes even their political representatives) to discern and understand the positions taken by bureaucratic elites in inter-governmental negotiations. This is particularly so given the relatively complex (hence low saliency) nature of financial regulation issues.

Once scope is conceded for agency problems, then it is possible to understand why politicians and agents may not want to adopt an agreement that would be welfare-enhancing from the perspective of citizen-voters. As Alan Cairns has observed:[34]

> The growth of one federal and ten provincial governments has produced large and powerful complexes of institutions and personnel with their own professional and personal interests and their own official purposes for the provincial and federal populations they govern. . . . It makes little sense to think of these impressive concentrations of power and personnel as superstructures whose existence and purposes are largely derivative of the electorate. . . .

In these terms, the failure of governments to put in place a mutual recognition regime for financial institutions is related to divergences in the welfare functions of citizens and bureaucrats. Like producers in stable, co-ordinated markets, bureaucrats charged with regulation of financial institutions may prefer the present situation of dysfunctional federalism to a superior world of intense intergovernmental competition.

This propensity is exacerbated by bureaucratic loss aversion. As a large body of experimental literature has shown, individuals charged with making important decisions will often "weight losses substantially more than objectively commensurate gains in the evaluation of prospects and trades".[35] In the case of financial insti-

[34] Alain Cairns, "The Government and Societies of Canadian Federalism" (1977), 10 Canadian J. Pol. Sci. 695 at p. 702-03.

[35] D. Kahneman, J. Knetsch, and R. Thaler, "Experimental Tests of the Endowment

tution regulation, bureaucrats fear the gale force of competition because it increases the prospect that other jurisdictions will be able to lure footloose institutions to their jurisdiction by offering a superior product.[36] Such outward migration impacts directly on bureaucratic welfare functions by reducing the size of regulatory fiefdoms.

A RECIPE FOR REFORM

The foregoing analysis revealed in quite stark terms the rather dismal prospects for concluding intergovernmental agreements that increase regulatory competition. Quite simply, bureaucrats (and politicians) have only muted enthusiasm for abandoning the quiet life of co-ordination and cartelization in favour of the hurly burly world of competition — an inclination that is buttressed by loss aversion. And although these problems are common to virtually all inter-governmental negotiations aimed at creating conditions for increased governmental competition, negotiations in the financial institution area are complicated by the difficulties in specifying clear performance obligations, as well as the conditions for breach.

Against these constraints, how can the logjam in negotiations for a mutual recognition regime for loan and trusts be remedied? There is little doubt that the dynamic supporting the existing impasse is slowly, but assuredly, being whittled away by the decline of an independent (*i.e.*, non-bank affiliated) trust industry. Arguably, the more dramatic the industry's decline, the less leverage the provinces will have in the mutual recognition bargaining process. But despite steady industry contraction, it is unlikely that provinces will unilaterally surrender authority over loan and trust regulation to the federal government. The perception that an indigenous industry is an important tool in the capital allocation process dies hard — particulary in Quebec. In

---

Effect and the Coase Theorem" (1990), 98 J. Pol. Econ. 1325 at p. 1327. This effect derives from the observation that individual utility functions are based not on absolute but on comparative welfare levels.

[36] K. Scott argues that loss aversion is a prime motivating force in the behaviour of regulators charged with administering the dual banking system in the United States: "[b]anking agencies apparently respond more vigorously to the loss of existing members than to the prospects of obtaining new members; behavior is more defensive than aggressive". See K. Scott: "The Dual Banking System: A Model of Competition in Regulation" (1977), 30 Stan. L. Rev. 1 at p. 33.

these terms, the decline of the industry may push in the direction of an agreement, but is unlikely to secure it. Something more is needed.

In thinking about improvements to the current system, the most obvious set of proposals relates to the salutary effect that strong, dynamic federal leadership could have on the negotiating process. As my colleague Robert Howse has argued, the federal government could, as in the case of international negotiations, assume the role of hegemon.[37] Hegemonic leadership involves a situation in which "one state is powerful enough to maintain the essential rules governing inter-state relations, and [is] willing to do so".[38] However, power alone is not sufficient to create a stable regime; the hegemon must be willing to project that power towards the end of producing a collective good.[39]

How does this imperative to act as a hegemon translate into a concrete course of action in the regulation of financial institutions? First and foremost, effective federal leadership in this area requires a disciplined commitment to the creation of a regime in which *all* governments are able to compete with one another in an effort to secure citizen patronage, not a regime in which the federal government is able to exploit bargaining infirmities among the provinces in an effort to create or shore up what could become a sclerotic federal monopoly over the provision of policy. In some cases, the imperative of leadership will require the federal government to use its superior bargaining position to discipline opportunistic provincial hold-outs. In other cases, the federal government should direct its efforts to creating institutions that will enforce agreements for competition.

What carrots and sticks are available to the federal government in effecting improvements to the bargaining climate for a mutual recognition regime? At the outset of negotiations, the federal government should seize the initiative by framing the goals of the negotiating process and by identifying the range of issues necessary to be resolved in order to secure agreement. Most

---

[37] R. Howse, "Comment on Patrick Monahan 'Political and Economic Integration: The European Experience and Lessons for Canada' ", unpublished comment presented at the Annual Workshop on Commercial and Consumer Law, 1991, Faculty of Law, University of Toronto.

[38] R. Keohane and J. Nye, "Transgovernmental Negotiations and International Organizations" (1977), 27 World Politics 39 at p. 44.

[39] R. Keohane, *After Hegemony*, (Princeton, N.J., Princeton Univ. Press, 1984), p. 39.

importantly, the federal government should prepare principled position papers on contentious issues in advance of the process, which would then be circulated to the participating governments once the negotiations begin in earnest. With a dearth of support services available to intergovernmental negotiating committees, federal leadership in the preparation of these materials would greatly enhance the quality and structure of deliberations. It would also provide the federal government with an important tactical advantage in the negotiations.

In a similar vein, if (or more likely, when) negotiations break down, the federal government should show no hesitation about using its substantial powers to break whatever impasse has emerged. At the simplest (and least confrontational) level, the federal government should be prepared to undertake or commission research that would evaluate the merits of competing positions advanced by different parties in a principled and rigorous way. Too often in the commercial and corporate realm, divergence over policy issues is a byproduct not of irreconcilable normative beliefs, but rather of how widely shared goals (like the promotion of wealth creation) are actually achieved. These sorts of problems can be resolved (or, at least, substantially illuminated) by rigorous empirical analysis.

For instance, if certain governments disputed either the ambit of the subjects to be remitted to the minimum core of regulations or the impact of different regulatory rules on industry behaviour in the course of negotiating a mutual recognition regime, then background research could be undertaken on these subjects. In this respect, like the effect of a mediator's report in labour relations, federal analysis could expose positions that are bereft of any normative or empirical support through the sunlight of rigorous, objective study.

Another key component of an effective negotiating process would be the creation of formal mechanisms for securing the inclusion of informed citizen and industry voice. As stated earlier, among the most disturbing features of intergovernmental negotiation is its lack of public transparency. By formalizing citizen opportunities for input, further discipline would be brought to bear on the negotiating process. Hold-out governments would be forced to justify their positions against clearly articulated expressions of the public interest. Sadly, in the case of negotiations for a mutual recognition regime there has been little real urgency on the

part of many of the participating governments to conclude an agreement. This is not at all surprising when one considers the stark asymmetries in the views of industry and government officials regarding the adequacy of the current regime. One suspects that clearer opportunities for public consultation and debate would rectify this complacency.

In the end, however, no matter how cogent and principled, independent analysis, even when buttressed by public pressure, may only be able to push the parties so far, and resort to more assertive action will be required to break deadlock. The most extreme option available to the federal government is to step outside intergovernmental negotiations and simply impose a mutual recognition scheme of its own creation on the provinces. Federal jurisdiction to act in this way draws support from the steady expansion of the scope of the trade and commerce power by the Supreme Court.[40] Under recent jurisprudence, it is likely that the court will be willing to condone federal unilateralism (having some incidental aspect or effect on intraprovincial jurisdiction) where it can be shown that the provinces are incapable of

[40] Originally, the trade and commerce power was given narrow scope by the Privy Council in a series of cases commencing with *The Citizens Insurance Co. of Canada v. Parsons* (1881), 7 App. Cas. 96. Essentially, federal power was restricted to those matters having an international or interprovincial nature or trade affecting the whole Dominion. The court was concerned with the capacity of an expansive reading of the trade and commerce power to include every regulation of trade, thereby overwhelming provincial jurisdiction (at p. 110). Slowly and sporadically, since being freed from the shackles of the Privy Council, the Supreme Court has abandoned the restrictive view enunciated by the Privy Council. For instance, in *Can. (Attorney General) v. Canadian National Transportation, Ltd.* (1983), 3 D.L.R. (4th) 16, [1983] 2 S.C.R. 206, Dickson J., concurring found that the federal government was competent to promulgate combines legislation under the general limb of the trade and commerce power.

Although the federal government was precluded from regulating specific trades or business in the provinces, Justice Dickson held, at p. 62, that the situation was different where "what is at issue is general legislation aimed at the economy as a single integrated national unit rather than as a collection of separate local enterprises. Such legislation is qualitatively different from anything that could practically or constitutionally be enacted by the individual provinces either separately or in combination." Dickson J. then proceeded to enumerate five indicia that could evaluate the purported validity of an exercise of power under the general limb: (i) presence of a national regulatory scheme; (ii) oversight by a national regulatory agency; (iii) concern with trade in general, not with an aspect of a particular business; (iv) the provinces are constitutionally incapable, either jointly or severally, of passing such an enactment; and (v) the failure to include one or more provinces would jeopardize the successful operation of the scheme.

These criteria were subsequently relied upon by the Supreme Court in *General Motors of Canada Ltd. v. City National Leasing* (1989), 58 D.L.R. (4th) 255, [1989] 1 S.C.R. 641.

creating a co-ordinated arrangement by themselves and where the failure to act is impairing interprovincial capital movements — conditions which are both demonstrably present in this case.

A more moderate variant on this proposal would involve a federal constitutional reference to the Supreme Court respecting the provinces' authority to regulate extra-provincial incorporations under Equals Approach-like schemes. Even in the absence of a concrete proposal for a mutual recognition scheme, there is considerable force to the claim that because the Equals Approach impairs the core status and governance structure of extra-provincially incorporated companies, it is *ultra vires* the provincial government.[41]

In addition to these measures, there are several other less drastic steps that, akin to "tit for tat" negotiating strategies, could be used to discipline provincial hold-outs. For one thing, the federal government could move to establish a Schedule III-type bank that would allow institutions having concentrated shareholdings to conduct fiduciary activities in-house. Once reincorporated as banks, these institutions would enjoy wide protection by virtue of the expansive interpretation the Supreme Court has given the federal banking power.[42]

Alternatively (or perhaps concurrently), the federal government could restructure the scheme by which deposit insurance and bail-out assistance is provided for provincial loan and trusts. If provinces want to regulate, either directly (by chartering) or indirectly (by licensing agreements), the activities of loan and trusts, then they would be required to assume the political and financial responsibility for failure. One way of achieving this goal would be to exclude provincial institutions from coverage by the Canada Deposit Insurance Corporation. Another and less drastic solution would involve the creation of risk-rated deposit insurance pools in a scheme administered by the CDIC. Under this arrangement, institutions would be segregated by jurisdiction of incorporation, with the chartering government

---

[41] This claim is strongest vis-à-vis federally incorporated trust companies.

[42] See, for instance, *Canadian Pioneer Management Ltd. v. Labour Relations Board of Saskatchewan* (1980), 107 D.L.R. (3d) 1 at p. 24, [1980] 1 S.C.R. 433, *per* Beetz J., concurring, quoting from the factum of the Attorney General of New Brunswick: Banking defined as " 'a set of interrelated financial activities carried out by an institution that operates under the nomenclature and terms of incorporation which clearly identify it as having the distinctive institutional character of a bank' ".

responsible for shortfalls in funding. This solution would ensure that out-of-province depositors would not be made to suffer discriminatory treatment at the hands of the chartering jurisdiction, as the deposit insurance corporation would have day-to-day responsibility over the administration of the fund.[43]

CONCLUSION

As in other work I have done, one of the central themes of this article is the value of decentralized systems of regulation in generating a regulatory product that is more attentive to consumer preferences. Such sensitivity is of particular value in the corporate-commercial area given the relatively low saliency of these issues compared to others on the broader legislative agenda. Absent pressure from footloose industry or consumer groups, legislators are unlikely to take seriously the need for legislative reform in the corporate-commercial area. One need only take note of the dismal pace of reform leading up to the federal bankruptcy amendments to see the substantial difficulties that even the most committed regulators face in getting corporate-commercial issues on the legislative agenda.

However, as examination of the current regime of loan and trust regulation shows, decentralization by itself does not always assure the creation of sound policy. Indeed, in the absence of workable framework rules, decentralization can be just as — if not more so — dysfunctional as centralized arrangements. The challenge for enthusiasts of decentralized governmental arrangements is to demonstrate how these decentralized arrangements can be created through multilateral assent. This is familiar to students of international political science, who have long wrestled with the vexing issue of how sovereign, self-regarding states can be induced to adopt welfare enhancing agreements. And, it is here that scholars have fastened on the catalytic role that hegemonic leadership can play in negotiating, securing and enforcing agreement.

---

[43] The potential for discriminatory treatment of non-resident investors by a chartering province is more than academic. Following the collapse of the Principal Group of Companies, the Alberta government (which had granted the companies a charter under provincial investment contracts legislation) offered compensation that was proportionate only to the amount of money lost by Alberta residents. Selective treatment of investors was designed to place pressure on other provinces to make their own Principal investors whole. See "Playing Regulatory Catch-Up in the Wake of the Code Report", *Financial Times*, July 24, 1989.

The lessons of hegemonic leadership in the international realm have direct bearing on the prospects of improving the current malaise in loan and trust regulation: the federal government should project its power into the regulation of financial institutions with a view to securing co-operative agreement for healthy competition. The only factor that seriously impedes federal hegemonic leadership (as in other areas) is the will to power. Instead of vigorously asserting its very considerable jurisdiction, the federal government seems more inclined to opt for co-operative or co-ordinated solutions to federal-provincial problems. But as Breton has argued in his thoughtful dissent to the Macdonald Commission Report, one of the inextricable byproducts of a commitment to co-operative federalism has been an impairment of the federal government's core responsibility to create a more competitive and vigorous union:[44]

> Co-operative federalism, because it proscribes unilateral action, is therefore a disguised ploy to shackle the federal government, to prevent it from addressing the problems that it alone can resolve and is constitutionally responsible for resolving.

One can only hope that in a post-Charlottown world, the federal government will be more willing in this, as in other areas, to assume its historic responsibility to create the conditions that conduce to governmental competition, hence to nation-building.

[44] Albert Breton, Supplementary Statement, *Report of the Royal Commission on the Economic Union and Development Prospects for Canada*, Vol. 3 (Ottawa, Ministry of Supply and Services Canada, 1985), at p. 493.