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DEVELOPMENTS

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I. INTRODUCTION

Following three years of delay and six years of review, the Banks and Banking Law Revision Act was passed in Canada and became effective December 1, 1980.[1] The Act will, for the first time, enable foreign banks to enter mainstream banking in Canada as chartered banks (licensed by Parliament) while at the same time limiting the role of foreign bank subsidiaries to ensure that the Canadian "banking system remains predominantly in Canadian hands."[2] The new Bank Act establishes two separate classes of banks.[3] Under the Act, existing chartered banks will become Schedule A banks. Schedule A banks are widely held banks with relatively few limitations and encumbrances when compared with closely held or Schedule B banks.[4] The Schedule B category was created specifically to enable foreign bank affiliates operating in Canada to enter mainstream banking and be subject to federal regulation and oversight.[5] Unlike Schedule A banks, Schedule B banks (foreign bank subsidiaries) are subject to periodic licensing, separate organizational limitations, individual and collective limitations on size and market share, restrictions affecting asset mix, and restrictions on asset location.[6]

In short, the architects of the new Bank Act have been exceedingly diligent in their efforts to ensure that control of the financial system re-

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1. Banks and Banking Law Revision Act, 1980, ch. 40 [hereinafter cited as Bank Act].

2. Canadian Dep't of Finance, White Paper on the Revision of Canadian Banking Legislation, Aug. 1976 [hereinafter cited as White Paper].

3. Bank Act §§ 5, 174(2)(e).

4. Schedule B banks are defined as banks with one shareholder holding more than 10% of issued voting shares. Bank Act § 174(2)(e).

5. *Id.* § 3.

6. Bank Act §§ 28(5), 175(2), 302, 303(5)-(8).

mains predominantly in Canadian hands as was recommended by the 1976 White Paper on banking.[7] What is not clear, however, at this point in time, is whether the architects of the Bank Act were as diligent in adhering to the corollary recommendation in the White Paper which suggested the entry of foreign banks into Canadian banking in an effort to maximize competition in banking to the overall benefit of the industry. Cursory review at this stage indicates that the role afforded foreign banks in Canada, under the Bank Act, is so limited that their competitive impact on the industry will be minimal.

The severe restrictions imposed on foreign banks under the Bank Act, when juxtaposed with the wide latitude afforded Canadian banks in the United States, has prompted considerable concern among U.S. banks and federal and state banking authorities. These concerns impelled numerous representations to the Canadian Government urging modification of the more severe aspects of the legislation prior to enactment. In addition to representations made by U.S. and other non-Canadian banks to the Senate and House Committees considering the Bank Act, the U.S. Government also made numerous representations to the Department of Finance on various versions of the Bank Act bill prior to passage. U.S. Government concerns were expressed not only through formal demarches made by the U.S. Embassy in Ottawa, but also by the Secretary of the Treasury directly and in the Treasury Department's Report to Congress on the treatment of U.S. banks abroad.[8] Despite some modifications in the Bank Act bill,[9] the final Act falls far short of reciprocal or even national treatment for U.S. and other foreign banks.[10]

II. OVERVIEW OF CANADIAN BANKING

Canada has a highly concentrated financial community dominated by the chartered banks. Chartered banks control over seventy percent of the assets of private financial institutions and five chartered banks control roughly ninety percent of the chartered banks' total assets. Despite the dominant positions of the chartered banks, so called "near" banks (trust, mortgage, loan, and finance companies) play a significant role in the financial community. Until passage of the revised Bank Act in December 1980, foreign banks were precluded from becoming chartered banks.[11]

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7. White Paper, note 2 *supra*.

8. U.S. DEP'T OF THE TREASURY, REPORT TO CONGRESS ON FOREIGN GOVERNMENT TREATMENT OF U.S. COMMERCIAL BANKING ORGANIZATIONS (Sept. 1979) [hereinafter cited as TREASURY REPORT TO CONGRESS].

9. The majority of these modifications resulted in the replacement of specific limitations and restrictions with language leaving the contested issues up to the sole discretion of the Inspector General of Banks.

10. In connection with Canada's endorsement of the 1976 OECD Declaration on National Treatment, the Canadian delegation formally notified the OECD that "banking and other financial" sectors were exceptions to the commitment to national treatment. OECD, DECLARATION ON NATIONAL TREATMENT (1976).

11. In 1963, First National City Bank of New York did, however, acquire 24% of Mer-

Consequently, foreign bank affiliates in Canada, including those controlled by U.S. banks, functioned primarily as wholesale finance companies.

Chartered banks operate under the revised terms and provisions of the Bank Act which defines activities and regulates internal aspects of their operations as well as their relationship with the government and the Bank of Canada. The Federal Bank Act, passed originally in 1871, is subject to revisions every ten years, with the latest revision occurring in December of 1980. Prior to the enactment of the 1980 Bank Act, there were only eleven chartered banks, all of which were federally chartered, i.e. licensed by Parliament. Since passage of the Bank Act, twenty-one foreign banks have been granted permission to operate as chartered (Schedule B) banks.

At the end of 1980, there were approximately sixty foreign bank affiliates operating in Canada with total assets estimated at $10 billion (Canadian) dollars, which was just under three percent of the Canadian private financial market. U.S. banks controlled about two-thirds of the assets of all foreign bank affiliates. Foreign bank affiliates in Canada engaged primarily in wholesale financial services, leasing and factoring. There were, however, some notable exceptions. Bank of America had an extensive branch network providing retail financial services. Foreign bank affiliates were funded predominantly through the issuance of ninety day commercial paper, often guaranteed by the affiliate's parent, with these funds in turn being lent to corporate customers.

Under the new legislation, U.S. and other foreign banks are permitted to set up subsidiaries as chartered banks in Canada.[12] Foreign banks desiring a "low profile" presence in Canada are permitted to maintain a representative office in Canada and to act as liaison between the foreign bank and clients, but the representative office is specifically prohibited from active banking operations in Canada.[13] Foreign banks are specifically prohibited from establishing branches in Canada.[14]

III. INTEGRATION OF FOREIGN BANKS INTO THE CANADIAN BANKING SYSTEM

Entry of foreign banks in Canada will, in general, be determined on a case-by-case basis under the new Bank Act. The Inspector General of Banks, who reports to the Minister of Finance, is directed under the Act to focus on two criteria in assessing a foreign bank's application for entry or conversion to chartered bank status through the issuance of Letters

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cantile Bank from a Dutch owner. This acquisition furthered growing national concern which culminated in the restrictive foreign ownership provisions of the 1967 Bank Act.

12. Bank Act § 302(2).

13. *Id.* § 302(2)(a), and Regulations Respecting the Registration and Operation of Foreign Bank Representative Offices, Can. Gaz., Pt. I, Dec. 20, 1980.

14. Bank Act § 302(1)(b).

Patent. The first is the potential contribution the bank can make to competitive banking in Canada. The second is the degree of reciprocity afforded Canadian banks operating in the applicant's home jurisdiction. Treatment must be as favorable for Canadian banks operating in the applicant's jurisdiction as the treatment that will be afforded the applicant in Canada.[15] The Inspector General will be afforded wide discretion in making these assessments and the issuance of Letters Patent will be at the sole discretion of the Finance Minister, subject to approval of the Cabinet through the Governor In Council.[16]

Foreign bank subsidiaries which are granted authority to commence and carry on the business of banking in Canada are subject to periodic licensing requirements.[17] Domestic banks are not subject to the periodic licensing requirement. The license may, notwithstanding any other provision of the Bank Act, set forth restrictions and conditions on the conduct of banking by the foreign bank subsidiary which are, in the opinion of the Minister, expedient and necessary.[18] Moreover, banking licenses are subject to renewal at least annually for the first five years after which time they are subject to review at least every three years.[19] Thirty days prior to license renewal, the Minister may inform the bank that the restrictions and conditions under which the bank is operating are to be altered or, in an extreme case, the Minister may inform the bank of the government's intentions not to renew the license.[20]

IV. FOREIGN BANK OPERATIONS UNDER THE NEW BANK ACT

The new legislation, through severe restriction, will make it virtually impossible for foreign bank affiliates to operate in Canada under any other guise but as a chartered bank. A nonbank affiliate of a foreign bank is prohibited from engaging in the business of both lending and accepting deposit liabilities transferrable by check or other instrument. To assure that this prohibition is not circumvented, the Bank Act now precludes the establishment of two separate entities by a single foreign bank if one of the entities is engaged in taking deposits while the other entity is engaged in lending money. Clearly, a foreign bank affiliate engaging in general banking activities in Canada can do so only in the form of a chartered bank.[21]

Moreover, in an effort to provide a strong inducement for foreign bank affiliates currently operating in Canada as finance companies to convert to chartered bank status, the Bank Act prohibits a nonbank affiliate of a foreign bank that engages in the business of banking from borrowing

15. *Id.* § 8(d).
16. *Id.* § 7(2).
17. *Id.* § 28(5).
18. *Id.* § 28(6).
19. *Id.*
20. *Id.* § 28(7).
21. *Id.* § 303(5).

money or issuing market securities on the guarantee of its parent.[22] The prohibition against the use of a parent's guarantee to raise funds in capital markets is, perhaps, the strongest inducement for foreign bank affiliates established in Canada to convert to chartered bank status. It should be noted, however, that some foreign bank affiliates have tested domestic financial markets with unguaranteed paper and found relatively little resistance. Even without the explicit guarantee of the parent bank, some bank affiliated finance companies will be viewed as having an implicit guarantee and will meet relatively minor resistance to the issuance of their paper. This resistance may, however, result in a slight increase in the cost of funds through this mechanism. Foreign bank subsidiaries which convert to chartered bank status will be permitted to continue using the parent's guarantee.

Under the Bank Act, most foreign bank affiliates operating in Canada will find it in their interest, and indeed, find it almost impossible not to convert their operations to Schedule B bank operations. This conversion will, however, subject these bank affiliations to the same reserve requirements—both primary and secondary—as chartered banks, resulting in an increase in funding costs.[23] As finance companies, foreign bank affiliates funded their operations predominantly through the issuance of ninety day commercial paper. Imposition of reserve requirements on foreign bank subsidiaries will add to their financing burden.

In terms of cost of funds, the biggest advantage foreign bank affiliates will reap through the conversion to chartered bank status is the exemption of chartered banks from withholding tax for interest payments paid on foreign currency deposits.[24] This exemption is in addition to existing United States-Canada treaty exemptions and will enable well-established foreign bank subsidiaries to tap the Eurocurrency market for funds. Prior to conversion to chartered bank status, foreign bank affiliates would only be able to tap the Eurocurrency market if they were willing to absorb the withholding costs and remit interest payments net of withholding. Consequently, foreign bank affiliates were effectively excluded from tapping this source of funds.

V. Specific Limitations Imposed on Foreign Banks

To ensure Canadian control of the banking system, the Bank Act imposes numerous limitations and restrictions on the Canadian subsidiaries of foreign banks. The total asset share of the Canadian market to be allocated to foreign bank subsidiaries under the new Bank Act will be limited to eight percent of total domestic assets of all banks in Canada.[25] At the

22. *Id.* § 303(8).

23. The minimum cash requirement for each chartered bank is 11 ¼% of reservable Canadian dollar demand deposits, 1½% of reservable Canadian dollar notice deposits in excess of $500 million, and 3% of Canadian residents' foreign currency deposits.

24. Income Tax Act, 1970, ch. 63, § 212(1)(B) (amended 1971, 1972).

25. Bank Act § 302. Domestic assets are determined by reference to Schedule Q filed

time of passage, overall domestic assets earmarked for foreign bank subsidiaries amounted to approximately $14 billion (Canadian) according to the Inspector General's Office.[26] Assets of foreign bank affiliates operating in Canada in December 1980 are estimated to have amounted to $13 billion (Canadian), of which approximately $10.7 billion (Canadian) were domestic currency assets.[27] Consequently, available estimates indicate a growth potential in Canada for foreign banks of $3.3 billion (Canadian), which is not much when one considers the fact that banks from Japan, Latin America, and other nations not currently represented will take up a large portion of this potential.

The use of domestic assets as the basis for allocating the market share afforded foreign banks was to encourage foreign bank subsidiaries to exploit nondomestic asset areas of growth. It is important to note that the Bank Act's focus on domestic assets provides foreign bank subsidiaries more latitude than would have been afforded had the overall bank limitation been set vis-à-vis total bank assets—as was originally proposed. In the past three years, Canadian dollar assets, a fairly accurate indicator of domestic assets, increased 65.8%, while foreign currency assets, an indicator of all nondomestic assets, increased 119.6% over the same period of time.[28]

The asset size of each individual foreign bank subsidiary is to be determined basically on an ad hoc basis by the Inspector General of Banks in conjunction with the periodic licensing process. The Act does, however, contain the following specifics concerning individual bank size. Schedule B banks are limited to twenty times authorized capital.[29] The Act provides for a minimum capitalization of $5 million (Canadian) for Schedule B banks and $2 million (Canadian) for Schedule A banks.[30] The Act is silent on the maximum permissible capital except to state that it will be determined by the Cabinet through the Governor In Council and, effectively, by the Minister of Finance.[31]

Prior to commencement of business, a Schedule A bank is required to have $1 million (Canadian) in paid-in capital, while a Schedule B bank is required to have $2.5 million (Canadian).[32] If the level of paid-in capital is less than one-half of authorized capital at the time the bank com-

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monthly in the Canada Gazette by Canadian banks. Schedule Q includes: (1) notes of and deposits with the Bank of Canada; (2) deposits with banks; (3) checks and other items in transit, net; (4) securities; (5) loans to investment dealers, Provinces, municipal corporations, banks, others and lease receivables; (6) mortgages; and (7) customers' liabilities under acceptances and other assets.

26. Data on domestic assets, as defined in Schedule Q, was not compiled prior to November 1981.

27. U.S. bank affiliates accounted for roughly two-thirds of this amount.

28. BANK OF CAN. REV., Mar. 1981.

29. Bank Act § 174(2).

30. *Id.* § 116(1).

31. *Id.*

32. Bank Act § 27(1).

mences operations, the authorized capital is automatically reduced to a multiple of $1 million (Canadian) but not greater than twice-issued capital.[33] Schedule B banks may be granted six months to meet the paid-in capital requirements.[34] An ancillary limitation imposed on foreign banks is that foreign bank subsidiaries are limited to a main office and one branch, with establishment of additional branches subject to ministerial approval.[35]

Under the Act, a foreign bank subsidiary operating as a bank in Canada is required to maintain assets in Canada at least equal in value to the aggregate of the liability of the foreign bank subsidiary to residents of Canada, and to the paid-in capital of the foreign bank subsidiary.[36]

Banks, including foreign bank subsidiaries, are required to prepare and maintain in Canada all bank records required by the Bank Act. Moreover, if a foreign bank's subsidiary maintains copies or extracts of any records or further processes information or data on the bank's Canadian banking operations, the bank is required to inform the Inspector General and to provide him with a description of the records as well as a description of the further processing of these records.[37] In effect, the new Act requires foreign bank subsidiaries to duplicate data processing done at the head office as part of the bank's worldwide operations in order to satisfy the requirement that the records concerning the bank's Canadian operations be generated, processed, and maintained in Canada.

A foreign bank or corporation associated with a foreign bank which owns shares in a foreign bank subsidiary in Canada is precluded from acquiring or owning shares in any bank other than the foreign bank subsidiary. Also, there is an ownership limit of not more than ten percent of the total voting shares of any other corporation whose principal activity in Canada consists of providing banking, fiduciary, investment, or insurance services. There is, however, a proviso whereby the Minister of Finance is permitted discretionary latitude in granting exceptions to this prohibition under certain conditions.[38] This exception was specifically incorporated into the statute to accommodate several European banks faced with this problem.[39]

The Bank Act provides, subject to ministerial approval, for the grandfathering of certain assets as long as the assets were held at the time of the application for Letters Patent incorporating the foreign bank

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33. *Id.* § 29(1).

34. *Id.* § 29(2).

35. *Id.* § 173(2). There is a proviso in the Bank Act which permits, subject to ministerial approval, grandfathering of existing branches. This proviso was included to permit Citicorp and Bank of America to maintain their extensive branch networks.

36. *Id.* § 175(2).

37. *Id.* § 155.

38. *Id.* § 305.

39. White Paper, note 2 *supra*.

subsidiary.[40] The following types of assets can be grandfathered under this provision: (1) otherwise prohibited assets which consist of shares of a corporation incorporated under federal or provincial law provided the shares were held by the foreign bank subsidiary's parent, the parent's holding company, or an affiliate of the parent;[41] and (2) assets held by nonbank affiliates of the foreign bank subsidiary's parent, or branches which are not otherwise permitted by the Bank Act if such branches replace branches of a corporation incorporated by or under federal or provincial jurisdiction, provided such branches are affiliates of the foreign bank subsidiary.[42]

VI. CONCLUSION

Canada's new Bank Act undeniably improves the position of foreign banks in Canada. The Act does, however, fall short of a reasonable and justifiable approach to the treatment of non-Canadian banks. Canadian chartered banks are major, highly competitive international financial institutions which do not require protection from foreign competition in the domestic market. Moreover, the prominent position of Canadian banks in the United States and the better than national or reciprocal treatment afforded Canadian banks in the U.S. market argue persuasively for further liberalization of the treatment of U.S. banks in Canada.

The Senate Committee on Banking, in its Report on the International Banking Act of 1978,[43] argued that the U.S. Government, "in light of the substantial privileges enjoyed by foreign banks in the United States should seek to secure national treatment for our banks abroad."[44] The Treasury Department's conclusions and recommendations contained in the Report to Congress on Foreign Government Treatment of U.S. Commercial Banking Organizations[45] was critical of some aspects of the then pending banking legislation in Canada, but did not have the benefit of final legislation and, consequently, the Department was unable to make concrete recommendations to Congress concerning the Canadian Government's treatment of U.S. banks operating in Canada. Banking legislation has now been enacted in Canada which does not provide for national treatment, i.e. equality of competitive opportunity is not ensured.[46] In the Report, the Secretary of the Treasury did, however, recommend

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40. *Id.* § 28(8).

41. This exception applies primarily to European banks whose holding companies maintain interest and control unrelated corporations in Canada which would otherwise be prohibited under the law.

42. Primarily, this affects operations such as Citicorp Canada, Ltd. and Bank of America, both of which have extensive branching operations connected with their current activities as finance companies.

43. International Banking Act of 1978, 12 U.S.C. § 3101 (1978).

44. SENATE COMM. ON BANKING, HOUSING AND URBAN AFFAIRS, S. REP. No. 1073, 95th Cong., 2d Sess. 1429 (1978).

45. TREASURY REPORT TO CONGRESS, note 8 *supra.*

46. International Banking Act of 1978, 12 U.S.C. § 3101 (1978).

that "the Department of Treasury, in collaboration with other U.S. Government agencies . . . should continue the implementation of . . . remedial efforts"[47] to press for adherence to the principle of national treatment. Consequently, the new banking regime in Canada will undoubtedly command the continued attention of interested Washington agencies as well as the international banking community. Under the newly established regime, the potential for major growth of U.S. banks in Canada is severely limited. Unfortunately, prospects for significant liberalization of major constraints are dismal given the political realities in Canada and the current surge of Canadian nationalism.

47. TREASURY REPORT TO CONGRESS, note 8 *supra*.