THE POLITICS OF FINANCIAL SECTOR REFORM

by

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B.A., McGill University, 1987

A THESIS SUBMITTED IN PARTIAL FULFILMENT OF THE REQUIREMENTS FOR THE DEGREE OF MASTER OF SCIENCE

in

THE FACULTY OF GRADUATE STUDIES
Faculty of Commerce and Business Administration

We accept this thesis as conforming
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THE UNIVERSITY OF BRITISH COLUMBIA

AUGUST 1993

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Date October 14, 1993

DE-6 (2/88)

ABSTRACT

This thesis presents a detailed case analysis of the evolution of regulatory policy in the financial sector in Canada between 1981 and 1991. The thesis adopts both normative and positive analyses of the issue to determine whether economic or political factors were more important in shaping policy outcomes in the sector. While both played a role, the author concludes the political dynamics of the policy-making process were far more influential than the application of objective economic norms. Yet, a positive analysis alone is insufficient in explaining policy outcomes in the financial sector. Exogenous events, the length time involved in formulating and implementing policy changes and the impact of overlapping federal-provincial jurisdiction in the sector further frustrated attempts to engineer policy changes.

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CHAPTER 1

INTRODUCTION

On the morning of October 29, 1992 -- a mere three days after the country's decades-old constitutional crisis was prolonged indefinitely by Canadians' rejection of the Charlottetown accord -- the latest salvos were launched in another interminable, mind-numbing national obsession: financial sector reform. At a press conference in Ottawa, Marie-Josee Drouin, the co-chair of the blue ribbon task force commissioned by the Mulroney government to draft a strategy for the country's international competitiveness, presided over the release of the group's $20 million report. Among the 54 policy changes the committee advocated were far-reaching reforms to liberalize and harmonize regulations governing financial institutions. Four hundred kilometres away in Toronto, Ontario Financial Institutions Minister Brian Charlton announced a review by his ministry of all regulations affecting trust companies, insurers and securities dealers operating in the province. The purpose of the ambitious initiative, Charlton continued, was to "address issues fundamental to the efficiency, growth and stability of the financial services sector."

Neither of the foregoing events generated much enthusiasm among anyone not directly involved in organizing them. Onlookers commented wistfully on the superfluity of it all. The Canadian Labor Congress' Nancy Riche likened the Drouin group's report to "giving Better Homes and Gardens to the homeless." The Toronto Star, in an editorial, added the document might more appropriately be titled "Cliches for the '90s."[1]

Such cynicism is understandable. French political philosopher Jean-Jacques Rousseau aptly remarked almost 250 years ago that "the fruits of deliberation are often lost through constantly deliberating."[2] And in the decade since the Trudeau government first promised to revamp the regulatory apparatus for banks, trust companies and insurers, deliberation there has been. Reports, position papers, policy proposals and counter-proposals have, in great profusion, dissected ad nauseaum the issue of regulatory reform in the financial sector, a crusade the Mulroney adopted as its own when it came to power in 1984. Thus, no matter how credible, estimable and warranted, the latest proposals might in themselves be, they are of little relevance to a public policy debate that long ago surpassed the boundaries of meaningful discussion.

That is unfortunate for the future of Canada's financial system -- and by extension, for an economy whose performance is so inextricably dependent on the dynamism and efficiency of that system. The financial sector is the axis on which every other sector of the economy, from manufacturing to mining, revolves. Banks and trust companies are called "financial intermediaries" precisely because they "mediate" between savers (depositors) and investors (borrowers). A car or home loan made today is recycled several times over, generating economic activity each step of the way and months into the future. If governments have a role to play in the intermediation process, included in it is fostering the public's confidence in the soundness of system, in order to ensure a steady and stable supply of deposits, and promoting the efficiency of the system by removing roadblocks to competition and minimizing disruptions caused by bank and trust company failures.[3] Governments often face the difficult task of balancing these often conflicting objectives. Thus, that Canada, in the 1980s, witnessed abundant public discourse about how the government should best fulfill this role is not surprising. But the dynamics of the public policy-making process -- in which opposition from different vested interests derailed the government's proposals at almost every turn -- generated a policy issue so complex as to be quite intractable. It is indeed ironic that for an industry that epitomizes the dictum "time is money," this process proved languorous, lagging years behind the domestic and global economic forces that made regulatory reform so necessary. Determining why this was so is a principal aim of this thesis.

The late American literary journalist Ambrose Bierce described politics as "the pursuit of public interest for private advantage." Decades later, Bierce's dictum was formalized in George Stigler's economic theory of regulation (ET).[4] Drawing on Peltzman,[5] the characteristic features of the ET are: i) that political actors are presumed to be self-interested maximizers, whose primary objective is securing and maintaining political power; ii) that politicians prefer decisions that directly elicit favourable votes, or the monetary (or other) resources needed to wage successful campaigns; iii) and that producer interests will normally win out over consumer interests in public policy decisions because of the different organizational costs (inverse to their size) the two types of groups face.

Without doubt, the politics of financial sector reform in the 1980s exemplified many of the theory's features. Bankers and trust company executives alternately claimed to be speaking out in the public interest in clamouring for changes to the regulations that govern their institutions' activities. Fresh from its historic election win in September, 1984, the Mulroney government eagerly heeded this mostly self-serving advice from industry representatives by drafting a veritable rainbow of discussion papers, only to gut and revise them when disgruntled industry executives fired off yet another round of position papers and counter-proposals criticizing Ottawa's ideas. The cycle continued until Ottawa finally passed its financial reform package in December, 1991 -- a mere seven years after former Progressive Conservative Finance Minister Michael Wilson vowed to at once modernize and harmonize legislation regulating banks, trusts, insurers and brokerages. By then, the industry and the issues confronting it had changed so fundamentally that the reforms seemed dated and largely inconsequential. In attempting to please everyone, the government pleased no one. As one of Bay St.'s most respected bank analysts confided: "They bent over backwards to accommodate virtually every lobby that pushed hard. But nobody in the industry is happy with the legislation; everybody wanted something they didn't get."[6]

To be fair, the reforms do encompass much needed modifications to what were archaic and rigid restrictions on the scope of institutions' activities. By embracing the concept of universal banking -- by allowing banks to own insurers and sell trust services, on the one hand, and permitting trusts and insurance companies to do more bank-like commercial lending -- the efficiency of the system stands to be enhanced as institutions will have more flexibility to adapt financial products and services to their customers' specific needs. But in reality, such innovation has by necessity been common in financial services for some time, as intense competition has forced a revolution in customer service. This innovation has led to the creation of a plethora of "hybrid" financial products that defy such restrictive monikers as "bank loan" or "insurance policy," engendering a de facto confluence in the business activities of different types of financial institutions. In this respect, Ottawa's reforms are only the legislative acknowledgement of a well-established trend.

That the reforms, which came into force July 1, 1992, fall short can hardly be surprising to anyone who followed the industry in-fighting that characterized the financial sector in the decade leading up to the changes. While the debate lacked nothing in length, it did lack breadth. Almost from the outset, a single issue monopolized the agenda -- an agenda that was set not so much by the executive as by the bureaucracy, interest groups and prominent individuals in the industry. As such, most of the discussion about financial sector reform focused not on the broad swath of changes envisioned by the government, but rather was mired in arguments about whether deposit-taking institutions should be widely-held (with no single shareholder large enough to control it), or whether majority-ownership might not serve the public interest just as well.[7]

All other issues, it seemed, took a back seat to this one. The banks remained unremitting in their calls for the extension to the trust sector of bank-like ownership rules, which prohibit any one shareholder from owning more than 10 per cent of an institution. Bankers held up the spectre of the dozen or so small trusts that had failed in the early 1980s, in large part due to owners who funnelled customers' deposits into their own business ventures, to illustrate the deleterious consequences of allowing institutions to be closely-held. The banks and their allies also raised warnings that trusts with corporate parents outside the financial sector might deny credit to their parents' competitors, creating a "credit crunch" of sorts for borrowers without alternate sources of capital. That most of the country's large trusts had by the mid-1980s come to be owned by such industrial behemoths as Brascan Ltd., Power Corp. and Imasco Ltd., only served to give a prophetic ring to the bankers' admonition. In the end, however, trust executives and owners were triumphant. They convinced the government to reject the bankers' pleas, arguing that majority-ownership fostered healthy competition and greater management accountability, neither of which, they argued, were abundant in the cartelistic banking sector.

While a case may be made for both arguments, it was disingenuous on the part of most bankers and trust executives to claim to have the public interest at heart in raising them. It was clear to any objective observer that the banks would have benefited from stiffer ownership rules on trust companies -- which in the early and mid-80s had been siphoning market share from the banks -- since they would put up a de facto iron curtain around the financial sector blocking the entry of any new, large players into the banks' domain.[8] The 10-per-cent rule would also have forced several prominent trust owners -- the powerful Toronto Bronfmans, Montreal magnate Paul Desmarais, and Upper Canada Tory operative Hal Jackman among them -- to divest their holdings. As such, the latter group had an obvious self-interest in quashing any attempts by Ottawa to force them to give up control of what were then profitable concerns.

After seven years of task forces, parliamentary hearings and vitriolic public debate -- not counting earlier initiatives launched by the previous Liberal government -- what did the government decide exactly? That the status quo is best. Ignoring for the moment the arbitrary nature of such a policy -- given that different ownership rules apply to banks and trusts even though the business of the latter group has become largely indistinguishable from that of the former -- the focus on ownership rules left other pressing issues unaddressed.

The need to reassess disclosure rules -- which govern what deposit-taking institutions must tell depositors and shareholders about their affairs and when -- had become glaringly apparent with the 1980s failures. In those cases, regulators and managers withheld sensitive information about weak institutions fearing that any disclosure of the truth would surely seal a fledgling institution's fate by triggering a run on deposits. That principle, a hold over from the Depression but whose saliency had diminished with the advent of deposit insurance, was blatantly inconsistent with institutions' obligations as public companies to report the state of their affairs to shareholders.

The disclosure issue was to resurface repeatedly when the commercial real estate debacle of the early 1990s led to a new round of failures, starting with the collapse of Standard Trust Co. It came up again when the Reichmann family's Olympia & York Developments Ltd. imploded in early 1992. The large banks ignored for several months demands from shareholders, the media and analysts that they disclose how much they had lent to the fallen behemoth, instead seeking shelter under the veil of "client confidentiality." The episode raised questions about the extent to which a client's right to privacy should prevail in an instance where there appeared to be a greater public interest in discerning the toll the collapse of the world's biggest property developer would have on the country's financial system.

Another important area left untouched by the reforms was the country's deposit insurance system, despite the widely-held view among experts that the current system gives lenders a "perverse" incentive to take excessive risks with depositors' money. The Mulroney government paid lip-service to this concern, commissioning a study on the subject in 1985. It ignored, however, recommendations that the system, which had left the Canada Deposit Insurance Corp. with a chronic deficit, be overhauled either by putting more of an onus on depositors to steer clear risky institutions or forcing the latter to pay higher premiums based on the riskiness of their loan portfolios. The United States recently broke new ground by adopting the latter approach. Lacking the resolve to undertake such a politically unpalatable initiative or offend its allies in the trust industry the Mulroney government opted to do nothing for six years. With the CDIC's financial viability threatened by recent failures and record-sized bailouts, however, the government has been forced to respond. It has commissioned once again a task force to suggest ways to improve the deposit insurance system.

Unfortunately, it seems to take a catharsis like the de facto bankruptcy of the deposit insurance fund to precipitate meaningful changes to financial services legislation. In two other instances during the long and winding debate over financial sector reform Ottawa's hand was similarly forced by events beyond its control. One such instance came with the Ontario government's watershed move in late 1986 to open up the province's securities industry to all domestic and foreign financial institutions. The announcement impelled Ottawa to amend the *Bank Act* to allow banks, over which it had exclusive jurisdiction, to own investment dealers, which had traditionally operated under provincial rules.[9] Quick action was needed to give domestic institutions a head-start over the feared incursion of U.S. and Japanese rivals, and by March, 1987 Ottawa had the enabling legislation in place.

Similarly, the Labour Day 1985 failures of the Canadian Commercial and Northland banks shook the government in its tracks. The debacle, which constituted Canada's first bank failures in more than 60 years, spawned criticisms that regulators charged with policing the industry lacked both the weapons and the will to carry out their mandate. After a hastily commissioned public inquiry and a spate of parliamentary investigations had run their course, the government was ready with new legislation promising a top-to-bottom overhaul of the agency that polices the industry.

But while legislation hobbled together to address a crisis may help the government achieve its primary short-term objective -- in this case, restoring calm to the system -- it may not address the roots of crisis. The powers Parliament bestowed upon the newly-created Office of the Superintendent of Financial Institutions in early 1987 were indeed substantive. Unfortunately, however, Ottawa ignored criticisms about the manner in which regulators discharged their responsibilities -- tolerating the dubious business and accounting practices of the Alberta banks' managers for at least two years before they failed. Except for appointing a new superintendent, the agency's existing hierarchy, staff and examination procedures remained largely in place.[10] Is it any surprise, then, that many of the same regulatory lapses that were so glaring in the CCB-Northlands fiasco have also been cited in recent, post-reform failures?

In the past two years, Canada's financial system has incurred shocks never before experienced in its history with the failure, near-collapse or capital impairment of more than a dozen deposit-taking institutions. Many firms that were once considered solid, "blueblood" institutions, such as Royal Trustco Ltd., have reported massive losses, capital shortfalls and become speculative plays in the eyes of stock market investors.[11] Needless to say, public confidence in the system has been eroded. The failures of some and difficulties of others have impaired the efficiency of the system and exacerbated the current economic downturn.

Regulators attributed the collapse of Standard Trust Co. on April 18, 1991 to poor management and the then nascent real estate recession. Yet, the same regulators had first questioned the probity of management practices at least four years before Mackenzie's lieutenants shut down what was then the country's ninth-largest trust company. It had taken more than three years of unheeded warnings before OSFI ordered Standard to obey the rules -- and only then after a scathing report by Ontario trust regulators raised doubts about its loan portfolio and the Ontario Securities Commission itself threatened to intervene.

After Standard came the Bank of Credit and Commerce Canada, whose flagship Toronto branch was ironically located only a floor below Standard's head office. BCCC was seized by Superintendent Michael Mackenzie's office in July, 1991 as part of an unprecedented international crack down on the Abu Dhabian institution. Guardian Trust Co., meanwhile, was transferred after heavy losses to the Laurentian Bank. First City Trust Co., the foundation on which the Belzberg family built a financial empire with $6 billion in assets at its peak, was the next to fade from the Canadian corporate landscape. In breach of capital requirements and still bleeding losses, the country's fifth biggest trust company was sold to North American Life

Assurance Co. in January, 1992 in a deal backstopped by $475 million in cash and guarantees from the federal and Quebec deposit insurance agencies.

A little more than a month after the ink had dried on the First City deal, Quebec Inc. was called on to rescue one of its own. The major shareholders of General Trustco of Canada Inc. -- pillars of the Quebec economic establishment led by Industrial-Alliance Life Insurance Co., the Caisse de depot et placements, the Montreal transit workers pension fund and the National Bank -- provided a $70 million capital infusion. The managers of the country's sixth largest trust had a gargantuan work-out situation on their hands -- $350 million worth of sour commercial real estate loans. The capital infusion was insufficient to save General Trust, which was forced to sell its Ontario branches to the Laurentian Bank and it Quebec operations to the National Bank.

Those failures and bailouts paled in comparison to the record $3.6 billion rescue of Central Guaranty Trust Co. in October, 1992. Had Central failed, it would have been not only by far the biggest shock ever incurred by Canada's financial system, but would have ranked among the top ten *U.S.* bank collapses. But with about $12 billion in assets, Central was spared such a fate by the "too big to fail" doctrine espoused by regulators. According to that principle, the incalculable ripple effect and blow to public confidence that such a large failure would engender creates an imperative for regulators to avoid such an outcome at all costs. In Central's case, the CDIC put up $1.6 billion in guarantees to persuade the Toronto-Dominion Bank to take $9 billion worth of the trust company's loans off its hands. The agency also gave the bank a $2 billion debenture, bringing the total package of cash and guarantees to $3.6 billion, or roughly 15 times CDIC's annual premium income.[12]

The foregoing chaos, meanwhile, took place while the federal government was steering its long-awaited financial reform package through Parliament. It is indeed ironic, then, that the most ardent advocates of liberalized financial regulation, such as Central Guaranty and Royal Trustco, were fading into history just as the government was passing the legislation for which they had lobbied so hard and so long. The irony of the situation should not be lost on students of public policy. For it illustrates the extent to which fundamental concerns, such as the adequacy of prudential regulation, were overlooked as the ownership issue dominated the debate on financial reform.

Determining why this was so is the subject of this thesis. More specifically, this thesis will to dissect the policy process that led up to the introduction and subsequent passage of the Mulroney government's financial reform package to explain the outcome of that process. The goal is to leave the reader with a greater understanding of the way policy is made in one sector in which powerful economic interests vie for the ear of government. The methodology adopted is essentially that of a detailed chronology of the process, from the point at which financial reform made its way on to the federal government's agenda, to the passage a decade later of legislation to implement the reforms. A debate spanning this length of time allows for a broader exploration of the multitudinous factors which affect its outcome than a policy debate waged in a more circumscribed period. Not only do a greater number events, both indigenous and exogenous to the process itself, alter its outcome, but the individuals involved the process can change many times over during the debate, further changing the course of the process.

On undertaking this examination of the public policy-making process, we proceeded from essentially four assumptions, based on widely-used models of public policy analysis -- normative analysis and public choice theory/economic theory of regulation. The four assumptions yielded by these theories are: i) that the normative rationales for government intervention play a role in formulation of public policies; ii) that actors in the political process are self-interested maximizers; iii) that government is the only actor in the policy process with the legitimate power to coerce other actors and enforce outcomes on them in the name of the "public interest;" iv) that the influence of different economic interests is commensurate with the their wealth, degree of organization and stake in the policy at issue, but inverse to their size.

Normative theory, which regards market failure as the primary rationale for government regulation, provided much of the framework for policy documents, produced by governments and organized interests alike, for the public discussion of financial sector reform during the 1980s. It would, hence, seem reasonable to attribute considerable weight to normative theory in explaining the policy outcomes in this sector in that period. Chapter 2 is devoted to outlining the principal normative rationales that were raised during the debate for government intervention in the financial sector, and more specifically for the imposition of ownership restrictions on financial institutions. These rationales are generally considered to be objective norms policy-makers -- in this case, non-partisan bureaucrats -- should refer to in designing policies in this sector.

That being said, the very fact that conflict arises over the choice of policies indicates that there is more often than not no consensus among actors in the process as to what constitutes "the public interest." It is in recognition of this factor that positive analysis, based on public choice theory, enters into the equation. It would seem only natural that actors with ability to impose *their* view of the public interest on society must possess certain attributes that contribute to their success. In this light, public policy decisions must be seen as political, rather than technical, decisions. Following Stanbury, the various actors in the process behave in a rational, self-interested fashion, although their behaviour is constrained by other actors and the structure of the policy-making process. In sum:

> Behind the political calculus may well lie substantive problems attributable to various types of market failures...(but) participants in public policy making are interested in altering the distribution of income rather than improving the efficiency of resource allocation.[13]

Accounting for the influence of different organized interest groups on policy outcomes leads us the an examination of interest groups behaviour. Following Olson[14] and Stigler, a group's wealth, homogeneity, size and stake in the policy at issue are determinant factors in its ability to successfully influence policy outcomes. Producer groups are by definition more likely to have a greater direct stake in the decision to impose a new tax on or subsidize its products, for instance, than consumers, who inhabit diverse economic strata and who, individually, would bear only a minute portion of the cost of the new tax or the benefit from the new subsidy.

Finally, while government has the legitimate power to coerce interest groups in accepting policies, its ability to do so is based on the extent to which a consensus on the appropriate policy exists within the government itself. If there are opportunities for interest groups to exploit competing interests in the government, the latter's ability to effectively employ its coercive powers is compromised. Given that government is made up individuals from diverse backgrounds, and whose responsibilities, interests and powers are constantly changing, this is often the case.

Proceeding from the four assumptions discussed above, then, the thesis primarily draws on three sources to explain the outcome of the public policy debate in the financial sector in the 1980s. The first consists of primary sources, such as policy statements, discussion papers and position papers prepared by actors in the process. Secondly, we turn to media accounts of the policy debate, drawing almost exclusively on articles from the business press, practically the sole arm of the media to follow the debate. The third, and arguably most important, source for our research was a series of in-depth interviews conducted with more than 30 participants in the process: bureaucrats, interest group representative, lobbyists, financial institution executives, as well as one former cabinet minister. From this, the policy process is dissected through an in-depth chronology of the debate which seeks to illustrate how financial sector reform made its way onto the policy agenda, the sheer and fluidity of the process, the impact of exogenous events on the process and the effect of different individuals' participation at different conjunctures in the process.

The chronology complete, the thesis adopts an analytical framework common to the study of state-society relations to shed light on the outcome. The approach taken emphasizes the structure of governmental instances, on the one hand, and organized interests, on the other, to propose a typology of possible state-society relations in a given sector. We discuss how structural changes in government disrupted the previous clientelistic policy network in the financial sector and gave way to the emergence of pressure pluralism.

The application of this typology alone is insufficient, in itself, to fully explain the outcome of policy making process in the financial sector. Thus, other insights gleaned from our detailed chronology, are highlighted to demonstrate the sheer complexity of the policy-making process. First among these insights is the importance of exogenous events in altering policy outcomes. The failures of the CCB and Northland Bank, for instance, shifted the debate from *deregulation* to *re-regulation*, while the globalization of securities markets forced Ontario and the federal government to almost completely shift policy gears within a matter of months. Had such developments not occurred, financial sector reform would likely have followed a dramatically different course.

The second important insight focuses on the sheer length of the policy-making process, which i) allows a multitude of ever-changing actors to participate in the process at different points in time; ii) increases the probability exogenous events will occur to alter the course of the process; iii) and for the political or electoral cycle to interfere with the process. In the case of financial sector reform, one was not dealing with a policy issue that was important for the electorate, and thus a potential vote-getter. Rather, as the political cycle neared its en, the government's priorities shifted to issues that were considered more salient by the public, leaving financial sector reform in limbo.

A final insight derived from our analysis deals with the inherently conflictual and often competitive nature of federal-provincial government relations in Canada. In areas of shared jurisdiction, such as financial institutions regulation, the area for conflict is large and one province's opposition to Ottawa's policies can be effective tool for interest groups seeking to derail federal initiatives.

The thesis is divided into eight chapters, including this introduction. Chapter 2 sets out the most widely-accepted normative rationales employed by public policy analysts for the regulation of financial institutions. While the objective of regulation, according to these rationales, is primarily increased economic efficiency, concerns such as fairness and equity can carry equal weight in choosing the best option depending on policy-makers' goals. Thus, Chapter 2 outlines the regulations available to policy-makers to address specific problems in the financial sector, highlighting those that are most often employed by governments in Canada. Chapter 3 presents a short history of the Canadian financial sector in order to provide the context for the analysis that follows in subsequent chapters. The events discussed in this chapter will no doubt be well-known to many readers. Their presentation here is useful, nonetheless, since subsequent chapters proceed on the assumption that readers will be familiar enough with the incidents discussed in Chapter 3 that they need not be explained in such detail again.

Our analysis of the policy process begins in Chapter 4, when we discuss the factors that propelled financial sector reform on to the policy agenda. This chapter spans the period between the previous Liberal government's tabling of a "White Paper" on trust companies in 1982 to Conservative Minister of State for Finance Barbara McDougall's unveiling of a vastly different "Green Paper" in early 1985. We follow in Chapter 5 with a presentation of the factors that led to the Green Papers's ultimate rejection, while Chapter 6 discusses one such factor in greater detail: Ontario's move to unilaterally open its securities industry to outsiders. Chapter 7 builds on the previous two by outlining the other incidents that led to the replacement of the Green Paper by a "Blue Paper" in late 1986 and chronicles the failure of that proposal to see the light of day. It concludes with a discussion of the factors that allowed the government to proceed with a legislative package in September, 1990.

Finally, Chapter 8 adopts a model of state-society relations well-known to students of political science in order to offer some insight into the paralysis that characterized the policy process during the debate on financial reform. It focuses on the relative strength and influence of the economic interests involved in the debate, and the government's ability to counter and process the competing claims put on it. The thesis concludes with a short discussion of the implications of making policy in this manner.

NOTES

1. "Bankruptcy of ideas," *The Toronto Star*, November 1, 1992.

2. Jean-Jacques Rousseau, "On Social Contract or Principles of Political Right," in *Rousseau's Political Writings*, ed. Alan Ritter and Julia Conaway Bondanella (New York: W.W. Norton & Co. Inc, 1988), 124.

3. The appropriate goals of government regulation in the financial sector have themselves been the subject of some debate in recent years. Still, the twin objectives of soundness and efficiency remain the cornerstone of most theories advocating government intervention in the sector, a subject we examine in greater detail in Chapter 2. Were the government's sole objective the soundness of the system, it might simply mandate that financial intermediaries engage only in "narrow banking" (i.e. invest customer deposits in government treasury bills and bonds only). This, however, ignores the other prime objective of regulation -- economic efficiency.

4. George Stigler, "The Theory of Economic Regulation," *Bell Journal of Economics and Management Science*, 2 (Spring 1971): 3-21.

5. Sam Peltzman, "The Economic Theory of Regulation after a Decade of Deregulation," in *Brookings Papers on Economic Activity: Microeconomics*, eds. Martin Neil Baily and Clifford Winston (Washington, D.C.: The Brookings Institution, 1989), 1-59.

6. Confidential interview, October, 1992.

7. To be sure, we do not mean to suggest the ownership issue was the *only* issue to figure in the decade-long debate on financial reform. We acknowledge that the Estey Commission and Wyman report (discussed later), which addressed risk monitoring procedures, were produced during this period. However, both Estey and Wyman were responses to exogenous events (failures) and both were dealt with in fairly short order. The ownership issue, on the other hand, dominated the debate on financial sector reform from beginning to end and its resolution preoccupied policy-makers. There was thus little room for other issues on their agenda. It is for this reason we suggest other regulatory issues may not have been given adequate consideration. As evidence of this, one has only to point to the post-reform failures (discussed later in this chapter).

8. From the perspective of the 1990s, it is not clear that the trusts have benefited from liberal ownership rules. The latter, after all, have done nothing to prevent the steady decline of the trust sector over the past five years. But from the perspective of the early 1980s, it is easy to see why the banks believed they would have benefitted from the extension of ownership limits to the trust sector. At that time, trust companies were the fastest growing members of the financial sector, encroaching on the banks' domain. Their growth was underwritten by controlling shareholders, such as Brascan, Imasco, and Power Corp., with the ability to attract and inject the capital needed to fuel this growth. Trust companies argued that this dynamism would have been undermined by tight ownership rules. The banks would have welcomed such a development.

9. Of course, it was the Quebec government that set the deregulation process in motion in 1983 by lifting ownership limits on investment dealers in the province. But the move had little impact initially since the largest investment dealers preferred to remain headquartered in Toronto, which was the centre of all capital markets activity in Canada. The threatened exodus of firms to Quebec was only one of the factors that led the Ontario government, in late 1986, to act. And the federal government acted in response to the developments in Ontario, not Quebec.

10. This assertion is based on discussions with regulators and financial institution executives. While the Canada Deposit Insurance Corp. began work in the late 1980s on new regulatory guidelines for member institutions, these have only been formalized recently. Furthermore, the CDIC does not monitor institutions directly, but rather relies on examinations conducted by the Office of the Superintendent of Financial Institutions for indications of institution's financial health. Only when an institution's difficulties have become readily apparent -- and publicly disclosed -- has the CDIC sent in its own consultants to assess an institution's solvency. This was the procedure followed with Central Guaranty Trust.

11. At time of writing, Royal Trustco Ltd. was in the process of obtaining approvals to sell its operations to the Royal Bank. The transaction will leave Royal Trustco, now renamed Gentra Inc., with a portfolio of essentially non-performing loans, which it will liquidate over time.

12. Of course, the $3.6 billion cost cited is only a nominal figure. For instance, the true cost may be lower than $3.6 billion since all of the guarantees may not be drawn upon. On the other hand, the overall cost may be well in excess of $3.6 billion if one considers the externalities generated by this failure. Quantifying the true economic cost of Central's demise is, however, a complex task and beyond the scope of this thesis.

13. W.T. Stanbury, *Business-Government Relations in Canada* (Toronto: Methuen, 1986), 128.

14. Mancur Olson, *The Logic of Collective Action* (Cambridge: Harvard University Press, 1965).

CHAPTER 2

THE NORMATIVE BASIS OF FINANCIAL REGULATION

Regulation in the Canadian financial sector is pervasive. Yet, policy-makers have rarely, if ever, justified this extensive regulation in light of economic principles. An understanding of the political process alone is often more useful in appreciating the origins of regulations governing the sector. For example, as Antosz *et al* note,[1] "there is a great distrust of banks by Canadians, which alone may account for over-regulation. This widespread distrust is felt acutely by the politicians who create banking regulations, as shown during last year's House of Commons Finance Committee investigation of bank service charges." Similarly, the imposition of foreign ownership restrictions on Canadian banks in 1967 and investment dealers in Ontario in 1971 was likely influenced more by the spectre of "foreign domination", at a time when that was a particularly salient issue among Canadian economic nationalists.

Even politically-neutral policy-makers, however, have advocated extensive regulation of deposit-taking institutions. For example, an Economic Council of Canada study[2] asserts: "an adequate regulatory framework is needed because the financial system performs a key role in the economy." This idea that, because a stable financial system is critical to the efficient functioning of the real sector of the economy, it must be well-regulated, permeates the literature on financial regulation.

Brander[3] notes that, traditionally, this body of literature has offered four principal rationales for the regulation of deposit-taking institutions.

> (1) The liabilities of deposit-taking institutions are money, the quantity of which the central bank seeks to control in pursuing the goal of economic stabilization.

(2) Because DTI's channel capital (credit) to firms in the real sector of the economy, governments often seek to influence the direction of such lending as an instrument of industrial development policy.

(3) DTI's serve as repositories for the public's savings and hence must be subject to strict consumer protection legislation.

(4) "Prudential regulation" of DTI's is necessary because the collapse of any one institution can have serious consequences for the entire economy which extend far beyond those suffered by its own shareholders and depositors.

All four rationales have undeniably influenced the scope and structure of regulations facing deposit-taking institutions in Canada. The impact of the first rationale is evident in the Bank of Canada's setting of reserve requirements on the chartered banks' deposits, ostensibly to control the money supply and, hence, the cost and availability of credit. Governments in Canada have often attempted to influence the allocation of credit by exerting "moral suasion" on the chartered banks. For instance, Shearer *et al*[4] note that "during the 1950s and 1960s the government made requests to the banks to favour certain sectors such as small business and firms in depressed regions during tight monetary policy." In addition, many of the portfolio regulations facing banks and trust companies have the de facto effect of channelling credit to certain sectors of the economy.

The goal of consumer protection has been, to give only one example, met by mandatory state-backed deposit insurance. Interestingly enough, the threat of government intervention is often all that is required for legislators to achieve the desired effect of altering financial institutions' behaviour, as witnessed by "proposed" legislation governing service charges and credit card interest rates.

Finally, "prudential regulation" to ensure the solvency of financial institutions is evidenced in the myriad of portfolio and structural regulations imposed on DTI's. Ownership regulations, which fall under the category of "prudential regulation" and which are the primary focus of this study, are often justified on the grounds that they ensure solvency by minimizing the potential for conflicts of interest and self-dealing. We will examine this justification in more detail below.

Some economists[5] assert that of the four rationales for regulation of DTI's traditionally offered by policy-makers, only the first has any grounding in basic economic or normative principles. Control of the money supply, through the imposition of reserve requirements, is generally seen as a legitimate activity of governments given their role in promoting economic stabilization. Yet the usefulness of reserve requirements, which apply only to the chartered banks, as a tool to control the money supply must be seriously questioned since *all* DTI's (not just banks) transform assets and create liquidity or "money".

Economists of this school argue the first rationale appears even more specious when one considers that the imposition of secondary reserve requirements, held in interest bearing securities, appears to have had as its goal the creation of a captive market for Government of Canada Treasury Bills and, thus, an indigenous money market.[6] Hence, the government has been able to borrow at lower rates than through the New York market by forcing domestic banks to hold its securities.

Such an assertion can easily be countered, however, if one considers that government intervention in this case allowed for the creation of the critical mass necessary to sustain a domestic money market. The latter is a laudable goal of public-policy in that it enhances the country's economic well-being and efficiency.

Critics attack the second rationale for regulation (ie. directing the allocation of credit) on the grounds that it runs counter to the professed commitment of Canadian governments to free markets. More to the point, however, such intervention more often than not imposes efficiency losses on society that far exceed the gains enjoyed by the beneficiaries of such policies. Brander[7] offers one example:

> In many countries (including Canada) banks are required to fund government housing projects. The problem is that the funds devoted to government projects are withdrawn from higher value projects. It sounds great for governments to force banks to finance low-income housing. Unfortunately, such projects take funds away from business investments that would generate higher real incomes, and undermine the private housing market as well. In short, such regulations have a very high opportunity cost.

Hence, from a normative point of view, this type of regulation appears sub-optimal, and likely inferior to redistributive policies implemented through the tax system. Again, however, one must recognize that government policy goals are not always consistent with economic efficiency. Fairness and equity are primary concerns of all policy-makers. By targeting credit to the low-income housing sector, the government's ultimate goal might be achieved more directly than through broad redistributive measures.

The third and fourth reasons traditionally offered for government intervention, contrarian economists assert, are on equally shaky ground when evaluated on the basis of strictly normative theory:

> Reason three (consumer protection) is just a version of the idea that economic services that are important should be regulated by government. This only makes sense if there is some reason to expect government regulation to perform better than private markets. A similar comment is true of (the fourth) reason (prudential regulation): the mere presence of risk does not in itself justify government intervention. Risk is part of normal business activity, and markets have natural ways of responding to risk, notably insurance and diversification. Only if the government can improve upon the performance of such markets (ie. only if there is market failure) is intervention warranted on these grounds.[8]

The contention that government intervention to regulate the risk-taking activities of DTI's is justified only if there is a market failure is central to our analysis of the ownership issue.

Market failure occurs where private markets fail to allocate resources efficiently due to the existence of public goods, externalities, information asymmetries or increasing returns to scale and government intervention is required promote a more efficient outcome. With respect to "prudential regulation" governing DTI's in Canada, the implied market failure has been one of asymmetrical information between depositors and shareholders on the one hand, and between minority and controlling shareholders on the other. Where information asymmetries exist, less-informed parties (in this case, depositors or minority shareholders) will be unaware of their true marginal benefit from a transaction and can be exploited (by DTI's in the case of depositors or controlling shareholders in the case of minority shareholders). In the absence of government intervention, it is suggested, DTI's would engage in excessive risk-taking and self-dealing activities.

The very nature of financial intermediation implies that deposit-taking institutions are highly-leveraged, with debt to equity ratios that, on average, exceed by more than a factor of ten those of firms in the real sector of the economy. Hence, shareholders of DTI's have a small amount invested relative to creditors (depositors). DTI's, therefore, face incentives to take excessive risks, since the gains from any risk-taking activity are enjoyed only by the shareholders, while losses (in excess of the firm's capital base) are borne fully by creditors.

Another example of market failure often cited to warrant government regulation is self-dealing. The Economic Council of Canada[9] defines this phenomenon as follows:

> Self-dealing occurs when a conflict of interest results in a non-arm's length transaction for the sole advantage of the person or institution making the decision. For example, self-dealing occurs when the owner or manager of a financial institution approves a loan to himself or herself, a relative or an associate, at a favourable rate of interest or with little or no collateral... Self-dealing also occurs when a subsidiary finances its parent company at favourable conditions.

Brander[10] outlines the consequences of the latter type of self-dealing, using the example of two financial institutions, one wholly-owned by a holding company, and the other 51% owned by the holding company.

> The holding company has an incentive to have the partially owned firm loan money at below market rates to the wholly-owned company. The partially owned firm will lose money, and the value of its stock will fall, but the wholly-owned company will appreciate in value by a corresponding amount. The loss to the partially-owned firm is shared by the holding company and by minority shareholders, but the gain to the other firm is fully captured by the holding company. In effect the holding company is able to expropriate wealth from the minority shareholders of the partially owned firm.

The implied market failure which leads to excessive risk-taking and self-dealing, of course, imposes consequences which extend far beyond those borne by depositors or minority shareholders. To the extent that either of these activities leads to the failure of a financial institution, the repercussions for the real sector of the economy can be serious indeed. Such externalities clearly constitute a third area of market failure, since the broad economic and social costs are not borne by the insolvent financial institution but rather by the users of credit who may be forced, for instance, to pay higher interest rates until the system absorbs the shock of the institution's collapse. Hence, the primary objective of regulations to limit excessive risk-taking and self-dealing has been to ensure the stability of the domestic financial system. We now turn to an examination of these regulations.

Traditionally, policy-makers in Canada have employed *portfolio* regulations and capital adequacy requirements to constrain the risk-taking activities of deposit-taking institutions, while a plethora of *structural* regulations, such as limits on non-arm's length transactions and ownership restrictions have sought to eliminate the potential for self-dealing.

In the past, capital adequacy requirements in Canada were never formalized, the *Bank Act* stipulating simply that every bank must "maintain adequate capital in relation to its operations."[11] The Office of the Inspector General of Banks (OIGB), (now the Office of the Superintendent of Financial Institutions), issued guidelines requiring Schedule I banks to maintain a ratio of gross assets to primary and secondary capital of not more than 30 to 1. For federally-regulated trust companies, the ratio is 20 to 1. Formal requirements were instituted recently, however, as Canada (as well as most other developed countries) agreed to adopt capital adequacy rules outlined by the Bank for International Settlements in 1988. The standardized requirement that banks hold capital equal to 8 percent of their assets, on a risk-weighted basis, took effect at the end of 1992. The primary rationale for setting a maximum ratio of assets to shareholders' equity is to provide a "cushion" for depositors by establishing "the amount of losses which can be sustained before the value of assets falls below the value of outstanding liabilities" (deposits).[12]

Portfolio regulations have also been an important tool for policy-makers in Canada. For instance, until 1967, the chartered banks were prohibited from engaging in mortgage lending because the accumulation of such illiquid long-term assets (almost all mortgages were for 25 year terms) was considered inappropriate for institutions whose liabilities (deposits) were withdrawable on demand. The events leading up to the empowerment of banks to make mortgage loans, which are discussed in a later chapter, led eventually to the introduction of five-year mortgages in 1969 and to the advent of mortgages of one year or even less by the mid-1980s. As a result, banks face strict liquidity requirements to ensure that they have sufficient current assets on hand to meet liabilities on demand.

Portfolio regulations facing federally-regulated trust companies have been even more restrictive, forcing such institutions to hold the bulk of their portfolios in relatively low risk assets. For instance, until recently, trust companies could:

* purchase or invest in mortgages but only invest or lend up to 75 percent of the value of any one parcel of real estate;

* purchase or invest in government bonds;

* purchase or invest in company bonds, debentures, preferred shares, or common shares *only* if the company meets certain quality tests;

* engage in commercial lending, but the total of all commercial lending not to exceed 7 percent of total assets.[13]

But while such restrictions appear onerous, regulators' traditionally lacked formal powers to enforce them. Unlike most of the portfolio restrictions facing banks, most regulations governing lending practices of trust companies, both federal and provincial, are not contained in legislation. In examining institutions' portfolios, regulators in the federal Department of Insurance and its successor OSFI, referred to lending guidelines issued in the mid-1970s by the Canada Deposit Insurance Corp. The guidelines were only that: they were not enforceable by law. This issue is further discussed later when we examine the factors leading to the proliferation of trust company failures in the 1980s.

By far the most important means by which Canadian banking authorities have sought to eliminate self-dealing, as well as to ensure the overall stability of the financial system, has been through the use of structural regulations. The most obvious of these was the division of the financial sector into four "pillars" (banks, trust companies, insurance companies and investment dealers), with institutions in each pillar exercising a core function which all others were prohibited from entering. Cross-ownership among the pillars was strictly prohibited, as well.

The *Bank Act* contains a number of measures regulating non-arm's length transactions in order to prevent self-dealing abuses. For instance, while loans to corporations in which a principal, director or officer of a bank has a 10 percent ownership are permitted, as long as there are no special terms, any such loan which exceeds two percent of the capital and contributed surplus of the bank must be approved by two-thirds of the board of directors.

The most contentious (for the purposes of our analysis) regulation used to prevent self-dealing consists of ownership restrictions on banks, as well as regulations prohibiting them from owning, or being owned by, commercial enterprises. No individual shareholder may own more than 10 percent of the outstanding shares of a Schedule A chartered bank, while a 25 percent ceiling is placed on total foreign ownership of any class of shares of a domestic chartered bank. The *Bank Act* stipulates that banks may not "deal in goods, wares, or merchandise," which in effect prevents banks from engaging in commercial activities. Furthermore, a chartered bank may not own more than 10 percent of the voting stock of a non-banking firm unless the firm's main business is banking support services.

In sharp contrast to the regulations facing the chartered banks, federally-regulated trust companies are not subject to any domestic ownership restrictions (ie. they may be closely-held), although the ceiling on foreign ownership applies. The absence of domestic ownership restrictions has resulted in a situation in which the largest trust companies are controlled by conglomerates with substantial non-financial holdings.

This inconsistency in the ownership regulations facing deposit-taking institutions constitutes the largest obstacle federal policy-makers have faced in their attempt to reform the sector. On the one hand, the aim of deregulation of the financial sector is to stimulate competition by eliminating barriers between the pillars and liberalizing and harmonizing the portfolio regulations which apply to banks and trust companies. In effect, the two types of institutions will be (and already are) engaging in the same types of business activities. On the other hand, however, by maintaining different ownership restrictions the government may be putting one type of deposit-taking institution at a competitive disadvantage to the other. At the very least, the normative justification of ownership restrictions as a means to prevent self-dealing rings hollow when such restrictions are applied selectively.

The literature on financial regulation proposes at least five different policy responses to eliminate the risk of self-dealing. They are, in no particular order, i) prohibition of all non-arm's length transactions, ii) internal corporate governance, iii) Chinese walls, iv) disclosure of information and v) ownership restrictions.

The first option, an outright *ban on all non-arm's length transactions*, is perhaps the most draconian of them all. There is little doubt that this method would be effective in eliminating the potential for self-dealing, as long as institutions' activities could be adequately monitored. However, it neglects the fact that not all non-arm's length transactions are harmful to minority shareholders or impose undue risk for depositors' savings. Hence opting for this policy would carry efficiency losses for the economy. As the Economic Council of Canada notes:[14] "The prohibition of all non-arm's length transactions, as recommended in the Green Paper, might enhance confidence in the system, but at a cost in terms of efficiency."

Internal corporate governance relies on minimal regulations, dictating only the structure and composition of the boards of directors of financial institutions. For instance, regulations often require that a majority of the board members be outsiders to the financial institution, as well as to any affiliated non-financial company. The *Bank Act* sets out the rules for the approval of non-arm's length transactions (i.e. two-thirds board approval is required for a loan in excess of two percent of the bank's capital base), but beyond that, banks are left to their own devices to decide on the merits of such transactions. The proponents of this approach to minimising self-dealing problems argue that it is

> an effective deterrent against the abuse of conflicts of interest, particularly when such abuse would result in loss of public confidence in the industry itself. Members of the industry are often in the best position to recognize and deal with abuses as they occur... Financial institutions themselves usually find it in their own interest to eliminate such abuses, since the potential gains from them are, in most cases, far outweighed by the damage to the institutions' reputations that public knowledge would bring.[15]

The third policy response offered is the erection of *Chinese Walls* to prevent information from flowing between different departments or companies under the same corporate umbrella. For instance, since trust companies are involved in both commercial lending and trustee activities, Chinese Walls would prohibit the exchange of information between those departments of the same financial institution. Hence, a conflict of interest, where, for example, the commercial lending department might advise the trust department to invest in one of its clients, would be avoided. However, as an Economic Council of Canada study notes:[16] "Chinese Walls are a double-edged sword... While they prevent harmful information from getting through, they also prevent the exchange of useful information. (They) are also of little use to preclude the flow of information at the executive level."

The proponents of *information disclosure* as a solution to the self-dealing problem argue that the market failure (as discussed above) created by non-arm's length transactions is one of asymmetric information between the parties to the transaction.

> Self-dealing is only a problem if there are relatively uninformed parties to be exploited by such transactions... If minority shareholders could insist that majority shareholders not undertake actions to expropriate their wealth before getting involved, the problem would disappear. Such agreements could be written into the company charter and enforced by the legal system, if everyone had

> sufficient information. The problem is that minority shareholders do not have enough information to anticipate particular actions that majority shareholders might undertake to formulate explicit contractual conditions. Furthermore, they may not have enough information to know when they are being exploited anyway.[17]

Hence, given that the source of the market failure is asymmetric information, advocates of this approach, suggest that the appropriate solution is full disclosure of information. As Antosz *et al* note,[18] "(d)isclosure will allow the stock price of all non-arm's length transactions to be incorporated into stock prices and interest rates. Depositors would then transact their dealings in an environment identical to that of a capital market. By allowing investors and depositors to decide what is in their own interests, no beneficial transaction will be prevented."

The implementation of this option would, of course, prove problematic, given governments' traditional desire to ensure that deposit-taking institutions remain essentially riskless repositories for the public's savings. Brander[19] notes, however that information has the properties of a public good, and hence there is a strong case for government provision of such information. With government collection and dissemination of information regarding the activities of financial institutions, and a deposit insurance system which prices insurance according to the risk revealed by this information, the goal of sheltering the public from putting its savings at risk could be achieved.

The final, (and central to this paper), policy option to minimize self-dealing is that of *ownership restrictions* on deposit-taking institutions. These include stipulations requiring DTI's to be widely-held, as well as the prohibition of financial and commercial links. The rationale for imposing such restrictions stems from the suggestion that "the incentive to self-deal depends on the ownership structure of the firm or the holding group. It has often been suggested that widespread ownership reduces such incentives."[20] Thus, where widespread ownership exists, no shareholder will be in a position of sufficient control to initiate transactions from which only he/she will benefit. On the other hand, "one hundred percent ownership... is a very strong incentive to self-deal, because the owners have the opportunity to enter into risky ventures financed by the institution for their own personal benefit."

The problem of ownership linkages between financial and commercial companies is of a similar nature. A non-financial holding company, which controls a deposit-taking institution, could use the DTI to finance its operations at favourable conditions. In addition to the allocative inefficiency that results, the public bears the burden (where a government-sponsored system of deposit insurance is in place), if the financial institution becomes insolvent.

While ownership restrictions may be an effective way of preventing self-dealing, there are efficiency losses which result from implementing this policy, since the potential for beneficial non-arm's length transactions is eliminated. Ownership restrictions impose a number of other costs, according to detractors of this policy option, such as reduced management accountability to shareholders, and the loss of entrepreneurship and leadership that a majority shareholder could bring to a DTI. Another important cost is that ownership restrictions can impose an artificial barrier to entry to the financial sector, given the capital base required to establish a new financial institution.

In sum, Canadian regulators have traditionally relied on several methods to control self-dealing, including the imposition of ownership restrictions, overseeing the composition of banks' boards of directors and strict regulation of non-arm's length transactions. Recent federal government proposals for reform have shown no consistency in their approach to responding to the self-dealing issue. The Green Paper, released in early 1985, opted for a ban on non-arm's length transactions, with no ownership restrictions on federally-regulated trust companies. The

1986 Blue Paper, on the other hand, proposed strict ownership controls on trust companies, while allowing for several types of non-arm's length transactions. The variables which explain the transition in the government's mindset from the Green Paper to the Blue Paper (and beyond) are part of the politics of financial sector reform, a subject examined in great detail in later chapters.

NOTES

1. G. Antosz, L. Laundy and I. Young, "Regulating the Canadian Banking Sector: Issues Arising from the American Express Company Application for a Banking Licence," Unpublished paper presented at the University of British Columbia, 1989.

2. Economic Council of Canada, *A Framework for Financial Regulation*, (Ottawa: Ministry of Supply and Services, 1987).

3. James Brander, *Government Policy Toward Business* (Toronto: Butterworths Canada Ltd., 1988), 229.

4. R. Shearer, J. Chant, and D. Bond, *The Economics of the Canadian Financial System* (Scarborough, ON: Prentice-Hall Canada, 1984), 286.

5. Brander, 229-230.

6. See Shearer et al, 286.

7. Brander, 230.

8. James Brander, "Economic Foundation of Financial Regulation," Unpublished paper, University of British Columbia, Faculty of Commerce and Business Administration, 1987.

9. Economic Council of Canada, 59.

10. Brander, *Economic Foundation*, 29.

11. Ibid. 24.

12. Shearer et al, 282.

13. Economic Council of Canada, 16.

14. Ibid., 61.

15. Ibid., 61.

16. Ibid.

17. Brander, *Economic Foundation*, 30.

18. See Antosz et al.

19. Brander, *Economic Foundation*, 32.

20. See Economic Council of Canada, 59.

CHAPTER 3

A BRIEF HISTORY OF THE CANADIAN FINANCIAL SECTOR

Bank-bashing remains one of the most enduring, if not exactly endearing, of Canadian traditions. Like the World Series, it serves to unite Canadians in all corners of the country and across the political spectrum against a common antagonist -- cartelistic and monolithic banks that pay us too little on our deposits, skim off criminal amounts in "service charges" and slap usurious interest rates on our loans, if, that is, they deign to lend us anything at all. Even a one-time bank employee like humorist Stephen Leacock could not resist the occasional dig against "The Banks," as Canadians disparagingly refer to the big six institutions that dominate the country's financial sector. It's been almost nine decades since Leacock, a university economics professor no less, penned what remains a seminal study of the bank-averse Canadian psyche. "When I go into a bank I get rattled," confesses the narrator of Leacock's "My Financial Career." "The clerks rattle me, the wickets rattle me, the sight of money rattles me, everything rattles me."

If Leacock's satirical prose represented a light-hearted look at Canadians' antipathy towards the banks, the country's legislators have usually been more vitriolic. Bank profits, service charges and credit card interest rates are sure bets for MPs in search of a crusade that will score them points with voters. The credit card "cause" was, for instance, most recently taken up by Liberal MP Ron MacDonald and New Democrat Phil Edmonston. The latter in 1991 uttered what must be one the most oft-used aphorisms in Ottawa: "The banks are reaping exorbitant profits on credit cards."[1] The truth of the matter is that only the banks themselves know for sure since they refuse to desegregate, for shareholders or the general public, their profit figures on individual product lines.

Whether or not the banks deserve the treatment they get, the fact remains that they are attractive targets, in part at least, because politicians believe they are fundamentally sound and can take such jabs without impairment to their financial stability or public confidence. Politicians know the same, often gratuitous, attacks would be much more damaging if directed at other business sectors or companies.

The banks also earn the public's enmity by slapping an ever growing plethora of service charges on their customers, who consider such "nickel-and-diming" tactics objectionable and unfair. Between 1980 and 1991, for instance, the banks' revenues from service charges and fees tripled, while net interest revenue on loans grew by only 50 percent.[2] Such revelations only serve to fuel public suspicions that the Big Six rely on milch-cow returns on Visa and MasterCard and hefty levies on deposit and small business accounts to offset loan losses and buttress paper-thin margins on the commercial lending side. Unlike with local telephone service, where long-distance revenue subsidizes local telephone service, this is a case of cross-subsidization at the expense of the average consumer.

Along with their penchant for secrecy, the banks sheer omnipresence and dominance of the financial sector render them prime objects of collective contempt and distrust. The main street of almost every Canadian community is invariably anchored by two pillared (and pilloried) institutions: a bank and a post office. The skyline of almost every large Canadian city is shaped by the gold, granite and steel bank towers that hover over the downtown core and the branches below, planted ubiquitously at every intersection. In all, there are about 7,600 bank branches across the country -- one for every 3600 Canadians, the highest such ratio in the industrialized world.[3] By contrast, the U.S. ratio is almost 13,000 to 1. In addition, with almost 12,000 automated banking machines, or one for every 2,300 Canadians, only the Japanese have access to more ABMs on a per capita basis. The Big Six chartered banks also have about three-quarters of the domestic deposit market, held in some 41 million accounts and half of all of the assets in the financial sector.

Even more disturbing to most Canadians is the fact that the four largest banks control almost two thirds of the domestic market for personal and commercial loans.[4] With this degree of concentration, the banking sector meets the official test of an "oligopolistic" industry. Such "market power" and it offends Canadians' sensibility for fair play. The loudest complaints usually come from small business owners, who insist that they are the first to bear the brunt of the cartelistic banks' behaviour. "They cut back on our guys mostly because they can," Catherine Swift, chief economist at the Canadian Federation of Independent Business, told The Toronto Star in early 1992.[5] "Big companies can threaten to go elsewhere for credit, but the little guys don't have the options."

Given such concentration, the question that appears most germane to this study of financial sector reform is whether the banks' influence in the economic sphere translates into a commensurate level of influence in the political domain. Contrary to popular opinion, the answer cannot be gleaned from a cursory review of anecdotal evidence. On the one hand, it is true, as Peter Newman aptly noted, that "the bank boards distil business power. Among them, the three hundred directors hold more than three thousand directorships of corporations with assets totalling $700 billion."[6] Without doubt, those who sit on the boards of the big banks are among the most politically-connected in the country.

On the other hand, however, we noted above the low esteem (at least in public) in which legislators hold the country's banks. And it would be a leap to say the banks have to themselves the ear of bureaucrats and policy advisors, who, according to a 1992 Conference Board study,[7] share small business owners' concerns about the persistence of "market gaps" in the financial sector that they feel deprive some regions and business sectors of credit. One of federal policy-makers' primary objectives since at least the early 1980s has been the closing of such market gaps. Their policy remedy -- fostering competition by allowing more institutions (read trust companies) into the commercial and consumer lending business -- has been vigorously opposed by the banks.

If anything, the banks' size belies what remains an incontrovertible trend in the decades leading up to the 1980s: their influence, on both the economic and political planes, has declined relative to other financial institutions. From the 1960s onward, trust companies made impressive inroads into the banks' domain. During the same period, the banks saw their avenues of privileged access to government narrowed as a result of a shift in responsibility for regulation from the Bank of Canada, which was preoccupied with above all maintaining international confidence in our banking system, to the Department of Finance, which targeted domestic economic objectives. In addition, the acquisition of the country's biggest trust companies by business magnates on familiar terms with senior politicians and the Prime Minister -- such as Peter and Edward Bronfman and their main operative, Trevor Eyton -- have accorded the trust industry a proximity to power that remains the envy of most bankers. At the same time, however, policy-makers know they disadvantage the banks at the country's peril, since the fate of the economy is dependent on a dynamic financial system, of which the banks remain the undisputed lifeblood. It is these conflicting forces, among others, that explain the evolution of public policy in the financial sector in the past decade.

The inroads trust companies have made onto the banks' turf in recent decades -- forcing the banks to embrace more consumer-driven business strategies to preserve their market share -- have nevertheless failed to temper Canadians' long-held perception of the Big Six as paternalistic, oligopolistic and arrogant bureaucracies. Countless have been the recent testimonies of recession-squeezed small business owners whose banks abruptly slashed their credit lines at the first hint of declining sales. The banks are criticized for the clinical, categorical and bureaucratic way in which they enforce loan covenants on small business borrowers, yet strive to accommodate corporate deadbeats such as Olympia & York Developments Ltd. and Bramalea Ltd.[8]

The banks' image problems have been particularly useful to the trust industry in helping it win converts among consumers, bureaucrats and politicians. Their image similarly handicaps the banks in corralling public support for the policies they espouse. A case in point arose during 1987 and 1988 when, while the banks were publicly pressing their demands for wide ownership of financial institutions and the right to retail insurance through their branches, they were being vilified in the media and before the House of Commons Finance Committee for their service charges. As one bank lobbyist conceded, the publicity accorded the service charges issue doomed the banks' hopes of swaying public opinion on financial reform. "It undermined any message that you were going to bring more competition and lower prices to the market. Anything that you said about lowering the price of insurance seemed to fly in the face of what people were feeling about service charges."[9]

Of course, public antipathy toward the banks was not born simply out of consumers' indignation over service charges during the 1980s. Rather, that issue spawned only one of its more recent manifestations. To trace the roots of the banks' unpopularity one must go as far back as the first half of the 19th century when the first chartered banks began laying the foundations for the oligopoly that was to emerge by the end of that century. By 1890, the direct predecessors of the current Big Six institutions had already locked up 42 percent of the country's banking industry.[10] Thirty-five years later, in 1925, they had 96.6 percent of the market.

Robert MacIntosh, the former president of the Canadian Bankers' Association, ascribes the consolidation before 1925 to "ineluctable economic forces. Canada was a thinly populated country when the banks first came into existence, and remained thinly populated as the banks marched across the continent in step with economic development. In many regions, the local economy depended on a narrow base of primary industries, not a good foundation for establishing new financial institutions."[11] The economic misfortune and pervasive self-dealing that plagued closely-held and loosely-regulated regional institutions triggered failure after failure, invariably leaving the Big Six to scoop up the assets and deposits left behind. The end result of these events was the concentration of bank assets in the hands of fewer than a dozen institutions, the 1925 creation of the Office of the Inspector-General of Banks with a mandate to implement stricter audit and examination procedures, and the establishment a decade later of the Bank of Canada.

In the midst of this consolidation exercise the big banks began stretching their ever-growing tentacles into another part of the financial system: the trust industry. Legally the banks were prohibited from engaging in the trust business themselves since trust activities[12] were deemed to be matters affecting property and civil rights and hence fell under the jurisdiction of the provinces according to the *Constitution Act, 1867.* Banking, on the other hand, was and remains a federal matter.[13] Nothing prevented banks, however, from owning trust companies or creating tutelary relationships with such entities. These alliances served as conduits through which the banks could steer clients' in need of fiduciary services or residential mortgage loans, from which the banks were then prohibited from making.

Just as a handful of "blueblood" institutions came to dominate the banking industry, then, an elite coterie of trust companies arose to lay claim to the lion's share of the market for fiduciary services. The doyen of the industry, the venerable Royal Trust Co., was established in 1892 as an affiliate of the Bank of Montreal and no fewer than nine of the bank's 16 directors took a seat on Royal's board.[14] Before long the other banks had established alliances with trust companies, as the Royal Bank lined up with Montreal Trust Co., the Bank of Commerce and Canada Life Assurance Co. with National Trust and the Toronto-Dominion with the country's oldest (1872) trust, Toronto General Trusts, which the bank later merged with Canada Permanent after acquiring the latter in 1961. Reflecting on this bank-trust symbiosis, Patricia Best and Ann Shortell assert that, by the early 1960s,

> A small circle of financial men ran the country's banking and trust lending operations, sitting on one another's boards and sending one another business. The links between the trust companies and the banks constituted an intricate maze of interlocking directorships that maintained the facade of independent institutions while permitting the banks to exercise over the trust companies a level of influence usually associated with ownership. In 1963, the nature of these links was not widely known -- a credit to the smug insularity of the system.[15]

Best and Shortell appear to contradict themselves later in noting that, following TD's lordship over the merger of Toronto General and Canada Permanent two years earlier, "public attention focused on the concentration of power in the financial sector."[16] The latter observation nevertheless appears to be accurate, for the merger coincided with the establishment of a federal Royal Commission on banking and financial issues, under the chairmanship of the Chief Justice of Ontario, Dana Porter. The bank-trust links had by then become controversial and were raised repeatedly during the commission's proceedings. In his 1964 report, Porter ultimately recommended a ban on interlocking trust-bank directorships and a dilution of bank shareholdings in the trusts to a maximum of 10 percent.[17] Porter believed the changes would enhance competition in the financial sector.

Mitchell Sharp, then Finance Minister, knew the banks would not accept the rolling back of their existing privileges without protest. In exchange for surrendering their influence over the trust industry, Sharp offered to meet two of the banks' long-standing demands: the opening up to the banks of the residential mortgage market and the lifting of the 6 percent interest rate ceiling on bank loans.

Prime Minister Louis Saint-Laurent had let the banks partially into the home loan market in 1954, by including them along with life insurers and trust companies in the *National Housing Act* of that year. The *Act* enabled the government to set, by decree, the rate of interest on NHA-mortgages insured by Crown-owned Central Mortgage and Housing Corp. When the *Act* was passed in March 1954, the rate was fixed at 5.5 percent, or about two percentage points above the prevailing rate on federal government long-term bonds.[18] The rationale for letting the banks in was simply that they were the only institutions with the scope required to accommodate the post-war surge in demand for mortgages across the country. The life insurance companies, which held 75 percent of the home mortgage market in the early 1950s, had shifted their emphasis to commercial mortgages. Trust companies had neither the capital nor geographical breadth to pick up the slack on their own.

Conservative to the core, bankers' were at first indignant at the changes, which Saint-Laurent announced "by decree" in a terse press release without even informing the banks in advance. "Lese majeste," David Mansur, then president of CMHC, told Best and Shortell. "The protests were just unbelievable...The financial community abhors change."[19] The change was, without doubt, revolutionary and the banks were rightly concerned about how it would play in public. After all, the banks' stock in trade was the certainty depositors' had about getting their money back on demand. If more and more bank deposits became tied up in illiquid, 25-year mortgages, however, what would happen to that certainty?

In the end, bankers' fears turned out to be overblown and between 1955 and 1958 the banks made $900 million worth of NHA-mortgage loans, second only to insurers' $1.5 billion, and ahead of the trust companies' $800 million.[20] But market interest rates crept upwards in the late 1950's, leading the government to peg the levy on NHA-mortgage loans at 6.75 percent. That had the effect of shutting the banks out of the mortgage market because the new rate exceeded the 6 percent ceiling that was then imposed on bank loans. Unlike trusts and insurers, the banks were not allowed then to write non-government-insured mortgages.

The banks' involuntary absence from the mortgage market was a boon to the trust industry. Most trusts recognized the golden opportunity in front of them and shifted their emphasis from fiduciary activities to intermediation, a shift that was to alter irrevocably the relationship between the banks and trusts, eventually giving rise to the heated public policy debates of the 1980s. Between 1955 and 1962, the corporate assets of the trust industry (essentially loans, not fiduciary assets managed in trust) went from 6.8 percent of bank assets to 12.6 percent.[21] At the same time, the number of provincially incorporated trust companies increased from 33 in 1959 to 47 in 1964, while trust branches more than tripled from 137 in

1956 to 470 in 1967.[22] The banks were hardly willing to see such a windfall left to their competitors alone. Sharp apparently concurred, and with the stroke of a pen two historic vestiges of the financial system were eliminated with the 1967 revision of the *Bank Act*. The banks had at long last wiggled out of the potentially devastating straight jacket created by the 6 percent ceiling and their interdiction from making non-government insured mortgage loans.

The removal of the interest rate limit also cleared the way for the banks to engage in consumer lending, where loan rates typically reached double digits. The consumer lending market, which until then had been largely controlled by finance companies such as Household Finance, had been growing rapidly since the 1950s along with Canadians' taste for the automobile and "consumer durables" such as washing machines that became status symbols among the middle classes. The banks recognized this trend and pushed for and won the right to take "chattel" mortgages in the 1954 *Bank Act*. But the interest rate ceiling prevented any meaningful bank presence in the consumer loan market. With the ceiling eliminated, the banks' horizons, which for decades had barely stretched beyond the provision of short-term commercial credit, were broadened considerably.

The 1967 *Bank Act* was a watershed not only because it changed forever the dynamics of competition in the financial sector by expanding the banks' lending powers. By restricting for the first time individual shareholdings in a bank to 10 percent, it also set the scene for the bitter schism that was to arise almost two decades later between the banks and trusts on the ownership issue. Public policy discussions on the ownership of financial institutions arose not primarily out of the banks' stranglehold on the trust industry, however. Perhaps even more important in bringing about the ownership restrictions that were to come into force in the mid-1960s was

Canadians' growing consciousness of and subsequent aversion to American domination of their economy.

Proponents of foreign ownership restrictions found their champion in Walter Gordon, Liberal Prime Minister Lester Pearson's first Finance Minister. Gordon, a devout Canadian economic nationalist, focused his crusade on the financial sector in 1963 when the First National City Bank of New York (now Citibank) announced its intention to purchase the Mercantile Bank of Canada from its Dutch parent, the National Handelsbank. The government lacked the legal powers to stop the sale, but Gordon voiced his displeasure with the transaction. The Finance Minister was spurred into action on learning soon afterward that another New York giant, David Rockefeller's Chase Manhattan Bank, was in the midst of merger discussions with the Toronto Dominion Bank.

The Finance Minister rose in the House of Commons on September 22, 1964 to announce new regulations governing foreign ownership of financial institutions. Henceforth, Gordon told the House, no single foreign shareholder would be allowed to own more than 10 percent of a Canadian trust company and cumulative foreign ownership would be limited to 25 percent. Furthermore, Gordon added, the so-called "10/25" provision "would be included in the *Bank Act* and made retroactive to that date."[23] By the spring of 1965, when the draft Bank Act amendments began circulating, a critical addition had been made to the ownership policy: the 10 percent limit on bank ownership was to apply to *residents* as well as foreigners. Whether or not the domestic ownership constraint "was applied almost as an afterthought," as the CBA's Robert MacIntosh contends,[24] is academic. What is important is that, for reasons that have never been satisfyingly explored, the Pearson government never saw fit to extend the 10 percent limit to the trust sector.

Thus, while the 1967 Bank Act set the stage for the further blurring of distinctions between the business activities of banks and trusts, it at the same time entrenched a gaping inconsistency in the regulatory treatment of the two types of institutions. This inconsistency lies at the root of the paralysis that was to characterize the Mulroney government's financial reform crusade almost two decades later. One must similarly not overlook the fact that ownership limits on deposit-taking institutions grew not out of normative or economic arguments about self-dealing, but rather were the product of economic nationalism. The case demonstrates the extent to which the strongly-held convictions and ideological disposition of individual policy-makers can be determining factors in policy-making.

The events of 1967 ushered in an era of profound change not only for the country's banks. The trust industry, too, was to undergo a revolution of its own as a result of developments that came to a head in the mid- to late 1960s. The absence of domestic ownership constraints on trust companies, the enforced lifting of the Big Banks' grip on the largest trusts, the booming market for real estate mortgages and the advent of deposit insurance in 1967[25] all coincided to make trust companies attractive investments in the eyes of the country's rising entrepreneurial class. Patricia Best and Anne Shortell documented in elaborate detail the rise of the new type of trust owner that emerged during this period in *A Matter of Trust*[26] -- a group motivated more by return on investment and the opportunity for synergies between a financial institution and their other (mostly real estate-related) business activities than had been the stolid "Old Guard" of trust company managers.

Montreal magnate Paul Desmarais was one the first of this breed to catch the public eye with his 1967 purchase of the blueblood Montreal Trust Co. from Canadian Pacific Ltd. He had nevertheless been preceded by Calgary's Belzberg brothers, who founded First City Trust Co.

with $1 million in capital in 1962. By the early 1980s, the Belzbergs had transformed their initial investment into a $4 billion empire, active in financial services, real estate development, industrial products and stock trading. Their aggressive tactics and apparent skill in the pursuit of quick stock market profits through "greenmailing" made them alternately revered and feared on Wall Street.[27] Under the stewardship of Sam Belzberg, the family attempted to enhance its presence in the Canadian trust industry in 1981 by launching a hostile, but ultimately unsuccessful, takeover bid for Canada Permanent. The old guard -- in this instance, Canada Permanent chairman Eric Brown and president J. Harold Deason -- was successful in repelling Belzberg's offer, but the two executives ended up losing their jobs when the trust company eventually ended up in the hands of Genstar Corp., a diversified real estate and financial conglomerate run out of San Francisco by Vancouver businessmen Angus MacNaughton and Ross Turner.

The Belzbergs were not the sole industry outsiders to be thwarted by "the establishment" in their drive to sink roots in the trust sector. Robert Campeau was similarly held back by the Toronto business establishment, who staged an elaborately orchestrated defence when the Ottawa developer went after Royal Trustco Ltd. in 1980.[28] The Toronto Dominion Bank, Sun Life Assurance Co., Edmonton developer Oxford Group Ltd., Edward and Peter Bronfman's Brascan Ltd., the Canadian Imperial Bank of Commerce and investment dealer McLeod Young Weir all joined in by accumulating positions in Royal's stock to thwart the takeover. The linchpin of the old guard's strategy proved not to be a member of the old guard, however, but the Reichmann brothers' Olympia & York Developments Ltd. The enigmatic Reichmanns, who had built the country's biggest real estate empire without help from the establishment, accumulated 23 percent of Royal's stock. While the group was successful in blocking Campeau, the Ontario Securities

Commission took umbrage with its tactics. The OSC launched a hearing to determine whether the group acted in collusion, to the detriment of minority shareholders.[29] In the end, Royal Trust's top two executives, Ken White and John Scholes, temporarily lost their securities trading privileges.

Meanwhile, Olympia & York, which had always acted as a passive investor in its forays outside the real estate sector, threw its lot in with Brascan's 18 percent. The partnership allowed the Bronfmans' to gain de facto control of Royal Trust[30], leading before long to the departure of Scholes and White. Brascan consolidated its lock on the trust company in 1983 by buying the Reichmanns' stake in exchange for cash and stock in a new, publicly-traded financial holding company, Trilon Financial Corp. Brascan traded its Royal Trust shares for 40 percent of Trilon, and also transferred ownership of London Life Insurance Co. to Trilon. The combination of Royal Trust and London Life, along with Trilon's own merchant banking operations, created the country's biggest financial conglomerate overnight.

Elsewhere in the trust sector, yet another member of the old guard was fighting to preserve its independence. London, Ontario-based Canada Trustco Mortgage Co. was threatened with a creeping takeover bid from Manufacturers' Life Assurance Co. in 1983. President Merv Lahn, an outspoken advocate of widely-held ownership, attempted to stall ManuLife by arguing that the suitor was in fact a foreign entity and thus prohibited by the "10/25" rule on non-resident ownership from acquiring more than 10 percent of the trust company.[31] Lahn argued that ManuLife, a mutual insurance company, was a foreign-owned company because the majority of its voting policy-holders lived outside Canada.

In 1985, however, ManuLife resumed its takeover bid and ended up in a battle for control of Canada Trustco with Genstar Corp., which had swallowed Canada Permanent a few years earlier. Genstar ultimately prevailed and rolled the Permanent into its newly acquired trust, leaving the merged entity to operate under the Canada Trust banner.[32] With combined assets of almost $22 billion, Canada Trust became the country's largest trust company.

Within months, however, Genstar itself was the subject of a takeover bid from Montreal-based tobacco conglomerate Imasco Ltd. Surprisingly, Lahn and Canada Trust's board supported the offer, preferring the ownership of a solid industrial company such as Imasco to that of a deal-making upstart like Genstar. "The real matter is whether Imasco is as suitable a non-financial company to own Canada Trustco as Genstar," Lahn told *The Toronto Star*, when queried about the apparent contradiction in his support of Imasco's bid. "We find them (Imasco) highly suitable."[33] To help assuage the federal government's concerns that the takeover might produce what bankers called "fertile breeding ground" for self-dealing, Canada Trust's board passed a resolution prohibiting it from lending to any shareholder with more than 10 percent, or any such shareholder's associates or affiliates.[34] The move preempted legislation that the Mulroney government had threatened to introduce to block the takeover. The anti-self-dealing resolution was in turn codified as an undertaking given to the government by Imasco. At the same time, Imasco agreed to limit its membership on Canada Trust's board to 25 percent, leaving Lahn and his highly-regarded management team in place to operate independently.[35] Lahn continued to speak out vociferously and often against closely-held ownership of financial institutions, even using Canada Trust's annual meetings as a forum to propagate his views.

Given that, by the early 1980s, most of the country's blue-blood trust companies had fallen under the control of a dominant shareholder -- invariably one from outside the WASP business establishment and with significant non-financial, industrial holdings -- one might have expected Lahn's views to have been echoed by policy-makers and the public. Yet, concerns about the concentration of economic power in the hands of a small number of closely-held conglomerates such as Brascan or Power Corp. were overshadowed by the unease the public and policy-makers expressed at the Big Banks' continued dominance of the deposit taking sector. With more than 72 percent of all DTI assets in 1985, the domestic Schedule I banks were still by far the biggest players in the deposit-taking sector.[36] With about 13 percent of DTI assets, the trust companies (including non-bank mortgage loan companies) were seen as upstarts; even farther behind were the Canadian units of foreign banks, the so-called Schedule II banks, with less than 5 percent of DTI assets.[37]

When governments and the general public did turn their attention to the trust sector in the early 1980s, it was usually not because another blueblood had been swallowed by one of the country's great family empires. More likely it was because one of the country's second-tier trust companies had gone under. Historically, there had been precious few financial institution failures in Canada. But between 1981 and 1985, no fewer than eleven trust and loan companies failed,[38] leaving the Canada Deposit Insurance Corp. to absorb losses estimated at $827 million.[39] The failures shed light on a litany of woes that plagued smaller institutions: self-dealing by dominant shareholders, lax regulation, sloppy management, misleading accounting practices and all-too-passive directors.

The most infamous of these failures were undoubtedly those of Ontario-based Crown, Greymac and Seaway trust companies. Crown and Greymac were controlled by Leonard Rosenberg while Seaway was run by one of his close associates. The transaction that ultimately led to the three trust companies' unprecedented and highly-sensational seizure by the Ontario government in January, 1983 involved a property flip executed by Rosenberg and his associates of 10,000 apartment units at a wildly inflated price. It was classic case of self-dealing -- the flips were financed by the trust companies and their mortgage subsidiaries -- with the risk almost entirely borne by minority shareholders, depositors and the CDIC.

In brief, the transaction worked liked this: Rosenberg's Greymac Credit Corp. had initially purchased the units for $270 million, but before taking title sold them to a company controlled by his associate Bill Player (who worked through Seaway) for $312 million. Player's company instantly flipped the properties for $500 million to a series of Ontario numbered companies, which he claimed were owned by anonymous Saudi investors. The additional mortgage financing -- $152 million -- was provided by Crown, Greymac and Seaway trusts.[40]

The fraudulent practices that came to light with the seizure of Crown, Seaway, and Greymac were by no means unique to those institutions. Detecting and curtailing crooked owners' use of a captive trust company to finance property flips at bogus, inflated prices had been the bane of regulators for years. But the problem appeared to reach epidemic proportions in the early 1980s. Typically, a closely-held trust company would finance the purchase of a property by a non-arms-length buyer at as much as twice its purchase price. Bogus appraisals would make the price appear legitimate. A property purchased for $250,000 could therefore be mortgaged at, say, $500,000, leaving the trust owner and the non-arms-length mortgagor (sometimes one in the same) $250,000 to split between themselves. The property was then flipped to yet another non-arms-length buyer at an even higher price, sufficient to pay off (at least on paper) the previous mortgage, with financing again provided by the captive trust company.

Fraudulent self-dealing was not the only vice that brought down financial institutions in the 1980s, however. Poor corporate governance procedures, regulatory neglect and complacency, and incompetent management were the dominant factors in most failures. The geographic concentration of assets in some regional institutions also proved fatal for many trust companies -- and banks. The latter group, which included the now-defunct Canadian Commercial Bank and the Northland Bank, had come into being as a result of federal and provincial government policies of the 1970s aimed at palliating Western Canadian resentment towards the Big Banks.

The perception that Western businesses and farmers faced discrimination by the Big Six was rife and the premiers of the four Western provinces believed locally-based banks would naturally "be more sympathetic to the needs of residents of the West."[41] Thus it was that the CCB was born in 1975 and the Northland Bank a year later. But from the start, the two never fulfilled their mandate, intended by politicians, of catering to the credit needs of Western small businesses and farmers. By 1985, in fact, the Edmonton-based CCB had a higher proportion of its loans in the United States (36 percent) than Alberta (31 percent). Almost a quarter of its portfolio was made up of loans originated east of the Manitoba-Ontario border.[42]

The events that conspired to bring down the CCB and Northland are complex and multitudinous. All of the factors cited in the above paragraphs (save, perhaps, outright criminal self-dealing) were present, along with many others. More importantly, however, the September, 1985 bank failures shook policymakers in a way a dozen trust company failures never could. Together, the two banks accounted for less than one percent of all the assets in the Canadian banking system. But the political fallout their collapse engendered belied their modest size.

What was most troubling about the bank failures was that they exposed serious lacunae in the regulatory apparatus, a fact forcefully brought to light by former Supreme Court Justice Willard Estey.[43] While the Crown Trust affair also triggered criticisms about regulators' negligence, the target of those criticisms was the Ontario government, the trust companies' lead regulator. The regulatory lapses in the CCB affair, on the other hand, were the fault of the

Inspector-General of Banks, William Kennett, and his staff, the same officials who were charged with monitoring the health of the Big Six and the other 65 odd banks in the country. Could the Inspector and his operatives have been overlooking similar signs of trouble at one of the Big Banks, which were still nursing their wounds from the Dome Petroleum debacle? Whether openly articulated or not, that question haunted many observers.

The CCB-Northland episode also damaged the stature of McDougall and the rest of the Mulroney cabinet. Despite the historically large contingent of financial and business types within the cabinet, including McDougall herself, the government had shown itself to be woefully naive about the gravity of the CCB's situation, first, in sponsoring an ill-conceived bailout attempt in March, 1985 and, later, in assuring investors that all would turn out well. To rehabilitate its standing, the government had to act. McDougall quickly dispatched Estey to conduct an inquiry into the failures, with a mandate to recommend ways to strengthen the regulatory system. She also announced, on the very day she shut the banks, that the government would pass legislation to compensate the banks' uninsured depositors. The latter move was a blatant admission that the government itself had misled investors about the banks' stability.[44]

Finally, the CCB-Northland fiasco cast doubt on the wisdom of the government's proposal, made public the previous April, to encourage ever more competition in the financial sector by favouring the creation of financial-commercial conglomerates like Brascan. Was the government so naive as to think it could open up the commercial and consumer lending sphere to ever more players without first assessing the adequacy of the regulatory apparatus to police them? And was it a good idea to allow these new players to be closely-held, after more than a dozen failures, including the CCB,[45] had exposed the dangers of such a regime? These questions were posed again and again as the House of Commons Finance Committee held hearings, in mid-1985, into the ill-fated bailout attempt led by Ottawa a few months earlier. The hearings made all parties involved in the CCB fiasco "look bad," *The Globe and Mail* concluded.[46] Not surprisingly, then, the bank collapses had a profound effect in shaping government policies relating to the financial system. The scope and import of this effect is discussed is greater detail in Chapter 5.

Despite the copious amounts of news copy that the failures of the early 1980s generated, however, the crisis atmosphere surrounding each collapse was relatively short-lived. This should not seem surprising considering the small size of the insolvent institutions relative to the deposit-taking sector as a whole. (Crown Trust had about $850 million in assets, the CCB around $1.5 billion.) Public confidence emerged essentially unscathed by the failures, thanks, in part at least, to the federal government's decision to triple deposit insurance coverage to $60,000 at the time of the Crown fiasco. Investors, too, seemed unfazed by the carnage of early 1980s, sending, for instance, the Toronto Stock Exchange's trust and loan company index 31 percent higher during the four months following Crown's seizure.[47] The relatively smooth transfer of the Bank of British Columbia to the Hongkong Bank of Canada in late 1986 also helped in buttressing public opinion that failures, as long as they remained of a limited size, could be managed without creating a threat to the system.

But undoubtedly what saved the Mulroney government from suffering greater humiliation as a result of these financial debacles was the inchoate economic boom that coincided with its rise to power. Robust economic growth, led by an inflationary surge in real estate prices and loan demand, brought many financial institutions back from the brink where they had teetered only a year or so earlier. After contracting 3.2 percent in real terms in 1982, Canada's gross domestic product expanded by 3.2 percent the following year and advanced by an energizing 6.3

percent in 1984. A year later, the economy was 4.6 percent bigger and growth in 1986 amounted to 3.2 percent. At the same time, inflation tumbled from a 1981 average of 12.5 percent, to 5.8 percent in 1983, 4 percent in 1985 and 4.1 percent in 1986. Interest rates followed suit. The chartered banks' prime lending rate slid from a punitive 19.29 percent average in 1981 to 11.17 percent in 1983 and lower still after that. More than anything, the interest rate decline spared many institutions the disastrous fate that loomed as long as they relied on short-term deposits to fund long-term mortgages already on their books. The rate declines also fattened profit margins, since deposit rates fell faster than loan rates.

With returns on financial assets softening, small and large investors alike sought alternate investments. Most settled on real estate, both residential and commercial in almost equal measures. The property boom that ensued generated unprecedented demand for mortgage financing, particularly in Southern Ontario. With half of the country's trust companies (based on assets) already located in that region, the trust industry was, proportionate to its size, the biggest beneficiary of rising mortgage demand. As financial services analyst Alain Tuchmaier told *The Toronto Star* in 1992: "There was so much growth in the market, that everybody was able to grow just by having branches out there. You were competing on how quickly you could turn around a mortgage approval."[48]

In this light, encouraging more competition to meet the double-digit growth in demand seemed to provincial and federal governments of the day like the obvious course to follow. When combined with policy makers' avowed belief in increasing competition as a means to achieving other economic goals[49] and long-standing complaints about banks' restrictive credit policies, the trust industry's rapid growth appeared to many in government and the investment community a propitious development in itself. Typical of the optimism that seemed to characterize the views of many in the investment community was a 1983 comment made by McCarthy Securities director Robin Cornwell in favour of expanding trust companies' powers to make commercial loans.[50] In a speech before the Trust Companies' Association of Canada, Cornwell declared in April of that year: "There is no doubt in my mind that syndicated lending is the way of the future whereby there will be *plenty of room for all contenders* and that the trust industry will certainly pick up very rapidly its share of the commercial loan market."[51]

Of course, trust companies could not seize such lending opportunities without first expanding their deposit base. What helped them accomplish this was the banks' apparent indifference to the domestic retail banking market in the early 1980s. Complacently believing their unrivalled distribution systems (branch networks) would be enough to sustain their lock on the retail (largely demand) deposit market, the Big Banks instead pursued opportunities in global markets. The future, bankers believed, lay in cross-border corporate lending and related investment banking activities.

What the banks were also slow to appreciate was consumers' receptiveness to the U.S.-style marketing tactics that the Canadian trust industry had by then embraced. One early pioneer of this approach was Canada Trust's predecessor, Huron & Erie Mortgage Corp., which in 1960 began offering gifts -- starting with a Kodak camera or coffee percolator -- to new depositors.[52] The gifts were an initial indication that financial services could be sold like any other commodity, with gimmicks and incentives. The implications of this trend for product design and customer service were to become enormous, rendering obsolete the time-honoured rules of financial intermediation -- rules to which bankers continued to subscribe.

Before long, the gifts got bigger and the innovations more complex and elaborate. Borrowers were baited by the chance at winning a car, a home or a boat, or lured by flexible mortgage terms. Canada Trust was the first to introduce a six-month term for home mortgages in 1981. While many trust companies followed suit almost immediately, it took the Big Six four years to do the same.[53] The trust companies also began to distinguish themselves from the banks, still perceived as cold and callous, on customer service. Again, Canada Trust led the way, giving new meaning to the term "bankers' hours," with its "8 to 8, Monday to Friday" business hours. Emblematic of the entrepreneurial mindset at the root of these initiatives was former Canada Trust chairman Arthur Mingay's assertion that "trying to sell money is not different from selling merchandise in Sears."[54] It took the banks several years to embrace this point of view with the same fervour.

A booming real estate market and superior customer service, then, allowed the trust industry to lead a charmed existence during the second half of the 1980s. Trust companies share of the $565 billion Canadian dollar deposit market grew to 21 percent in 1990 from 17 percent in 1984. During the same period, the banks' share slipped from 53 percent to 52 percent.[55] In 1986 alone, deposits at trust and loan companies surged by 30 percent, compared to 3 percent at the banks.[56] Robust deposit growth translated into rapid growth on the other side of the balance sheet, as the trust industry's assets expanded at a compound rate of 18 percent between 1985 and 1990. At the end of the period, total industry assets (excluding fiduciary assets) totalled $134 billion. The banks, on the other hand, grew at a more restrained 6 percent compound rate.[57]

Where the banks did manage to build market share, however, was in residential mortgages, increasing their slice of the $235 billion pie to 43 percent in 1990 from 34 percent six years earlier. The trust companies, on the other hand, held their ground at 31 percent. The banks grew at the expense of insurance companies and credit unions, continuing a trend that began in the 1960s. To fuel growth, trust companies relied on commercial mortgages and personal loans. The trust industry's commercial mortgage assets rose at an astonishing average annual rate of 17 percent between 1984 and 1990, while its share of the market for consumer credit doubled to 8 percent.[58]

Initially, the trust industry's overwhelming concentration in mortgages -- commercial property and home loans accounted for 65 percent of industry assets in 1990 -- worked to its advantage. Although trust companies in general had a higher cost structure than banks,[59] they experienced markedly lower loan losses during the second half of the 1980s. Between 1984 and 1988, provisions made for loan losses amounted to about 0.43 percent of average assets in the trust industry, compared to 0.63 percent for the Big Six.[60] As a result, their profit performance exceeded that of the banks during the same period. The trust industry earned an average return on assets of 0.72 percent and an average return on equity of 16.3 percent between 1984 and 1988. The comparable figures for the Big Six were 0.58 percent and 14 percent, respectively.[61]

By 1990, however, it had become evident that the industry dynamics that had proven so favourable to trust companies during the 1980s were shifting. The trust industry was broadsided from one direction by the onset of the deepest economic recession to hit Central Canada since the Depression. From the other direction, the trust sector confronted the brutal competitive realities that had come to define the financial industry.

Already endowed with distribution systems unrivalled by their domestic or foreign competitors, the Big Six increasingly began to exploit the until-then untapped synergies offered by their branch networks. This development was largely the product of a broad retrenchment by the banks, which, after giving up on their ill-fated offshore excursions of prior decades[62] and getting out of U.S. commercial real estate lending, began to focus on consolidating and building their customer base in Canada. In some respects, this was less a bold step for the banks than one dictated by rapidly changing market conditions. With better access to international capital markets, more and more creditworthy companies began to tap bond and stock markets directly for funds instead of raising money through bank loans -- a trend that became known, for obvious reasons, as "disintermediation." That left the banks to chose among other, riskier lending opportunities, which, for a time, they pursued with zeal. However, the herd mentality that led bankers to oversupply credit to Third World governments, oil companies and commercial real estate developers rendered those options unprofitable, as well.

As a result, several banks restructured internally, beefing up their marketing and retail banking divisions in order to become more consumer-driven and innovative in the design of new products. To outsiders, the shift in emphasis was readily apparent by 1991 when several banks launched expensive advertising campaigns to cast themselves in a kinder, gentler light. The most aggressive on this front was the Bank of Montreal. The first to launch an ad campaign on network television emphasizing the new service-oriented mindset, the Bank of Montreal also aimed to differentiate itself from its peers with a consistently lower prime lending rate and by offering loans to farmers and small businesses at a percentage point below prime. The point here is not that the banks' sudden focus on improved customer service was particularly novel or laudable in itself, but, instead, that it helped to undermine the trust industry's long-held claim as providers of superior service.

What enabled the banks to surpass most trust companies on the service front was not an army of more amiable and empathetic tellers and loan managers. More important in allowing the banks to build an advantage over their peers was technology. In September, 1991, the Royal

Bank opened a 24-hour "superbranch" in Burlington, Ont. that the bank declared would serve as a "prototype branch for the 21st century."[63] The branch bears a striking resemblance to both a video arcade, in its abundance of high-tech gadgetry, and a farmers' market, in the array of financial services on offer. In addition to automated banking machines (ABM) that handle basic transactions, there are machines that count and roll customers' loose change, dispense travellers' cheques and update passbooks. Drive-through teller and ABM services are available. Another computer system matches banking products to a customers' financial needs and goals, with bank personnel on hand to guide the customer through the process and seal the transaction.

In short, by harnessing technology, the Big Six have transformed the look and delivery of financial services, and, with it, customers' expectations. Computer technology has enabled institutions to reduce the cost of processing the billions of transactions they handle every year. It has allowed them to manage more effectively the mountains of information they compile on their customers, a powerful tool in the marketing and development of new products. And it has provided the banks (and large trusts) with new sources of "fee-income" to complement, and replace, lending income, the traditional mainstay of banking but which has declined in importance in recent years.[64] Institutions with the technological wherewithal have an advantage in tailoring and targeting products to specific groups of consumers, and in some cases, individuals. To the early fruits of technology -- daily interest savings accounts, multi-branch banking and ABMs -- have been added more sophisticated services such as electronic data interchange (EDI), debit cards, image processing and telephone banking.[65]

The capital investments required to develop and implement these technologies is beyond the capacity of most smaller financial institutions. In addition, because banks that develop such technologies regard them as proprietary, the opportunity for other institutions to purchase them without incurring research and development costs is not generally available. Technology, therefore, has forced consolidation within the financial services industry, prompting small players to combine their resources through mergers or seek refuge under the wings of the Big Banks or insurance companies. Slower growth in the market for traditional intermediation services at the retail level -- the result of changing demographics and stagnant economic growth -- has intensified pressure on institutions to become leaner and more productive. This is, in many ways, a reversal of the trends of the 1980s, when an ebullient service sector absorbed workers made redundant by increasing automation in manufacturing. While labour productivity in the Canadian manufacturing sector advanced at an annual rate of 3.4 percent between 1983 and 1990, productivity growth in the financial services industry lagged at 1.8 percent.[66] The impact of automation on employment is now manifesting itself in the financial services sector. The trend has been exacerbated by recession-induced credit losses and the recognition that Canada is "overbanked." Overexpansion in the 1970s and 1980s has left too many providers of financial services chasing too few customers. The unthinkable -- layoffs -- has suddenly become widespread throughout the financial services sector, and not just at trust companies with acknowledged, serious credit problems. The Big Six are also slashing their payrolls. While employment at the Big Six grew 12 percent to about 182,000 between 1987 and 1991, the figure had fallen to 179,500 by August, 1992.[67]

In the face of this upheaval, then, it is hardly surprising that the trust industry should find itself in a precarious position.[68] But the situation of many trusts has been made even more precarious -- and retrenchment, therefore, even more pressing -- by record levels of non-performing loans.[69] The banks, too, are grappling to work out hundreds of millions of dollars worth of sour loans (although not record levels). But the nature of the trust industry's predicament is far more serious, and the circumstances that led it there specific to it alone. The 1990s have already produced several casualties -- Standard Trust, First City Trust, Guardian Trust, Central Guaranty Trust, Royal Trustco, to name but five. Their stories have been instructive in explaining the industry-wide carnage, since the decline, and rise, of each appeared to parallel those of the others.

In particular, three dominant factors seem to lie at the root of their demise. First, each overinvested in commercial real estate, much of it of marginal quality, embracing borrowers that lenders with traditional (read higher) credit standards would not. Second, regulators acknowledged almost immediately that these companies had taken on a higher risk profile, and had contravened regulatory guidelines in doing so. But they were slow to recognize the consequences of this riskier lending activity, and when they did, were far too hesitant about employing sanctions at their disposal to stop it. Third, in several cases, it was the trust's parent company that encountered financial difficulties first. The parent then bled its trust subsidiary for funds, through dividend payments and non-arm's-length asset sales, for instance, to alleviate its own cash crunch. We briefly discuss these factors below. Before proceeding, however, it is worth noting that the opportunity for any of the three factors to arise would have been severely curtailed had the federal government enacted the proposals for reform it put forward in 1985. Instead, government action was delayed by the breakdown of the policy-making process between 1985 and 1990. What eventually emerged from that process was a policy, significantly watered down from earlier proposals and which, in large measure, failed to address the faults in the system discussed below.

As one federal regulator put it after reviewing Standard Trust Co.'s operations in early 1987, trust companies dived "with gusto" into the commercial real estate market of the late

1980s.[70] In a market that by 1985 looked to go nowhere but up, it seemed that for every developer with an idea, there was a trust company willing to finance it. Much of this activity took the form of what, in the industry lexicon, is called "interim construction financing." Trust companies routinely advanced millions to small developers to undertake projects from scratch, expecting to be repaid when the buildings -- invariably condominiums, strip malls or office complexes -- were completed and sold. Even then, the loan was often not repaid, but "rolled over" in the form of permanent financing assumed by the property's buyer. That was the way it was supposed to work; market conditions, however, proved fatally uncooperative. When the bottom fell out of the commercial real estate market, a development brought about by the oversupply that had been created by the ready availability of financing, there were no buyers to assume the mortgages developers had already taken out. Since properties were producing little or no income, developers could not meet debt payments. And because most projects were limited-liability corporate entities, developers lost only their (usually negligible) equity in abandoning projects. It was the lender that ended up paying the biggest price for the errors of the 1980s.

The first to succumb to these pressures was Standard Trust, which was closed by the Superintendant of Financial Institutions in April, 1991. Standard, had lent as much as $130 million, or 11 percent of its mortgage portfolio, against condominium projects in Barrie, Ont., London, Ont. and Halifax developed by Edmonton-based Owl Developments Ltd. It advanced millions more to Owl on other projects.[71] The loans directly contravened lending guidelines set out by federal regulators,[72] including stipulations that i) limit a trust company's exposure to a single borrower to 2 percent of its mortgage portfolio;[73] ii) restrict total interim construction lending, or "bridge" financing, to 5 percent of the portfolio; iii) hold the aggregate of all "large loans" to 20 percent of the portfolio; and iv) require trust companies to lend no more than 75 percent of a property's appraised value.[74]

There was still another lending guideline that Standard flouted: a requirement that residential mortgages account for a minimum of 75 percent of its portfolio. A September, 1989 letter from Deputy Superintendant of Financial Institutions Don Macpherson to Standard's president, Brian O'Malley, noted: "The residential component of (Standard's) portfolio was 57.3 percent at March 31."[75] In fact, that figure overstated the amount of Standard's loans that were residential mortgages because the trust company employed what one manager called "a rather liberal" definition for residential mortgages. It routinely classified loans made against office buildings, retirement homes, and hotels as residential mortgages to circumvent restrictions on commercial lending.[76]

Standard was by far not the only trust company with a concentration of commercial mortgages on its books. Most of the recent casualties discussed above and in Chapter 1 had a similar weighting in commercial real estate loans. An astonishing 88 percent of First City Trust Co.'s $1.65 billion mortgage portfolio was on commercial properties, including condominiums and apartment buildings, which fall under the rubric of construction loans and income properties, respectively. Only 12 percent of the portfolio was made up of loans against single-family homes, the traditional stock-in-trade of trust companies.[77] Commercial mortgages are by definition riskier than residential mortgages because they are loans against commercial concerns, mostly income properties that it only makes economic sense to put into bankruptcy if they are not earning enough to service the debt on them. Homeowners, on the other hand, will make huge sacrifices to avoid losing their homes because they have an emotional, not only economic, stake in them.

Opinion is divided on what propelled so many trust companies to pursue commercial real estate lending business with such untempered zeal in the 1980s. Some, such as Trust Companies Association of Canada president John Evans, blamed the industry's asset quality difficulties on archaic federal legislation. " We have been confined by law to the mortgage business and that has forced some companies into lending activities they may have preferred not to enter," Evans told *The Toronto Star* in early 1992.[78] Canada Trust doyen Merv Lahn demurred: "It wasn't legislation that got them in trouble, it was judgement...Management. Management. Management." Added McLean McCarthy analyst Alain Tuchmaier: "Ultimately, it came down to management strategies about the rate at which they wanted to grow the balance sheet."[79]

The incentives most trust companies offered their sales teams encouraged such behaviour. The practice at Standard Trust is instructive here. As at most trust companies, Standard's mortgage team consisted of "originators" and "underwriters." Working in the field, originators (who were often not Standard employees) identified lending opportunities and put together deals, earning lucrative commissions for the business they steered Standard's way. Borrowers paid a "management fee" of between 1.5 percent to 2 percent of a loan's value, half of which went to the originator. Asset generation was, therefore, rewarded, regardless of the quality of the assets being generated. It was up to the underwriter to review the proposed mortgage and decide whether it should be passed on to a five-person credit committee for final approval. An inherent conflict of interest arose, however, because similar pay incentives were also extended to the underwriter -- at least one of whom sat on Standard's credit committee.[80]

Patricia Best uncovered similar circumstances at Royal Trustco Ltd. In a fall 1992 *Canadian Business* article, Best wrote: "To inculcate a sales mindset at the branch level, account managers went on commission...Some insiders swear lenders went on straight commissions with a draw as early as 1987...(Then-president Michael Cornelissen's) pay-for-performance policies meant that a hustling mortgage lender at Royal Trust could earn as much as $150,000 to $200,000 a year...But, says a senior bank executive: "You should never tie a person's incentive to loan products.""[81]

For Toronto Dominion Bank president Robin Korthals, the trust industry's dilemma is evidence in itself of the excess capacity in the banking system. With too many suppliers of credit chasing too few borrowers, lending standards became gradually more accommodating in the 1980s. Marginal projects that would not have been financed in a market in equilibrium, became acceptable in an "overbanked" one. In a *Toronto Star* interview in late 1991, Korthals blamed misguided federal and provincial government policies, which encouraged more lenders to enter the market in the 1970s and 1980s. The situation will only be made worse, Korthals said, by the new (1992) *Trust and Loan Companies Act,* which will abolish limits on trust companies' commercial lending activities. Korthals told *The Star*: "It's easy for politicians to say more competition is great...but they're going to cost our nation a lot of money before they're through, in terms of failures and regulation. Because don't forget that failed competition...represents a huge cost."[82]

Superintendent Michael Mackenzie himself appeared to share this view. Expressing frustration in the face of an ever-growing list of problem trust companies under his watch, Mackenzie said in an early 1992 interview: "The frustration of the regulator is that...you can tell people not to do this or that, don't pay dividends, don't take on this kind of mortgage, or do put in more capital. But none of these solve the basic problem. Instead, the classic way of resolving problems, *particularly in a world where we have more financial institutions than there is need for*, is mergers."[83]

Another characteristic Standard, Central Guaranty, First City, Royal Trust and others held in common was their ownership by a highly-leveraged parent holding company. Establishing holding companies -- such as Standard *Trustco* Ltd., as opposed to its trust subsidiary, Standard *Trust Co.* -- had been the predominant means of investing in the trust industry since the late 1970s. Among deposit-taking institutions, the structure is unique to the trust industry, since banks are prohibited from having upstream owners. For investors and controlling shareholders, the initial attraction of opting for the holding company structure instead of investing directly in a trust company was twofold: leverage and investment flexibility.

As tightly-regulated entities with stringent capital requirements, trust companies have severe restrictions on the amount of debt they can issue. Regulators insist on equity capital, especially common equity over preferred shares. However, holding companies -- which are outside the purview of regulators and are hence, "unregulated" -- were able to circumvent these limitations by raising debt and subsequently investing the funds into their trust subsidiary as equity capital. The attraction of this set up stemmed from the lower cost of capital of debt over equity, since interest expenses on borrowings are tax deductible. The downside of this structure, however, is that leverage carries with it higher risks and debt must be supported by a steady stream of income, in the form of dividends from the trust subsidiary. Equity capital carries with it no such obligations, since dividends are declared at the discretion of a trust company's board of directors.

The second advantage of the holding company set up was that it enabled "trustcos" to engage in a wider variety of activities, such as merchant banking or dealing in penny stocks for their own account. Regulated trust companies, whether federally or provincially chartered, are expressly forbidden from engaging in such activities. As the scope of financial services expanded in the 1980s, many owners found the confines set by trust legislation too constraining and plunged into other business activities through the holding company.

But the holding company structure contains within it the seeds of conflict and presents opportunities for self-dealing. Such conflicts of interest become even more apparent and dangerous if the same team of directors and officers are in place at both the holding company and its trust subsidiary. This proved almost invariably to be the case during the 1980s. Of the 27 directors of Central Guaranty Trustco Ltd., for instance, twenty-six sat on the board of Central Guaranty Trust Co.'s 27-seat board in 1990.[84] The two companies' shared identical senior officers. In such instances, when can minority shareholders of a regulated trust company be certain that directors are acting in their best interest when transactions involve the parent?

The lingering doubts created by the above question can be eliminated in at least three ways: i) by banning all "non-arm's-length transactions" between a trust company and its holding company; ii) by prohibiting holding companies from issuing debt and limiting the range of their activities to holding equity capital in the regulated financial institution alone; iii) by mandating that a significant proportion of the trust company's directors be different from those of the holding company. The Mulroney government proposed implementing the first two in its first policy paper on financial reform, the "Green Paper."[85]

The rejection of the Green Paper, and the government's failure to come up with a policy to replace it until 1990, left holding companies free to operate as they wished during the late 1980s. Self-dealing, which primarily took the form of asset shuffles, proliferated. And many holding companies that had borrowed heavily to inject equity into their trust companies or (more likely the case) to pursue other opportunities and acquisitions, became increasingly dependent on dividend flows from the trust unit to service their debt. This put directors in a potential quandary. As directors of the holding company, they knew they needed the dividends to make debt payments. But as directors of the trust unit, their first concern should have been the sanctity of the regulated entity's capital base. Which concern took precedence? Almost invariably, it proved to be the former. For some holding companies, including Central Guaranty Trustco and Royal Trustco, dividend flows became even more essential since they in turn had controlling shareholders that relied on the upstream flow of dividends. Between 1990 and the first quarter of 1992, Royal Trustco paid out $361 million in dividends while earning a meagre $66 million in accumulated profit.[86] Since its two foreign subsidiaries had not been paying dividends to their parent, Royal Trustco relied primarily on its two Canadian trust units to enable it to maintain dividends to its own parent, Trilon Financial Corp.[87]

With to respect to asset shuffles, an excerpt from the notes to Central Guaranty Trustco's 1990 audited financial statements is indicative of this type of activity. One note on "related party transactions" explains that during 1990, Central Guaranty Trustco purchased for cash $108 million in real estate development and other commercial loans from its parent Central Capital Corp.[88] The asset sale served no useful purpose other than it was a means for Central Capital, struggling under an unconsolidated debt load of some $1.2 billion, to extract short-term cash from its subsidiary. Although the loans were later repurchased by Central Capital, Central Guaranty Trustco had taken on debt to make the cash purchase, endangering its own financial health to help its parent.

In another transaction, in 1989, Central Guaranty Trust, purchased 5.7 million shares of a Central Capital subsidiary, MICC Investments Ltd., from Central Capital. The latter received from the trust company $49.6 million in cash and $34.5 million in preferred shares for the

MICC stake.[89] In addition to providing the cash-strapped parent with a quick $50 million, the transaction allowed Central Capital to book a capital gain of $39.7 million on the sale.

Asset shuffles were, of course, not the only type of related party transactions to occur between trust companies and their parents. One type of self-dealing that was particularly appealing to holding companies was the "participation loan." In such transactions, the holding company took an equity stake in a real estate project under development and further provided 25 percent of the financing in the form of a loan. The other 75 percent was financed with a loan from the trust company. Regulators looked dimly on these kinds of transactions because they were tilted in the holding company's favour, (since it shared in profits from the project's sale), while most of the risk was incurred by the regulated trust company.

Participation loans were a staple of Standard Trustco's business and regulators protested its heavy involvement in them. The Office of the Superintendent of Financial Institutions (OSFI) noted in 1987 that such loans "could be perceived as a form of upstream lending," posing a potential conflict of interest. Again in a 1989 memo, OSFI criticized the practice, stating that "it exposes the regulated (trust company) to greater risk."[90] The loans have also become a point of contention between the liquidator for the trust company and the trustee in bankruptcy for Standard Trustco. In an August, 1992 report to the Ontario Court, General Division, the liquidator asserted that the trust company "may have claims against Trustco totalling in the millions of dollars for losses (it) sustained or will sustain as a result of having funded more than the share of the mortgages than was bargained for with Trustco under the...participation agreement."[91]

Two questions arise naturally from the above discussion. First, are these prudent activities for deposit-taking institutions and, if not, are they the stuff of which public policy should concern itself? Judging from the debate on financial sector reform that raged in the background during the late 1980s, opinion on the first question appeared tilted towards a "no," while there appeared to be a consensus that related party transactions should be subject to some regulatory checks.

Yet, neither question occupied the fore during the public policy row that pitted trust company owners against bankers in the 1980s. Instead, the ownership issue dominated the debate. Of course, ownership regulations can in themselves be a means of addressing the self-dealing problem. (If there are no holding companies there can be no self-dealing between parent and trust, or if wide ownership is mandated, the opportunities for self-dealing are significantly curtailed.) But the ownership issue took on a life of its own and was just as often framed in terms of an "efficiency" argument, as trust company owners and their allies insisted competition, consumer choice and the dynamism of the financial sector were enhanced by their existence. In the face of Canadians' intuitive disdain for their banks, a trait ingrained after many decades, it can hardly be surprising that the trust industry's arguments held some currency for the general public. But ultimately, it was not a desire to enhance competition at the expense of the banks that swayed the Mulroney government into accepting the status quo on the ownership issue. What did lies in the politics of financial of financial sector reform, the subject to which we now turn.

NOTES

1. See Konrad Yakabuski, "U.S. move spark's MP's bid to cap credit card rates," *The Toronto Star*, November 15, 1991.

2. Allan Freeman, "Canadian banks cash in on host of service charges," *The Globe and Mail*, April 2, 1992.

Not all of the increase was due strictly to increases in service charges, as the banks strengthened their fee-generating activities. Fee income rose substantially as the banks began to consolidate the results of their securities subsidiaries after 1987.

3. Canadian Bankers' Association, *Bank Facts 1992* (Toronto: Canadian Bankers' Association, 1992), 4. The following figures in this paragraph are also drawn from the same source.

4. E. Neave, "Canada's Approach to Financial Regulation," *Canadian Public Policy* XV, 1 (1989): 2-3. These percentages are sure to grow further with Royal Bank's proposed takeover of the operations of Royal Trust.

5. Konrad Yakabuski, "Small firms urge banks to loosen screws," *The Toronto Star*, February 21, 1992.

6. Peter C. Newman, *The Canadian Establishment* (Toronto: McClelland & Stewart Inc., 1989), 153.

7. Conference Board of Canada, *The Future of Financial Services: Industry and Regulator Perspectives* (Ottawa: Conference Board of Canada, August 1992), 2.

8. Similarly, when bank chairmen wade into public discourse, they are criticized for being paternalistic. Royal Bank chairman Allan Taylor was accused of just this when his bank released -- during the campaign leading up to the fall 1992 constitutional referendum no less -- a study on the catastrophic economic consequences of Quebec separation. See Royal Bank of Canada, *Unity or disunity: An economic analysis of the benefits and the costs* (Montreal: Royal Bank of Canada, September 1992).

9. Confidential interview, November, 1992.

10. Robert MacIntosh, *Different Drummers: Banking & Politics in Canada* (Toronto: MacMillan Canada, 1991), 23.

11. Ibid., 22.

12. Included in the definition of trust services are ETA (estates, trusts and agency) activities and corporate trust services, such as acting as stock and bond transfer agents. Trust companies were prohibited from engaging in intermediary activities of any sort until the 1920s.

13. While the *Constitution Act, 1867,* formerly known as the *British North America Act,* put banking under federal jurisdiction, the legislation failed to define banking. This is a problem that has plagued regulators ever since, as non-bank institutions have been able to engage in bank-like intermediary activities without having to surrender to federal regulations since they are not, technically and legally, banks.

14. MacIntosh, 209.

15. Patricia Best and Ann Shortell, *A Matter of Trust: Greed, Government and Canada's $60 Billion Trust Industry* (Toronto: Penguin Books Canada Ltd., 1986), 1-2.

16. Ibid., 5.

17. See MacIntosh, 136-141.

18. MacIntosh, 120.

19. Best and Shortell, 27.

20. MacIntosh, 120.

21. Ibid., 206.

22. Ibid., 207.

23. Direct quote from Hansard cited in MacIntosh, 163.

24. Ibid., 208.

25. The creation of a national deposit insurance fund in 1967, to which banks and trusts were required to belong if they wanted to raise deposits from the public, put the trust companies on an equal footing with the banks in the eyes of the general public. Prior to the creation of the Canada Deposit Insurance Corp., trust companies were generally perceived to be riskier places to store one's money than the banks' well-protected vaults. Insurance removed the risk borne by depositors, however, shifting it to the CDIC, and inevitably to the government, since the latter became the de facto guarantor of the fund.

The CDIC, incidentally, was formed in response to the 1965 failure of Stratford, Ontario-based British Mortgage & Trust Ltd. The trust company's demise was linked to its investment in Atlantic Acceptance Corp., a Toronto-based finance company that was itself brought down by its involvement in fraudulent activities. The Ontario government responded to the British Mortgage collapse by announcing its intention to set up a fund to insure deposits. The move in turn forced Ottawa to create a national deposit insurance program. Ontario yielded to the federal government and agreed to withdraw its plan. But Quebec, which had by then acquired the habit of "opting out" of federal programs, decided to set up its own agency. Hence, the CDIC insures eligible deposits in member institutions outside Quebec. In 1967, CDIC coverage was set at $20,000 for most deposits, with the fund financed by premiums paid by member banks and trust companies. In 1983, coverage was raised to $60,000 on most chequing, savings and registered retirement savings accounts. For more on the British Mortgage fiasco -- the first financial institution failure since the 1923 collapse of the infamous Home Bank -- see Best and Shortell, 140-153.

26. Best and Shortell.

27. "Greenmailers," or, more appropriately, arbitrageurs were a fixture on Wall Street in the 1980s. They made quick millions by accumulating stock in takeover targets and reaping profits on the subsequent appreciation in share prices. Sam Belzberg and his son Marc were among the only Canadians to gain notoriety for their greenmailing activities. They were considered active members of junk bond king Michael Milken's circle of associates, and were among the Wall Street insiders who attended Milken's annual "Predator's Ball."

28. See Sonita Horvitch and Ann Shortell, "Royal Trust: Could be a bitter battle," *The Financial Post*, September 6, 1980.

29. Amy Booth, "Royal Trustco Ruckus," *The Financial Post*, June 20, 1981.

30. See Sonita Horvitch, "Changes in the wind at Royal Trustco," *The Financial Post*, March 12, 1983.

31. See Best and Shortell, 53.

32. See Sonita Horvitch, "Canada Trust's coup," *The Financial Post*, January 18, 1986.

33. Cited in Kenneth Kidd, "Canada Trust bars lending to big owners," *The Toronto Star*, April 9, 1986.

34. Ibid.

35. See Sonita Horvitch, "The wary watch of Merv Lahn," *The Financial Post*, May 31, 1986.

36. This figure and those that follow are extrapolated from data in Economic Council of Canada, *A Framework of Financial Regulation* (Ottawa: Ministry of Supply and Services, 1987), 2. The data give an aggregate picture of the assets of all types of financial institutions (including deposit-taking institutions, insurers, finance companies, pension funds, and public sector financial institutions excluding the Bank of Canada) for 1985. By desegregating this information, we have arrived at figures for the deposit-taking sector (banks, trusts and credit unions) alone. They have been singled out because they are the focus of this study and are the only institutions with government guarantees of their liabilities.

Based on total DTI assets of $572 billion, the domestic Schedule A (since renamed Schedule I) banks held $414.8 billion, or 72.5 per cent. Included in this figure are the $42.2 billion held by bank-owned mortgage loan companies. The Big Six accounted for about 94 per cent of the $414.8 billion total, with the remainder made up by regional Sched A's such as the Bank of Alberta, the Bank of British Columbia and the Mercantile Bank.

The Schedule B (now Schedule II) banks accounted for $27.5 billion, or 4.8 per cent of the $572 billion total.

Trust companies, including non-bank mortgage loan companies, had assets totalling $74.8 billion, or 13.1 per cent of the DTI total.

Credit unions, including the credit union central banks, held $55 billion in assets or 9.6 per cent.

37. The Canadian banking sector was opened up to foreign entrants in 1980 by the Liberal government of Pierre Trudeau. It would be erroneous to conclude, however, that the move amounted to a repudiation of the "nationalist" banking policy articulated by Walter Gordon 15 years earlier. Rather, by granting foreign banks the right to set up a Canadian subsidiary, with its own, independent capital structure, the government and the domestic banks aimed to regulate what had until then been the unregulated business of foreign banks in Canada.

This business began to flourish, ironically, as a result of Gordon's nationalist policy itself. When foreign ownership restrictions were imposed in 1967, foreign banks found an imaginative way to skirt the rules. Seizing on the government's failure (to this day) to define banking, they set up provincially-incorporated investment companies, leasing companies, venture capital firms or trust companies. These entities were able to borrow at privileged rates of interest in the commercial deposit markets because they enjoyed the explicit guarantees of the parent, invariably a U.S. money centre bank or a European institution. Because of this guarantee, some of these foreign-owned entities were able to raise deposits more cheaply than the domestic banks. They also had a cost advantage because they did not have to pay deposit insurance premiums.

The activities of these entities multiplied in the 1970s, with assets climbing from $1.3 billion in 1974 to $8.3 billion six years later (see MacIntosh, 171).

The government, with the strong endorsement of the domestic banks, created the Schedule B (now Schedule II) designation to bring the foreign banks under its jurisdiction. As many as 60 foreign banks set up Canadian units after 1980, but a handful have since left. Several others have severely curtailed their operations here during the 1990-92 recession.

Schedule II's differ from Schedule I's in that they are closely-held (by a foreign parent bank, not by commercial interests). The largest among them are the Hongkong Bank of Canada and Citibank Canada. The group was initially subject to an asset ceiling of 16 per cent of the assets held by the domestic banks. When U.S. banks were exempted from this restriction under the Free Trade Agreement the ceiling was lowered to 12 per cent for the rest.

The Schedule II's are not a primary focus of this study because they have not been significant participants in the debate over financial reform and they are almost wholly absent from the retail banking market (with the exception of the Hongkong Bank). Most of these banks have focused recently on activities that fall more within the ambit of investment banking than intermediation.

However, for a good overview on the politics of foreign banking in Canada see Louis Pauly *Opening Financial Markets: Banking Politics on the Pacific Rim* (Ithaca: Cornell University Press, 1988), 94-118, and MacIntosh, 142-188.

38. The eleven were District Trust Co., AMIC Mortgage Investment Corp., Seaway Mortgage Corp., Seaway Trust Co., Greymac Mortgage Corp., Greymac Trust Co., Crown Trust Co., Fidelity Trust Co., Northguard Mortgage Corp., Pioneer Trust Co., and Western Capital Trust Co. In addition to the eleven failures, others, such as North West Trust, were bailed out or transferred to new owners.

39. The figure is cited in MacIntosh (216). Of the $3.2 billion the CDIC paid out to insured depositors of these institutions, it had by 1990 recovered about $2.3 billion from the disposition of assets.

40. A decade later, the Crown trust affair has finally wound its way through the courts.

In October, 1992, Seaway president Andrew Markle pleaded guilty in Ontario Court, general division to 18 counts of fraud totalling $147 million and was sentenced to five years in prison. Markle's guilty plea earned him a rather lenient sentence from Mr. Justice David Watt, who also noted that Markle "had shown good character before the frauds." See Peter Small, "Businessman jailed five years for role in '82 apartment flip," *The Toronto Star*, October 9, 1992.

Markle was widely seen to have been the pawn of Bill Player, who pleaded guilty to 35 counts of fraud in 1987. After serving a third of a 15-year sentence, Player was released on parole in 1992 and is said to be active in real estate in the Calgary area.

Seaway solicitor and director (and one-time owner) Joseph Cornacchia was convicted and sentenced to 3½ years for what the judge in the case described as "looting the treasury." See "Seaway Trust lawyer jailed 3½ years for "looting," *The Toronto Star*, June 9, 1992.

Leonard Rosenberg was sentenced to a prison term in July, 1993.

Accounts of the infamous "Cadillac Fairview flips" abound. One of the best remains Patricia Best's and Ann Shortell's original article on the subject, ("A Matter of Trust," *The Financial Post*, July 9, 1983), which was the basis for a pivotal chapter in the duo's later book of the same name.

41. This assertion was made in a statement by the four Western premiers at the Western Economic Opportunities Conference of July, 1973.

42. *Report of the Inquiry Into the Collapse of the CCB and Northland Bank*, August 1986, 418. (Henceforth, *Estey Report*).

43. Estey, who was then still a top court judge, was hastily seconded by Minister of State for Finance, Barbara McDougall, to hold a one-person public inquiry into the failures. See Bruce Little, "Bank failures prompting tighter rules," *The Globe and Mail*, September 3, 1985.

Estey's 641-page report, cited above, was prepared in record time and is remarkable for its rigour. It has become required reading for students of Canadian banking policy.

The CCB and Northland were, incidentally, shut down on the Sunday of the Labour Day weekend. Even though it had every reason to do so earlier, the government, in choosing to close the banks on this day, may have been taking a page from the tactics of U.S. regulators. South of the border, where officials have more experience in these matters, regulators routinely wait until the next long weekend before seizing an ailing institution. The rationale for this is that the holiday prevents depositors from lining up outside the failed institution for their money. The extra day gives regulators more time to disseminate information so that depositors can be dealt with in a more orderly fashion when the bank does reopen.

44. The federal government paid out $875 million in October, 1985 to compensate the two banks' uninsured depositors -- essentially those with more than the $60,000 covered by the

CDIC on deposit. The CDIC paid out $388 million to insured depositors of the CCB and $318 million to the Northland's eligible account holders.

While the government was clearly worried about how the collapses would play among the general public, it was not the latter that would have had the most to lose had the government not anted up to reimburse uninsured depositors. The vast majority of CCB's deposits belonged to institutional accounts and investors, other financial institutions and public and parapublic agencies. The chartered banks, for instance, had $199.6 million on deposit, credit unions $129.7 million, investment dealers (on behalf of clients) $110.1 million, provincial governments and agencies, $165.1 million, municipalities $81.8 million, corporations $141.8 million. Only $27.1 million in uninsured deposits at the two banks belonged to individuals. See Bruce Little, "Banks, provinces to benefit most in bailout of CCB," *The Globe and Mail*, October 9, 1985.

For an account of the rise and fall of the CCB see Arthur Johnson, *Breaking the Banks* (Toronto: Lester & Orphen Dennys Limited, 1986).

45. While shareholders of the CCB were legally bound by the 10 per cent limit on bank ownership, the bank was, in fact, closer to being a closely-held institution than a widely-held one. Leonard Rosenberg -- whose ownership had proved so fatal to Crown Trust -- ended up controlling between 27 per cent and 33 per cent of the CCB's shares with the cooperation of Bill Player and Andrew Markle. Rosenberg, who was a close associate of CCB chairman Howard Eaton, engineered many deals between his companies and CCB. See Arthur Johnson, "Rosenberg tie gives CDIC stake in bank," *The Globe and Mail*, March 26, 1985.

46. David Stewart-Patterson, "Everyone involved looks bad, House CCB investigation says," *The Globe and Mail*, June 13, 1985.

47. Robin Cornwell, "An Objective Look at the Trust Industry from an Investor's Point of View," Speech to the Trust Companies' Association of Canada annual meeting, April 22, 1983.

48. See "Trust Industry Turmoil," *The Toronto Star*, February 2, 1992.

49. "Policy advisors" within the bureaucracy, in particular, are generally advocates of "positivist" policies toward the financial sector. These include interventionist policies that use the financial sector to produce certain redistributive outcomes, such as regional economic development or an increase in small business lending or residential mortgage financing, that would not result should markets alone dictate the allocation of resources. On this, see Conference Board of Canada, 5-6 and 17-18.

50. The federal Trust and Loan Companies Act of the day limited trust and loan companies non-mortgage loans and investments (including commercial and consumer loans) to 7 percent of assets. Excluded from this so-called "basket clause" were investments in government bonds.

51. Cornwell.

52. Best and Shortell, 40.

53. See "Mortgage rates plummet again," *The Toronto Star*, September 5, 1992.

54. Cited in Best and Shortell, 43.

55. Mark Zelmer, "Recent developments in the trust and mortgage loan industry," *Bank of Canada Review* (June 1991): 14.

56. Bob Leshchyshen, "The Canadian Trust and Loan Industry: An Overview," Unpublished paper, September 1991, 17.

57. Ibid., 3.

58. Zelmer, 8-9.

59. The higher cost structure is the product of essentially two factors. First, smaller trust companies lack the resources needed to automate their operations on the scale of their larger peers and the banks. Second, most trust companies rely on more "expensive" guaranteed investment certificates (GIC's) to fund loans than "cheaper" demand deposits, on which minimal or no interest is paid. GIC's with terms of a year or more accounted for 53 per cent of trust industry liabilities in 1990, while those with terms of under a year made up another 17 per cent of liabilities. Demand deposits (savings and chequing accounts) accounted for only 20 per cent of liabilities. (See Zelmer, 13). By contrast, 54 per cent of the chartered banks' Canadian dollar deposits consisted of demand deposits in 1990. The general exception to this rule is Canada Trust, which has a deposit base that parallels those of the Big Six.

60. See Robert Ulicki, "Canadian Trust Companies: An Overview," (Montreal: Canadian Bond Rating Service, August 1989), 1. The figure for the Big Six excludes special one-time provisions taken in 1987 against loans to less developed countries. The choice to exclude these provisions (the banks routinely reported their profits ex-LDC provisions) from most financial reporting was criticized at the time, and again in 1989 when the banks took even larger provisions against these loans. However, the banks were also praised for adhering to extremely conservative provisioning guidelines, even if the latter were mandated by the Superintendent of Financial Institutions, Michael Mackenzie. By 1990, the banks' LDC reserves reached 40 per cent of their total exposure. By 1992, they began to reap the benefits of their conservatism (on this front, at least) by taking recoveries against LDC provisions. By applying reserves previously allocated against LDC loans against loans Olympia & York Developments Ltd., several banks were able to buffer the gigantesque losses they suffered on their combined $3.1 billion in O&Y loans. The episode led many industry observers to question why Mackenzie had not enforced similar conservatism with respect to provisioning on the trust companies in the late 1980s. Several trust companies, including Royal Trustco Ltd., Central Guaranty Trust Co. and Standard Trust Co., proved later to have grossly underprovided against their delinquent loans.

61. Ibid., 3. Again, the figures cited for the banks exclude LDC provisions.

62. The offshore excursions consisted primarily of LDC lending and expansion into retail banking in selected foreign markets. Several of the banks closed or significantly downsized their retail banking operations abroad beginning in the late 1980s. Some shifted the emphasis of their foreign branches from intermediation to private banking and investment banking activities. On these trends see Sonita Horvitch, "Big Six banks fine-tuning their foreign plans," *The Financial*

Post, May 29, 1989. The exception to this trend has been the Bank of Nova Scotia, which has continued to build retail operations abroad, most recently in Chile and the Philippines. Scotiabank also broke with its peers in becoming the first of the Bog Six to signal its intention to tap the Mexican market by purchasing a 5 per cent stake (the maximum currently permitted by Mexican law) in that country's fourth largest financial conglomerate. See "Scotiabank buys into Mexico," *The Toronto Star*, August 29, 1992.

63. "Super Branch is world class blueprint for 21st century banking," Press Release, Royal Bank of Canada, September 24, 1991.

64. Fee income refers to revenues generated in providing a service to a customer, such as a monthly bank statement that consolidates all of a client's relationships with the bank (mortgage, credit card, savings account, mutual funds, etc.) on a single statement. Sophisticated computer systems have enabled banks to provide such statements, which have obvious appeal to customers, but they normally charge a fee for the service.

Traditionally, the bulk of banks' income has been earned on the spread, or difference, between the rate they charge on loans and the rate they pay on deposits.

Banks' fee-generating activities are likely to expand rapidly under the new *Bank Act*, which allows the banks to set up wholly-owned "information service corporations." The banks are likely to become major providers of data-processing services, since they already have the computer capacity to enter this business. The shape of things to come was signalled by the fall 1992 purchase of payroll services company Comcheque by the Canadian Imperial Bank of Commerce.

In describing the government's decision to allow the banks into the data-processing business, one government official commented: "We sat down and said to ourselves: Is (banking) a money business or an information business? You can probably equally make the case that its an information business, so why don't we allow these guys to be more in the information business? If (Bell Canada parent) BCE Inc. is going to own a trust company (Montreal Trustco Inc.), then why can't the banks be more in the information business?" (Confidential interview, November, 1992.).

65. EDI allows, for instance, companies to pay their suppliers directly via a telephone line hook-up with both parties' bank or banks. The major banks launched their EDI services in 1991, a development that is certain to improve the speed and efficiency of the payments system.

Debit cards enable customers to pay for goods and services by directly withdrawing the money from their banks accounts at the point of sale. The Interac Association (whose chartered members consist of the Big Six, Canada Trust and the central bank for the country's credit unions) has launched pilot projects in certain regions and plans to roll out the service nationally in the near future.

Image processing will eventually allow institutions to produce computer generated images of cheques on deposit, and subsequently transmit the image through the payments process instead of the cheque itself. The procedure improves both speed and cost-effectiveness of the payments system and banks' own data-processing capabilities. See Michael Quint, "Balances without any cheques," *The New York Times*, September 11, 1991. In Canada, the Canadian Imperial Bank of Commerce is the most advanced in developing this technology. In late 1991, the bank began offering customers monthly statements with computer-generated images of cancelled cheques instead of sending them a stack of the real thing. In addition to the marketing appeal of this service, the so-called "Double Cheque" service also promises banks' important savings on postal costs.

Telephone banking permits retail clients to perform basic banking transactions, such as bill payment and transfers between accounts, by phone. While most of the Big Six offer this service to customers in selected regions of the country, the CIBC offers the service cross-country.

The telecommunications expenditures required to offer these and other services are prohibitive. According to information provided by the Canadian Bankers' Association, the Big Six's telecommunications expenses totalled $440.4 million in 1990, up 56 percent from 1986. Those expenditures do not of course include the hundreds of millions spent on computer software and hardware, which have increased by 250 percent since 1982. (The banks do not disclose their actual computer expenditures for apparently proprietary reasons.)

66. Financial services includes finance, insurance and real estate.

67. See Harvey Enchin, "Financial services retrench with employees the victims," *The Globe and Mail*, December 5, 1992. The figure does not include CIBC's plans, announced in December, 1992, to cut 2,500 employees in fiscal year 1993. Overall, employment in Canadian banks (Schedule I and II) fell 1.1 percent to 196,400 between August, 1991 and August, 1992. Trust company employment slid 2.6 percent to 33,700 in the same period, while credit unions employed 26.4 percent fewer employees (49,100 overall), according to Statistics Canada data.

68. There are, of course, striking exceptions to this rule, such as Canada Trust and, perhaps, National Trust. The former has stood apart from its trust industry peers for decades, even pulling out of the Trust Companies Association in 1985. It has instead emulated the banks and, in fact, beat many of them at their own game. National has prospered by "sticking to its knitting" as it were -- lending against single family homes in the until-recently burgeoning industrial heartland of Southern Ontario.

69. Non-performing loans surged to 3.5 percent of total loans in 1990 from about 1.2 percent in 1989 at the country's small trust companies, according to Leshchyshen (18). Large trusts' NPL ratio was 1.4 percent in 1990, compared to 0.4 percent a year earlier. By June 30, 1991, the ratio had reached 2.3 percent. It should be noted that the ratio would be considerable higher had Canada Trust and National Trust not been included.

Obtaining industry wide data for more recent periods has proved difficult, since many analysts have stopped covering the trust sector due to a lack of investor interest. The Trust Companies Association does not track the aggregate performance of its members either.

70. See "Standard kept bank regulators at bay, records show," *The Toronto Star*, September 8, 1992. The comment was made by Keith Bell, a senior official in the Office of the Superintendent of Financial Institutions and its predecessor, the Department of Insurance. The comment was disclosed in confidential minutes of a meeting between regulators and Standard's top managers. A copy of the minutes were obtained by *The Star*.

71. See "Sleepy trust firm ended up in '80s nightmare," *The Toronto Star*, July 24, 1991.

72. The guidelines were drafted by the Canada Deposit Insurance Corp. in the 1970s and were subsequently applied by examiners in the Office of the Superintend of Financial Institutions. Although they are not legally binding, the superintend has the legal power to enforce them by issuing "directions of compliance" to trust companies that fail to observe its lending guidelines. A trust company that disregards a direction from OSFI can have its licence suspended by the superintendent.

It was not until Standard was on its last legs, in mid-1990, that Superintendent Michael Mackenzie issued a "notice of intention to issue a direction of compliance" against Standard, to prevent the trust company from paying a dividend to its parent. The superintendent subsequently ordered Standard to give it an undertaking to turn away deposits above the $60,000 insured by CDIC and place deposits in one of an approved list of eligible investments. Needless to say, commercial mortgages were not among them. This information is contained in correspondence between OSFI and Standard that was filed in Ontario Court, General Division, in connection with its liquidation.

73. Standard exceeded this limit in about a dozen cases in addition to Owl, according to a list of its mortgages filed in Ontario Court, General Division at the time it was put into liquidation in 1991.

74. This regulation, unlike the others, had the force of the law behind it, since it was contained in the federal Trust and Loan Companies Act.

75. This letter was also filed as an exhibit in Ontario Court, General Division in connection with Standard's liquidation.

76. See "Sleepy trust firm...".

77. First City Trust Co., *Annual Report 1990.*

78. See "Trust Industry Turmoil."

79. Ibid.

80. See "Sour real estate loans leave empty legacy," *The Toronto Star*, August 7, 1991.

81. Patricia Best, "Royal Bust," *Canadian Business* (November 1992).

82. See "Confessions of a philosopher banker," *The Toronto Star*, November 24, 1991.

83. Interview with the author March 22, 1992. Emphasis added.

84. Central Guaranty Trustco Ltd., *Annual Report 1990*, 37.

85. See Department of Finance, *The Regulation of Canadian Financial Institutions: Proposals for Discussion*, (Ottawa: Ministry of Supply and Services, 1985), 33, 36. The government finally opted in 1991 to implement strict controls on self-dealing and require financial institutions to adopt tougher and more formal corporate governance procedures, which are to be overseen

by mandatory sub-committees of the board of the directors. The government also added a requirement to the new *Trust and Loan Companies Act* that at least one-third of directors be unaffiliated with the company.

86. See "Troubles at Royal Trust," *The Toronto Star*, July 19, 1992.

87. The extent of that reliance is unknown since Royal Trustco does not disclose the financial statements of its wholly-owned Canadian trust units, Royal Trust Co. and Royal Trust Corp. of Canada. Royal Trustco cut its 18.5-cent quarterly common share dividend to 10 cents in late July, 1992 and subsequently lowered it again. It continued to pay a nominal common dividend, however, even after losing $243 million in the third quarter of 1992. Needless to say, the payment of dividends in excess of earnings has depleted Royal's capital base substantially.

88. Central Guaranty, 20.

89. Ibid., 16.

90. See "Standard Trust in worse shape than liquidator thought," *The Toronto Star*, August 10, 1992.

91. Ibid.

CHAPTER 4

FROM WHITE TO GREEN: THE ORIGINS OF FINANCIAL SECTOR REFORM

Bob MacIntosh, the president of the Canadian Bankers Association, couldn't believe his ears.

"They're fools," he snapped.

"Bob," Helen Sinclair countered, "they don't believe in it anymore."

It was late 1982 and Sinclair, MacIntosh's assistant, had just returned from a meeting of the CBA's pivotal Financial Institutions Committee. The committee, made up of a handful of vice-presidents from the Big Six banks, was charged with formulating the industry's position on regulatory issues. And, at the session Sinclair had just attended, the group had signalled that the staid, conservative world of Canadian banking was on the verge of a long period of profound change and upheaval. What the bankers present at the meeting no longer believed in, as Sinclair put it, was the long-sacrosanct principle of "pillarization" under which the Canadian financial system had operated since its beginnings.

MacIntosh, who was then only months shy of his 60th birthday, had strong reservations about the banks' new stance. Having spent most of his 30-years in banking climbing the ranks of the Bank of Nova Scotia, MacIntosh's career had up to then spanned what had perhaps been the most glorious days for the Big Six: the prosperous post-War decades. He believed in tradition. As chairman of the CBA committee that led the negotiations with Ottawa leading up to the 1980 *Bank Act* revision, MacIntosh had endorsed the new legislation's reinforcement of the "pillarization" concept. Pleased with his performance, the banks' asked him in 1980 to become the first full-time president in the CBA's nearly century-old history.

After the 1980 revision, however, the committee, made up of some of the banks' most senior executives, disbanded. In its place, the Financial Institutions Committee was struck. It was comprised of more junior-ranking executives,[1] its membership reflecting top bankers' belief that the saliency of regulatory issues would ebb until the late 1980s, when talks would begin on the next decennial up-date of the *Bank Act*. Within months, however, regulatory change was back on the agenda and the new wave of bankers charged with drafting the industry's position on regulatory policy were steering it toward the uncharted waters of depillarization. The turn was nothing short of revolutionary.

For decades, banks, trust companies, insurers and investment dealers had observed a practice -- partly entrenched in law and partly the product of convention -- whereby each had exercised an exclusive, core function that the others could not. Banks had to themselves the field of commercial lending, which consisted mostly of short-term credit to businesses; trust companies were the only institutions able to perform fiduciary services, such as the management of estates and acting as stock and bond transfer agents; insurance companies alone were empowered to underwrite life insurance and issue annuities; investment dealers dominated the domain of market intermediation, underwriting corporate stocks and distributing them to the investing public.

So rooted in Canadian tradition was the "pillarized" structure of the financial system that it went unchallenged and unquestioned for more than a century on grounds that might best be described as "Burkean." In defence of the "organic," hierarchical social structure of 18th century England, which he believed protected, not diminished, the Englishman's liberty, conservative political thinker Edmund Burke wrote:

> Thanks to our sullen resistance to innovation, thanks to the cold sluggishness of our national character, we still bear the stamp of our forefathers...We fear God; look up with awe to kings, with affection to parliaments, with duty to magistrates, with reverence to priests and with respect to nobility. Why? Because when such ideas are brought before our minds, it is *natural* to be so affected...[2]

Much in the same way, then, the four pillared-structure of the Canadian financial system had endured because it elicited reverence on the part of policy-makers and the banks. Just as Burke believed political liberty was best guaranteed by an ordered and stable social structure, policy makers and financial executives believed the probity and prosperity of the financial system was best assured through pillarization. Each pillar was seen as an essential and constituent part of an organic whole. A society tampered with such venerable structures at its peril.

By far the greatest defenders of the status quo were the banks, which sat at the apex of the financial hierarchy. Conservative to the core, bankers had resisted change above all. When change had been imposed from above, such as when Prime Minister Louis St. Laurent decreed in 1954 that banks would henceforth be allowed into the residential mortgage market, they accepted it only grudgingly. Again in 1980, the banks tacitly endorsed the federal government's decision to formally bar them from underwriting or distributing corporate debt and equity.[3] Before the 1980 *Bank Act* revision, the banks had not been explicitly forbidden from entering the securities business. But, respectful of the pillarized structure of the financial system, they had chosen not to trample onto investment dealers' turf. Nor is there any evidence that they ever had the urge. For they believed banking differed fundamentally from securities underwriting, and different character traits and cultures separated bankers from investment professionals. The banks exhibited the same attitude when the government inserted another clause into the 1980 *Bank Act* prohibiting them from managing mutual funds, an activity tantamount to acting as both portfolio manager and trustee, even though the banks had for decades operated trust subsidiaries outside of Canada.

By 1982, however, the banks were beginning to regret their complacency of only two years earlier. They now saw the right to underwrite corporate securities and the ability to exercise fiduciary powers at home as essential to their future prosperity. What precipitated this "sea change" in attitude, as one bank lobbyist described it,[4] was a sudden recognition that the world around them was changing rapidly and they would have to adapt to it if they were to maintain their dominant presence in the Canadian financial system. Most of the new "banking" products being developed and pedalled by their foreign counterparts looked more like securities than commercial loans. In place of lending to companies directly, many banks were instead guaranteeing corporate securities such as commercial paper, making such instruments more attractive to investors and lowering firms' cost of capital. Where banks in the past relied almost exclusively on interest on loans, the fees earned in providing such guarantees and on other services, such as arranging cross-border mergers, were starting to account for a much bigger share of their revenues. At the same time, the rapid growth in cross-border capital flows, coupled with the desire of companies and wealthy individuals to diversify their investments internationally, provided new business opportunities for banks that fell more within the rubric of asset management and trusteeship than banking.

Meanwhile, banks were witnessing the entry of new players into the financial domain as commercial entities snapped up or incorporated financial institutions. General Motors Acceptance Corp. and the financing arms of other automakers and manufacturers, although not new to the game, were competing more aggressively in the early 1980s to win a bigger share of the consumer credit market. In the U.S., department store giant Sears Roebuck & Co., the country's biggest life insurance company, Prudential Insurance Co. of America, and charge card king American Express Co. each bought a securities firm[5] in the early 80s. Not surprisingly, U.S. banks began clamouring for the rescinding of the *Glass-Steagall Act*, the 1933 legislation that had barred them from the securities business. American banks were also forced to adapt to new competition for their client base when the 1982 *Garn-St Germain Act* vastly broadened the lending powers of savings and loan associations,[6] enabling the latter to outgrow their traditional role as residential mortgage lenders and compete directly with the banks for commercial clients. These seismic shifts in the financial services terrain had their roots in two mutually-reinforcing developments: the internationalization of financial markets and advances in computer and telecommunications technology.

The globalization of financial markets traces its origins to the emergence, in the 1960s and 1970s, of the London-based "Euromarket." The latter acquired its name because the then almost exclusively U.S. dollar-denominated market sprang up outside the purview of U.S. regulators and the central bank, the Federal Reserve Board. Instruments denominated in other currencies -- from Japanese yen to German marks and Canadian dollars -- eventually came to be traded there, as well. But the market's essential, extra-regulatory nature has been preserved and is at the root of its success. Financial institutions active in the Euromarket face *ceteris paribus* lower costs because they are exempt from various regulatory requirements, such as holding a portion of the deposits they collect as reserves with the central bank. A dollar raised in deposits in the Euromarket is a dollar that a bank can lend out and earn interest on. A dollar's worth of deposits raised at home is more likely to leave 90 cents or 95 cents to lend after reserves.

The Euromarket, arguably one of the capitalist world's most efficient markets, ironically owes its birth to the Soviet Union. Eager to protect the U.S. dollar reserves they needed to conduct trade with the West from Cold War American authorities, the Soviets shifted their U.S. currency balances to European banks in the 1950s and 1960s. Between the time Soviets received U.S. currency as payment for their exports to the West and the time they spent the funds on imports, they deposited the funds with banks in Britain and France, which subsequently invested them in U.S. dollar-denominated securities.[7]

Another prime factor leading to the rise of the Euromarket lay in a single U.S. regulation that engendered a shift of capital from that country to Europe. Until the early 1980s, the U.S. Federal Reserve's "Regulation Q" limited to 6 percent the interest rate banks could offer on deposits held in the U.S. To escape this limit, a number of U.S. banks opened European offices and accepted U.S. dollar deposits at higher rates than those offered in the U.S.[8] And, as Levi notes, because banks operating in the Euromarket were not subject to holding non-interest bearing reserves "the cost of operations in Europe was reduced... This encouraged U.S. banks to move some of their depositors' accounts - including the accounts of many Americans - to the relatively unregulated European market."[9]

On this foundation, then, the world of international banking was built. From about $110 billion in 1970, to $450 billion in 1975, the size of the Eurocurrency market was estimated by the mid-1980s at more than $2.5 trillion. The Eurobond market has grown at the same astounding pace. In 1963 there were only 13 Eurobond issues and the total size of the market was less than $150 million. By 1980 funds raised on the Eurobond market exceeded $25 billion. Between 1980 and 1986 funds raised on international bond markets grew by a factor of six[10] increasing the size of the Eurobond market to more than $135 billion in 1985.[11]

It was not only U.S. regulatory and tax policies that prompted financial institutions to branch out from their home jurisdictions into greener financial pastures. Dozens of countries, principalities and cities structured tax laws and regulatory policies so as to nurture the development of international financial centres within their borders. Tax havens, such as the Cayman Islands and Jersey, are well-known in the world of international banking. Similarly, Singapore emerged as an international financial centre (IFC) in the early 1970s primarily through the tax concessions it offered financial institutions active in the "offshore" Asian dollar market. "Offshore" or international banking centres were subsequently established in a number of locations, including the United States and Tokyo. As one observer explains:

> ...National regulatory authorities permitted banks to establish special "offshore" facilities - typically, segregated accounting units - for conducting transactions with foreign customers or transactions in foreign currencies. In effect, banks were permitted to carry out "offshore" transactions as though the facility was physically located in the home nation. Regulations, supervision, and taxation were altered to discriminate in favour of offshore transactions.[12]

By 1987, offshore banking centres accounted for $973 billion, or 21%, of deposit banks' foreign liabilities of $4.73 trillion.[13]

International banking received its impetus from more than political, regulatory and tax policies, however. Trade imbalances were, and continue to be, central to its growth. Because the U.S. dollar was and remains the foremost currency of international trade, countries with large current account surpluses accumulated large reserves of U.S. dollars which, for the most part, were subsequently recycled through the Eurodollar market and loaned to importing countries. The most oft cited example is that of the vast sums of "Petro-dollars" earned by oil-producing countries in the 1970s, which were recycled, initially through the Eurodollar market, and subsequently through offshore banking centres, such as Bahrain.

Necessity is the mother of invention, or at least innovation, and the 1971 breakdown of the post-War "Bretton Woods" agreement (which had pegged the developed world's currencies to the U.S. dollar) engendered a great deal of it. The adoption of floating exchange rates after 1971 upped the risks of doing business in foreign currencies, giving rise to a proliferation of new financial instruments, such as forward contracts, and currency futures and options, as a hedge against exchange rate fluctuations. These instruments enjoyed their initial popularity among companies active in international trade, which were willing to pay for the peace of mind that a forward contract offered. But the appeal of dealing in currencies and the derivative financial instruments they spawned soon attracted others, including arbitrageurs and speculators, to the game. By the mid-1980s foreign exchange transactions exceeded $150 billion per day or $35 trillion per year,[14] dwarfing by more than a factor of ten the $2.5 trillion worth of world trade goods and services in 1985. By 1992, daily volume approached $1 trillion.[15]

To accommodate the increase in international financial flows, financial institutions significantly enhanced their investments in advanced technology, in the areas of telecommunications and computers. Whether the internationalization gave rise to technological advances or the other way around, the symbiotic relationship between finance and technology deepened to the point of almost perfect interdependence. Each flourished because of the other.[16] *The Economist* noted in 1989 that without the mainframe computers that they began implementing in the 1960s, "British banks would need to employ the country's entire population to deal with the business they now do."[17] The growth of interbank transactions in the Euromarket necessitated improvements to the paper- and labour-intensive methods of clearing and settling international transactions. The first such improvement came in 1970 with the creation of the Clearing House Interbank Payments System (CHIPS). In 1987, approximately

25 million fully automated transactions were processed for 138 member-banks, with an average daily volume of $300 billion.[18] In 1972 the Society for Worldwide Interbank Financial Telecommunications (SWIFT) was formed to transmit international payments instructions. When it came into operation in May, 1977, SWIFT carried about 800 banking transactions daily. By the late 1980s it was able to carry close to one million such transactions daily.[19]

A concomitant by-product of telecommunication advances was the advent of 24-hour global trading on stock, option, currency and commodity exchanges. By the mid-1980s, stocks interlisted on the Toronto and Tokyo Stock Exchanges, such as BCE Inc., could be suddenly traded by securities dealers with a seat on either exchange at the most advantageous price.

Technological advances also facilitated innovation,[20] which became another dimension of the internationalization of financial markets. Beginning in the 1970s, hundreds of new financial instruments and products were developed. Market-broadening instruments, such as note issuance facilities (NIFs), Eurocommercial paper, and revolving underwriting facilities (RUFs) and risk management instruments, such as forward contracts and currency options revolutionized the financial services industry. They also radically changed the nature of banking. Instruments such as Eurocommercial paper and (now out of use) NIFs enabled corporations with good credit ratings to tap financial markets directly for funds, by-passing their banks for credit -- a trend that became known as "disintermediation." Where banks did become more important was in the provision of risk management instruments like swaps. These services generated fees for banks, displacing their traditional source of revenues -- interest on loans.

Banks themselves jumped to take advantage of the deepening of financial markets by packaging pools of loans and selling them as securities to investors. In doing so, they no longer incurred the risk of the loans going sour, instead charging fees to investors for administering the loans and collecting interest payments on their behalf. This process became known as "securitization." U.S. banks were the first to actively engage in securitization by selling off pools of home mortgages as early as the mid-1970s. By 1985, the global volume of securitized loans had reached $84 billion. Two years later, it was $637 billion.[21]

This, then, was the brave new world of financial services that led Canada's Big Banks to question the long-held principles of pillarization. When the CBA's Financial Institutions Committee met in 1982, some of trends in international finance described above were well-established, others were only in their nascent stages, and still others had not yet evolved past the conceptual stage. But it was clear that the business of banking was being irrevocably altered and banks around the world were transforming themselves to adapt to it. The bankers on the CBA committee knew they could not stand still; nor could they afford to embrace change at their leisure. As one bank lobbyist recalled the events surrounding the banks' sudden decision in 1982 to push for depillarization -- a concept then still limited to the merging of commercial and investment banking:

> It (the changes in international banking) was happening so quickly then. The banks were starting to get worried about the securities business in the world. They thought it was going to get so globalized. Before that, most of the bankers never believed banks should be in the securities business, were wildly against it.[22]

What made the globalization of securities markets even more threatening for the Canadian banks was that their best domestic clients -- the federal government, the provinces, and triple-A-rated corporations -- were adapting to it faster than they were. Between 1963 and 1970, almost 73 percent of Canadian bond issues were placed in Canada and the rest largely in the U.S.[23] The banks benefitted from this arrangement because they had the power to underwrite the debt securities of the biggest issuers -- Ottawa and the provinces. Between 1981 and 1987, however, only 53 percent of Canadian bond issues were placed in Canada, while 36 percent were placed outside North America -- mostly in Euromarket and Japan.[24] And, more often than not, Canadian borrowers that went abroad for funds procured the services of foreign financial institutions. Canadian institutions managed only 44 percent of all Canadian-dollar Eurobond issues between 1980 and 1988,[25] while the federal government employed exclusively foreign institutions to manage its 10 Eurobond issues during the same period.[26] It became apparent that Canadian banks would have to achieve greater economies of scale in their securities operations in order to compete for a bigger share of Ottawa's business. That meant acquiring the powers to underwrite and distribute corporate debt and equities, not just government debt.

This realization came faster to some banks than others. The Toronto Dominion Bank seized on the deregulation of brokerage commission rates in April, 1983 to launch its "GreenLine" discount brokerage. With its advanced computer systems and 1000-branch distribution network, the bank could charge lower commissions than a Bay St. dealer with higher overhead costs. But the TD's move provoked outrage from the established dealers, eager to maintain the fences that had spared them competition from other financial institutions, and they pressured the Ontario Securities Commission to hold a hearing into the matter. In October, 1983, the OSC ruled that, as long as GreenLine only processed unsolicited orders for stocks, it was doing nothing wrong.[27] The OSC reiterated, however, that underwriting and the provision of investment advice would remain the preserve of the dealers. But the die was cast: a major bank was now selling equities and the pillars continued to crack.

If the GreenLine episode was not in itself enough of a catalyst to prompt the rest of the banks to start pushing for regulatory change, the ground-breaking steps taken by the Quebec government in 1983 and 1984 were. Under the aegis of Parti Quebecois Finance Minister

Jacques Parizeau, the Quebec Securities Commission opened up the province's securities industry to other financial institutions in 1983, and allowed brokerage houses to diversify into other financial activities. The practical impact of this shift was minimal at the time, since Ontario, where more than three-quarters of the country's capital market transactions took place, still maintained a 10 percent ownership limit on investment dealers. Hence, a wholly-owned Quebec dealer would not have been able to do business in Ontario. "But," as Parizeau told author Matthew Fraser, "the door was opened and a few of the large institutions in Quebec started to buy 10 percent stakes in some brokerage firms. They knew that if the rules changes in Toronto they had the right to go up from there to 100 percent. They had put in a toe."[28]

The other shoe dropped in June, 1984, when Parizeau entrenched the concept of depillarization in law with the introduction of Bill 75. The new legislation empowered insurance companies to i) diversify into all areas of financial services through a downstream financial holding company; ii) raise deposits directly from the public; iii) and engage in more commercial lending. The same powers, the government made it known at the time, were to be extended to trust companies and caisses populaires in future legislation. The legislation also allowed Quebec-chartered mutual life insurance companies to form downstream holding companies that could raise debt and equity on public markets, improving their access to capital. What inspired the new rules was Parizeau's desire to create more fertile soil for Quebec-based financial conglomerates, a strategy that constituted a key plank in the separatist government's overall goal of repatriating control of the Quebec economy and enhancing the economic prowess of indigenous industries. Considering that Parizeau had first articulated his vision 15 years earlier, the changes he brought forward in 1983 and 1984 should not have surprised anyone.[29] But it was only as Quebec-based institutions such as the Laurentian Life Assurance Co. rushed to take advantage of the legislation, transforming themselves into financial conglomerates with holdings in deposit-taking institutions and stock brokerages, that the banks began to take notice.

Meanwhile, the push for regulatory change was emerging on another front as the trust industry began aggressively pressing Ottawa for wider business powers. The lobbying for attention had actually begun during the late 1970s while Ottawa was soliciting input on changes to the *Bank Act*. During its consultations with the financial services industry, the Trust Companies' Association and influential individuals from the industry voiced their discontent at the fact that the banks had their legislation updated every 10 years, while the *Trust Companies Act* had not been modernized in more than four decades. Hence, the Liberal government of Pierre Trudeau undertook to review the legislative framework for the trust industry once the *Bank Act* was put to bed for another decade.

The embodiment of that pledge was a White Paper, in form of draft legislation, tabled in 1982. The Trudeau White Paper aimed primarily to update some of the technical provisions of the federal *Trust Companies Act* and *Loan Companies Act*. But while it was clearly rooted in the pillarization vein, the White Paper contained four proposals that would have significantly altered the shape of the country's trust industry. First, it would have allowed federally-chartered trust companies to hold up to 15 percent of their assets in non-mortgage, commercial loans; second, it proposed allowing trust companies that wanted even greater commercial lending powers to convert into federal savings banks; third, it would have prohibited a single shareholder from owning more than 10 percent of trust company with more than $1 billion in assets and fourth, it proposed to empower the Minister of Finance to block share transfers above 10 percent.

The White Paper was essentially the last gasp of the old guard of trust company managers, such as Canada Permanent's Eric Brown and Royal Trust's Ken White, on a crusade to protect their industry from the likes of corporate raider Robert Campeau. As one trust industry source described it, the White Paper "was basically the management of the bigger trust companies trying to protect themselves from takeover."[30] But the draft legislation's fate was essentially decided before it was tabled, as the Toronto Bronfmans' Brascan Ltd. and the Reichmanns' Olympia & York Developments Ltd. secured their lock on Royal Trustco Ltd. during 1982. For Brascan and the rest of the new wave of trust company owners, the 1982 White Paper was simply unacceptable. They had invested in the trust industry not because they foresaw opportunities in the fiduciary side of the business, but rather because they recognized the synergies that could be had by adding a financial intermediary to their stable of business interests. They wanted not only full commercial lending powers for their trust companies, but the ability to branch out into other areas of financial services and create "networking" arrangements between their various financial institutions.

It goes without saying that the 10 percent ownership limit proposed in the White Paper was a non-starter with the new breed of trust owners. The proposal was opposed on economic grounds --it was argued that the 10 percent limit would have nearly quadrupled the industry's capital requirements[31] -- as well as ideological grounds. As Sandy Ross wrote in *Canadian Business* in 1983:

> The men who run the Canadian banking system are hired hands who don't own anything; (Trust owner Hal) Jackman's entire world view, like his father's before him, is built around the sturdy virtues of private ownership. His objections to the federal proposal, accordingly, are as much philosophical as they are financial.

Neither Power Corp.'s Paul Desmarais, who controlled Montreal Trustco Inc., nor Bronfman operative Trevor Eyton were prepared to stand idly by while their holdings were in essence expropriated. But the two made surprisingly few public comments to that effect, leaving the articulation of policy positions to the hired hands who ran their trust operations: Robert Gratton at Montreal Trust and Michael Cornelissen at Royal Trust.

The one trust owner who took a different tack was Hal Jackman, who controlled National & Victoria Grey Trustco Inc. (now National Trustco Inc.), as well as Dominion of Canada General Insurance Co. and the Empire Life Insurance Co. While properly a member of the Old Guard, whose family had deep roots in the Toronto business establishment, Jackman's views on ownership meshed more neatly with those of the new guard. "I believe in proprietorship," he told Sandy Ross in 1983.[32] And he was assiduous in letting his views be known. As Patricia Best and Ann Shortell noted in 1985: "Jackman meshes business with politics in an overt way, while the Bronfmans, Desmaraises, and the (Conrad) Blacks of this world do their politicking behind closed doors."[33] With generations-old Tory connections, Jackman had been a three-time candidate for the Progressive Conservatives in Rosedale, while Sommerville was a long-time Liberal party activist.

Although National was an Ontario-chartered trust company and would not have been directly affected by the White Paper's proposals on ownership,[34] Jackman spearheaded the industry's public campaign to stop the draft legislation in its tracks. His public stance stemmed in part at least from a desire to prevent a similar move by the Ontario government, which was also in the midst of reviewing its trust legislation. Typical of the pleas Jackman made to politicians and the public were the following:

> We do not have four pillars. We have one pillar -- a veritable colossus -- the chartered banks and three very weak saplings which run the risk of disappearing altogether if the powers of the banks are allowed to expand at the expense of other intermediaries. Not only is the size of our banking system an issue, it is the concentration of power by five large banks within the system that is the issue.[35]

> The Canadian banking system is too much under the control of the big players, the big corporations. I'm not going to give you a populist line, but you do need a balance. I don't think we'll get that balance unless you get smaller financial institutions making commercial loans.[36]

Comments like those put the banks on the defensive. Their early hopes of controlling the pace of regulatory change and working it to their advantage had been shattered by the Quebec government's moves. And now, the trust industry had adopted an aggressive stance, exploiting public concerns about the cartelistic nature of the banking system to press for new powers. In response, the banks claimed to welcome competition -- as long as it played by the same rules they did. The CBA seized on the ownership issue, arguing for an extension of the 10 percent rule to trust companies on the grounds of establishing a "level playing field."[37] But while prominent trust company owners led the public campaign for their industry, the chairmen of the Big Banks deferred to the CBA's president Bob MacIntosh. The latter argued in late 1983:

> If you want to talk about concentration of ownership and control, it is quite ludicrous to point a finger at large banks which are widely-held. One might more usefully look at the concentration of conglomerate financial power in the hands of single families in this country, through financial holding company structures. Thus we have a little club of trust company owners who evidently have more political and financial power than everyone else put together, and politicians seem to accept this with remarkable equanimity.[38]

With the financial services industry speaking increasingly in a bifurcated voice and waging an internecine battle in the public eye, the federal government was suddenly confronted with a political problem. Until then, public policy relating to banks and trust companies was largely eked out separately and in private. Ottawa proceeded in this vein during the 1980 *Bank*

Act revision and the drafting of the 1982 White Paper: the Inspector-General of Banks, the top supervisory agency, and the Bank of Canada were put in charge of the former, while the Department of Insurance, which then regulated trust and insurance companies, produced the draft trust legislation. For the purposes of generating public policy, this was a nice fit that eliminated much of the potential for conflict. The banks had their sponsors in government in the form of Inspector-General Bill Kennett and central bank governor Gerald Bouey; the trusts had theirs in Superintendent of Insurance Dick Humphrys. On issues where a particular government policy created an advantage for one side --such as the opening up of the home mortgage market to banks in 1967 -- rarely was opposition raised by the other. By the early 1980s, that situation was no more and, accordingly, the government was forced to adapt to the new reality.

Under the aegis of deputy finance minister Mickey Cohen, primary responsibility for financial institutions policy was shifted in 1983 from the regulatory agencies to the finance department's Capital Markets Division. Until then, the division had largely occupied itself with structuring the federal government's borrowing programs. With a new and enlarged mandate, the division was renamed the Financial Sector Policy Branch in 1984. One senior government official explained the genesis of the reorganization this way:

> The formation of the (financial sector) branch came out of a process of the DM (deputy minister) saying, "Well, hey, maybe we need a group of people looking at financial services policy as a whole, instead of running it out of two or three places...I think there was a recognition, partly from the industry, party from the political policy-making process, that there were a bunch of bigger issues to deal with, like depillarization, like ownership. And, therefore, you saw a much bigger role for broader policy people like finance, as opposed to the OIGB (Inspector-General) guys.[39]

Meanwhile, with legislation and studies proceeding apace in Quebec and Ontario, the federal government sought to reassert its role in setting the direction for financial services policy. Trudeau appointed Toronto MP Roy MacLaren as Minster of State for Finance in August, 1983, giving the advertising executive and publisher a mandate to formulate a policy to replace the White Paper, which by then was acknowledged to be unsalvageable. MacLaren had solid credentials for the job. As an entrepreneur and small business owner -- he controlled *Canadian Business* publisher C.B Media Ltd. -- MacLaren was sensitive to the difficulties many businesspeople faced in raising capital. Vancouver born and raised, he also identified with regional discontent about the banks. On economic policy, his Liberalism lined up squarely with the policies of Finance Minister John Turner in the early 1970s -- a free trader and advocate of competition -- rather than the interventionist and protectionist stance Turner later adopted as Liberal leader. While a member of the private sector in the mid-1970s, MacLaren had chaired a federal task force on business-government relations and he had a firm grasp of economics, having supplemented a master's degree from Cambridge University with studies at Harvard University's graduate business school. He was particularly well-informed about events in the global economy, having developed a heightened appreciation for international institutions and economic interdependence while representing Canada in several capacities at the United Nations during the 1960s.

During the fall of 1983, MacLaren worked closely with Cohen -- who assumed a direct role in financial institutions policy-making by chairing a departmental advisory committee on the matter -- in laying the groundwork for regulatory change. MacLaren decided that any future policy would have to address five essential issues that had come to shape the financial services industry. The first was the acquisition of some of the country's biggest trust companies by commercial entities, such as Brascan and Power Corp., "which was contrary to the tradition in Canada."[40] Any hopes that the government could suddenly reverse that trend were naive: "It had advanced to the point where it would have been difficult to roll back without unduly penalizing investors."[41] Second, the creeping incursion of provincial governments into the domain of financial institutions regulation carried the seeds for both widespread duplication and conflicts with Ottawa. Third, MacLaren believed the country's investment dealers were "notoriously undercapitalized" to survive in the emerging global securities market. Fourth, the legislative framework for federal trust companies was seriously out-dated and finally, the apparent global drive towards deregulation of financial institutions could not be ignored. The first and fifth issues seemed to hold particular salience for MacLaren, who said: "My own priority was to move away from the autonomous four pillars concept, which the market internationally was moving away from as an anachronistic system. So, what we attempted to do was pose a first question: "How could the probity and viability of institutions be best assured?" Was that through regulation of companies or regulation by function?"[42]

An advocate of improved business-government consultation while a member of the private sector, MacLaren's strategy for gaining industry acceptance of any future policy was to give the industry a role in the formulation of that policy. In late 1983, he commissioned Mickey Cohen to assemble representatives from each of the four pillars to sit on a committee to advise the government. MacLaren was adamant, however, that the committee be chaired by a someone from *outside* the financial services industry. He nominated his friend and long-time Liberal activist Bill Dimma, then chairman of realtor A.E. Lepage, for the job.

MacLaren's public announcement about the forthcoming committee in December, 1983,[43] prompted a phone call from the CBA's Bob MacIntosh to Terry Popowich, MacLaren's executive assistant[44] and "gun" on the Dimma Committee. MacIntosh pressed Popowich for a seat at the table, but to no avail. MacLaren vetoed MacIntosh's appointment, choosing instead only two bankers to sit on the 14-member committee: Michel Belanger, then chief executive of the National Bank and Grant Reuber, the Bank of Montreal president who had served briefly as deputy finance minister during the Clark interregnum. The trust industry also had two representatives: Liberal activist and National Trustco chairman and CEO, Bill Sommerville, and Daniel Pekarsky, president of the Belzberg's First City Financial Corp. Royal Trustco, meanwhile, could count on a voice at the table in Earl Orser, president of sister-Bronfman company, London Life Insurance Co.[45] Dimma himself came to be associated with the Bronfman empire when, in the midst of the committee's meetings, A.E. LePage was absorbed by Trilon Financial Corp.

The composition of the committee, with no representatives from consumer or small business groups, was deplored by several observers. The discrepancy was even noted by a bank chairman. William Mulholland of the Bank of Montreal, told *The Toronto Star* in January, 1984: "In all of this debate about the restructuring of financial services, nobody has raised the question of what the public really wants."[46] Another prominent member of the financial community echoed Mulholland's sentiments. "It's like asking the fox to design and build the hen house," securities lawyer and former Ontario Securities Commission chairman Henry Knowles said.[47]

Those comments notwithstanding, however, public opinion was a secondary consideration for the government. The arcane and technical nature of the discussion meant that the issue was essentially absent from the mass media, save for the specialized business press. For the government then, this was not seen as a "political issue," according to one senior official, who added:

> As a general matter, developments in this area, because of the fact that it is understood and cared about by a relatively small number of players in both the public and private sectors, are not moved by public opinion or the media. It's not like drug patent legislation, where you have all kinds of interest groups and seniors who feel the effects of it.[48]

Since the issue, in its early stages, had little profile in the media, public opinion was difficult for policy makers to gauge, except where it related to perceptions of anti-competitive behaviour among the country's monolithic banks and of the instability of smaller financial institutions, both of which had been long-standing concerns among Canadians.[49] It is not surprising, therefore, that both bank and trust executives couched their demands in language that was seen to be congruent with one or the other of these concerns, arguing, hence, that their proposals were in the "public interest."

Those familiar with workings of the Dimma committee, which usually met over dinner on a monthly basis until December, 1984, described the banks' stance during the consultative process as "defensive." One bank representative attributed the industry's scepticism toward the committee to the banks' perception that "they were not strongly represented" on the committee.[50] "It didn't help that Belanger never showed up or that Grant Reuber was a great non-attender of meetings, too."

It would be erroneous to conclude, however, that the banks limited participation in the process allowed their competitors to set the agenda. For if MacLaren's "corporatist" approach to policy-making was the impetus behind the creation of the Dimma Committee, Cohen and his officials in the Department of Finance were equally eager to preserve the distinctions between the governors and their agents (the politicians and bureaucrats) on the one hand and the governed (the industry) on the other. While Cohen had spent the 1960s in private practice as a Toronto corporate lawyer -- and would later go on to become president, first, of Olympia & York

Enterprises Corp. and then the Molson Companies Ltd. -- he had built his career in the bureaucracy. Before becoming deputy finance minister, he had held the same post in the Department of Industry, Trade and Commerce and the Ministry of Energy, Mines and Resources. Concomitantly with the appointment of the Dimma group, Cohen asked Gordon King, the general director of the Capital Markets/Financial Sector Policy Branch (FSPB), to undertake a series of background studies on the industry and the issues it faced. The studies, which were to form the basis for the Dimma Committee's discussions, were in turn prepared by Allan Popoff, a branch chief working under King, and his staff.

Popoff, then a 35-year-old economics Ph.D.,[51] had only recently returned to Finance after a two-year secondment to the Bank of Canada, where he had been a special adviser in the bank's Department of Monetary and Financial Analysis. His expertise lay in corporate finance and, from a public policy perspective, he was seen as favouring the development of alternate sources of capital for businesses. This earned him the label of being "anti-bank" from bank lobbyists,[52] while King was seen as "leftist, an economic nationalist" and "widely anti-bank." One bank lobbyist commented that among the FSPB staff, "there was a bias in favour of competition to produce more institutions, a belief that the more institutions you have the more competition you have."[53] Another bank representative added: "They were very sympathetic to the notion, at the policy level that competition in the industry needed to be pushed. Back then, it was competition for the small business market."[54]

The background studies prepared by Popoff and his staff consisted primarily of seven papers, averaging between 20 and 30 pages each, that served as the basis for the Dimma Committee's discussions.[55] Hence, it was the bureaucracy that set the agenda for the Dimma proceedings, deciding in advance what topics were to be addressed and framing each topic in accordance with its policy goals. One senior government official directly involved with the Dimma Committee described the process simply "as a way for us to get feedback on the ideas contained in the papers."[56] Another top bureaucrat expounded on Finance's role:

> With respect to the Dimma Committee, the department was pretty influential. Basically, (the committee) was a sounding board for Mickey Cohen and the department. The leg work done by the department largely set the agenda. The committee was reactive; it was not a full consultative process.[57]

The Popoff team structured the proceedings around six issues on which Cohen wanted to gauge industry opinion. The first was the issue of whether the government should opt for "regulation by function" instead of the traditional four-pillar method of "regulation by type of institution." The question that was being raised was, in short, whether the onus of regulation should shift from "banks" to "banking." The Finance Department clearly favoured the latter approach, but wanted advice from the industry on the best forms of "design and implementation." Conflicts of interest and concentration of economic power were the second and third issues and were seen as complementary concerns, since the former was largely, though hardly exclusively, a product of the latter. The issues of foreign ownership and the internationalization of financial services came next, while concerns about the overlap created by shared federal-provincial jurisdiction over non-bank financial institutions rounded out the discussions.

The Popoff papers devoted a considerable amount of space to a discussion of the factors that had, in many ways, rendered "regulation by type of institution" an inadequate and inequitable policy. By far the single largest factor in bringing this about was, according to the department's papers, the "blurring of distinctions" between the traditional four pillars of the financial system. While the reader will remember that this development was addressed earlier, it is useful to review it from the perspective of the bureaucrats most closely associated with the formulation of regulatory policy.

In a working paper released in January, 1984, the Department noted that "the blurring of distinctions served to focus attention on a regulatory structure which treats different types of institutions in different ways."[58] Thus, the Department hinted that the incongruent nature of the regulations in place might be reviewed on the grounds of ensuring the equitable treatment of all financial institutions. These studies attributed the blurring of the distinctions to two broad developments in the domestic and international economies:

i) Inflation and rising world interest rates. The double-digit inflation practically all industrialized states had experienced in the 1970s was responsible for higher and more volatile interest rates. The uncertainty this caused forced lenders and borrowers to shorten their time horizons, as interest rate volatility increased the risks for financial institutions in maturity transformation, and concentrate on matching the terms of their assets (loans) and liabilities (deposits). What resulted was the crowding of all deposit-taking and lending institutions into short-term intermediation and attempts by such institutions to diversify their activities. Hence, the mortgage lending activities of the banks and trust companies became indistinguishable and the trust companies and other non-bank financial institutions began moving more aggressively into commercial lending, long the protected domain of the chartered banks.

ii) Regulatory Changes. A plethora of legislative and regulatory changes enacted by governments since the mid-1960s had also contributed to the erosion of distinctions among financial institutions. For instance, the formation of the Canada Deposit Insurance Corporation in 1967, to which the trust companies could subscribe, enhanced their ability to compete for customer deposits with the chartered banks, previously perceived by the public to be more stable than their junior competitors. The lowering of reserve requirements on chartered banks' term deposits and the removal of the ceiling on bank loan rates the same year improved the banks' ability to compete with the trust companies for term deposits. Vast improvements in computer technologies and telecommunications permitted both the chartered banks and trust companies to offer a wide array of ancillary services to their customers and competition based on these services intensified. The result was that practically all deposit-taking institutions ended up offering "fairly standard packages of financial services."[59] The *Bank Act* revisions of 1954 and 1967 allowed the chartered banks to engage in consumer and mortgage lending, the latter of which had been one of the most lucrative of the trust companies' activities. Finally, although not directly noted in the Department's working papers, the 1980 formation of and the trust companies' hard-won membership in the Canadian Payments Association, a central clearinghouse for settlements among the nation's financial institutions, was a boon to the trust companies' ability to compete for the most widely-held of all customer accounts, the chequing account.

The next pair of issues that the Popoff team put before the Dimma Committee were those concerning conflicts of interest raised by closely-held ownership of financial institutions and the concentration of economic power in the hands of commercial-financial conglomerates. Both of these were dealt with in Chapter 2, since they are at the root of the normative rationales for ownership limits and bans on self-dealing, and the Popoff papers' treatment of them concurs with our earlier discussion. Those familiar with the proceedings of the Dimma Committee and the financial reform process in general indicated, however, that Cohen and his staff considered the concentration issue to be far greater policy concern than the conflict issue. The spate of failures in the early 1980s, most of them caused by some form or another of self-dealing, did not appear to preoccupy bureaucrats since all of the collapses involved relatively small institutions and their demise created no systemic threat. As one lobbyist recalled: "The conflict is interest issue certainly never moved the politicians and never really moved the people who were bringing the recommendations up in the bureaucracy. The concentration of power in the hands of a small number of industrial conglomerates was always a much bigger one back then."[60] This concern was, however, somewhat offset by policy-makers' desire to foster additional sources of credit, in addition to the banks, for some regions and small businesses.

Foreign ownership regulations, the fourth issue raised by the Popoff papers, entered into the Dimma Committee's discussions in connection with the globalization of securities markets. While the Ontario Securities Commission remained firm, at least in its public statements during the early 1980s, in its defence of foreign and other ownership restrictions on investment dealers, it was clear the issue would not go away as long capital markets continued to globalize. But because the responsibility for securities regulation lay with the provinces, the foreign ownership issue was dealt with in only a cursory fashion by the Dimma Committee.

By contrast, the internationalization of financial services, and its corollary, the deregulation of financial institutions, underlay much of Finance Department's thinking and, hence, the Dimma group's proceedings. The Popoff papers devoted a significant amount of attention, in particular, to a proposed deregulation of the banking sector in the United States. With the benefit of hindsight, it is clear that Americans' flirtation with meaningful deregulation of their banking sector foundered before really getting off the ground. But for Canadian policy-makers monitoring the situation in the early 1980's, the prospect of widescale deregulation south of the border carried important implications for Canada.

Several developments in the early 1980s indicated that deregulation in the U.S. was indeed gaining momentum. First, the much-maligned Regulation Q, which imposed interest rate ceilings on banks' deposits, was phased out. The blurring of distinctions among financial institutions appeared to be well underway in the U.S., as well. When the Federal Reserve Board allowed the Bank of America to acquire Charles Schwab & Co., the largest discount brokerage in the country, many saw the development as a signal that the rescinding of the *Glass-Steagall Act*, (which prevented commercial banks from engaging in investment banking), could not be far off. Commercial-financial linkages were becoming more important in the early 1980s, as the purchase of full service brokerages by Prudential, American Express and Sears Roebuck indicated. As was the incursion of unregulated non-banks, which skirted the U.S. definition of banking by offering only one of commercial lending or deposit-taking services, into the financial services industry. But by far the most important indicator that widescale deregulation was on the horizon was the tabling of a proposal by the Treasury Department to deregulate bank holding companies, allowing them to become diversified financial services firms through arms-length subsidiaries.

Policy-makers in the Department of Finance were well aware that the growing support for deregulation in the U.S. would have serious implications for Canadian financial institutions. The mindset in Finance appeared to be that once deregulation begins in one major jurisdiction, it cannot be resisted by others closely linked to it. A more liberal regulatory environment in the U.S. would encourage Canadian financial institutions to expand south of the border rather than in Canada. As well, as one working paper noted, "innovative financial institutions may respond to the "demonstration effect" from the U.S. and seek to expand the range of their activities in Canada."[61]

The final issue Cohen and the Finance team put before the Dimma Committee was that of the harmonization of federal and provincial regulations governing financial institutions. These discussions focused almost exclusively on Ontario's jurisdiction over the securities industry and Quebec's aggressive moves to deregulate its financial sector. The latter development was by far of greater interest to policy-makers since it raised the spectre of "competitive deregulation" between jurisdictions.

Quebec's initiatives were seen as an evolutionary step in the province's attempts, particularly under the separatist Parti Quebecois, to strengthen its economic base, consolidating control in the hands of Quebecers. Foreign ownership restrictions on investment dealers were removed in 1973, (under the Liberal government of Robert Bourassa, but on the recommendation of Jacques Parizeau, later to become Minister of Finance in the PQ government), and, as mentioned earlier, the province abolished regulations prohibiting the ownership of securities dealers by other financial institutions in 1983.[62] The P.Q. government's goal had clearly been to encourage the development of indigenous financial conglomerates, but its policies had the result of forcing the pace of regulatory change in other provincial jurisdictions. The measures taken by Quebec, and proposals by the Ontario government to review regulations affecting trust companies under its jurisdiction, led federal policy-makers to label the exercise as one of "competitive deregulation", in which provinces sought to create the regulatory environment most conducive to attracting financial institutions to their jurisdiction. Hence, the possibility was real that issues of stability would be neglected as each province attempted to draft more liberal regulations than those of its counterparts.[63]

Finally, the Popoff team rounded out the papers by stressing that need for regulatory change was pressing, but implementing the reforms would be a delicate exercise. With respect to the urgency of the matter, one paper noted that "if regulatory change is slow, financial innovation can achieve more or less the same results."[64] Institutions had become very good at designing products to get around prohibitive regulations, the paper continued, and unless the regulatory apparatus was reshaped it risked becoming altogether meaningless.[65] Yet, Finance was sensitive to the fact that the government faced a considerable challenge in attempting to implement future changes on a fair and equitable basis. One paper noted that "all the concerned institutions are anxious to have their legislation considered first... With regulatory change, it really matters 'who's on first."[66]

In summarizing the views expressed by the Popoff papers, then, regulatory reform was seen as necessary because the public was being serviced by financial institutions which, because of the blurring of distinctions between them, were becoming more and more alike in the types of products and services they offered, yet faced vastly different regulatory requirements and restrictions. At the same time, there was concern among these policy-makers that eliminating the barriers among the pillars of the financial system would lead to undue concentration, which might nullify the purpose of deregulating in the first place: that is, it could restrict competition instead of promoting it.[67] There was also concern expressed that, with a different regulatory structure, "institutions would face different solvency risks. Any change in the structure of the financial services industry, therefore, raises questions about how solvency-related goals are to be met."[68] Hence, the working papers prepared by bureaucrats in the Department of Finance indicated that the three primary objectives of regulatory reform should be competition among and solvency of deposit-taking institutions, as well as the equitable regulatory treatment of all institutions.

Yet Cohen was keenly aware that the government faced several constraints in realizing its policy goals. First, the emergence of commercially-owned financial conglomerates -- the so-called "rise of the Trilons" -- was seen as an irreversible, if not largely healthy, development.

The self-dealing that had led to the collapse of a dozen trust companies -- the so-called "fall of the Fidelity's" -- was not, however. Yet a policy that allowed closely-held financial conglomerates, but required the Big Banks to be widely-held, would inevitably be held up for criticism on grounds that it failed to impose a standard of equitable treatment with respect to ownership. Cohen and his staff were sensitive, therefore, to the need to frame any future policy in such a way as to deflate the potential claims of its detractors. Hence, "equitable treatment" came to be defined as the subjection of all financial institutions, including holding companies such as Trilon, to regulation. "Mickey understood that you had to have financial holding companies and that you had to regulate them. The "trustco" (holding company) problem we had in the early 80's, and which we're having again today, is a direct result of the fact that we don't regulate trustcos and that's what Mickey went after," said one trust industry representative.[69]

Thus, as the Dimma Committee continued to meet through 1984, Cohen and his staff were proceeding to draft a policy that would stand up to scrutiny as embodying a certain consistency and satisfy, as best possible, the government's objectives. The approach they settled on was described by one senior government official in the following manner: "We don't care who owns everything as long as we regulate the whole damn structure. That is a view that is, intellectually, a nice model that hangs together."[70]

The "Green Paper", the policy statement that eventually emerged from the process set in motion by Cohen and MacLaren, is the subject of the next chapter. Suffice it to say, for the moment, that its contents distinctly bore Cohen's stamp. "The main direction of the policy was the product of the bureaucracy," said one bank representative.[71] "Certain constraints, like the prohibition on insurance networking, as well as the dickering at the end of the day, were a political exercise." One observer with experience in both government and the bureaucracy added:

> A brilliant deputy minister like Mickey Cohen will try to develop a policy that is consistent with the general thrust of the government of the day. But its not the minister who's developing the policy. The minister evaluates the policy proposals that are put forward by the deputy... You don't ever get ministers coming up with complex ideas in the areas of their portfolios. A smart minister who's got a good deputy goes along with the ideas that the deputy puts forward.[72]

That being said, a deputy needs a willing sponsor to carry his or her ideas to cabinet, "because," as a senior government official commented, "bureaucratically you can't push anything onto the agenda unless the minister thinks it ought to be on the agenda."[73]

Cohen had a willing and eager sponsor in MacLaren, but the latter never had a chance to carry the policy forward. By the time the Dimma Committee was set up in January, 1984, the Trudeau government was already well into the fifth year of its mandate. When Trudeau stepped down the following month, plunging the Liberals into a leadership race, it was clear that any broad policy initiatives, including financial sector reform, would not be considered until after a general election. Yet the essential policy approach set out by Cohen survived the changing of the guard engendered by the election of Brian Mulroney's Progressive Conservatives in September, 1984. Cohen quickly discovered a new sponsor in Barbara McDougall, Mulroney's Minister of State for Finance.

Having spent the previous two decades in the investment industry, rising to the vice-president rank at Dominion Securities Ames Ltd., McDougall brought to her new post a quality that is rare in cabinet ministers: a comprehensive understanding of financial issues. After short stints at the Toronto Star Ltd. and the Canadian Imperial Bank of Commerce, McDougall joined Vancouver investment dealer Odlum Brown Ltd. in 1964. She remained at Odlum until 1974, earning her Chartered Financial Analyst designation in 1973. During that period she became not only one of the first women to penetrate the male-dominated investment industry, but also one of the country's first female business journalists with a *Vancouver Sun* column. In 1974, she moved to Edmonton, where she held the position of manager, portfolio investments at North West Trust Co., then owned by prominent broadcaster Charles Allard. Two years later she moved to Toronto brokerage A.E. Ames and Co. Ltd., which merged with Dominion Securities in 1981. While executive-director of the Canadian Council of Financial Analysts, she formulated the profession's response to the Trudeau government's 1982 White Paper in short. As Patricia Best and Anne Shortell noted in 1985: "McDougall has impeccable business connections."[74]

From the beginning, McDougall emerged as one of the most prominent members of the Mulroney administration and was seen to hold sway at the cabinet table. She worked closely with Finance Minister Michael Wilson in drafting the new government's economic strategy, articulated in November, 1984.[75] With the largest majority in Canadian history, and, so it seemed early in its mandate, the will to proceed with massive structural changes to the Canadian economy, the prospects for financial sector reform brightened. The idea of a revitalized financial industry was an integral part of the government's plans to promote a market-oriented approach to economic development. The structure of the sector was inefficient in the eyes of the government as each of the four pillars was spared competition from the others. The November, 1984 statement asserted that "(t)he prospects for economic renewal would be enhanced by greater competition among the financial institutions."[76] At the same time, criticisms levelled at regulators in the wake of ten federally-regulated trust and loan company failures led the government to add that regulatory powers had to be strengthened in order to maintain "adequate protection for investors and savers."[77]

Thus, observers cited McDougall's enthusiasm and familiarity with financial issues, which spared her the time-consuming task of having to "learn" her portfolio before proceeding with new policies, as a pivotal factor in the advancement of financial sector reform. One senior government official summed up her contribution this way:

> Political will to act was very important. Very, very important. This stuff does not essentially move forward unless there is a minister who thinks it is important, either because they're being buffeted by forces from outside or because they personally have some interest...It took a quantum leap from the Dimma Committee, when the department was interacting with a small group of people, to actually move forward to a policy paper -- and the first major policy paper in this area for many decades at that...Barbara was a person who was connected in the financial community, knew it, understood the issues.[78]

But having spent her financial career outside the banking sector, she was seen has being sympathetic to the concerns of non-bank institutions. She came out of an entrepreneurial "corporate culture" -- that of the investment industry -- that clashed with the conservatism of the banks. Her views meshed naturally with the policy framework set out by Cohen. "Barbara didn't like the banks," one lobbyist said. "She started her career in a stock brokerage and went on to work for Allard at North West trust. How could she like the banks?"[79]

Upon taking office, McDougall moved quickly to deal with the outstanding issues left over from the Trudeau administration. In January, 1985 she appointed Robert Wyman, chairman of Vancouver investment dealer Pemberton Houston Willoughby, to head a three-person task force on deposit insurance. (The existing system had been widely-criticized by the banks in the wake of the early 1980's trust company failures.) But the bulk of her time was spent putting the finishing touches on the policy paper, she was to table in April, 1985 -- a document one trust industry executive referred to as "Mickey's paper."[80]

NOTES

1. The committee was comprised of: Bob Ward, assistant general manager, Canadian Imperial Bank of Commerce; Lionel Scott, senior manager, Bank of Montreal; Perrin Lewis, assistant general manager, Bank of Nova Scotia; Peter Drake, senior economist, Toronto Dominion Bank; Henri-Paul Rousseau, chief economist, National Bank of Canada; Vince Langley, manager, Royal Bank of Canada.

2. Edmund Burke, *Reflections on the Revolution in France*, ed. H.D. Mahoney (New York: Macmillan Publishing Co., 1955), 97-98. While Burke is mostly commonly labelled a conservative political thinker by contemporary critics, he is more aptly described as a liberal. He was, after all, a long-time Whig member of the House of Commons, and spent most of his career railing against the abuses of power of George III. He supported the American Revolution and opposed the English King's oppression of the Irish on these grounds. He denounced the French Revolution, on the other hand, precisely because the revolutionaries abused their power, destroying all noble and salutary French traditions in the process.

3. See Robert MacIntosh, *Different Drummers: Banking and Politics in Canada* (Toronto: Macmillan Canada, 1991), 270.

4. Confidential interview, December, 1992.

5. Sears bought Dean Witter Reynolds. It also bought Allstate Insurance. Prudential purchased Bache Securities, while American Express acquired Shearson Loeb Rhoades, since renamed Shearson Lehman Bros.

6. James Ring Adams, *The Big Fix* (New York: John Wiley & Sons, Inc., 1990), 22.

7. See Maurice Levi, *International Finance* (Toronto: McGraw-Hill Book Company, 1983), 195.

8. Ibid.

9. Ibid., 196.

10. See Economic Council of Canada, *A New Frontier: Globalization and Canada's Financial Markets* (Ottawa: Ministry of Supply and Services, 1989).

11. See A. Hamilton, *The Financial Revolution* (New York: The Free Press, 1986), 55.

12. Ralph Bryant, *International Financial Intermediation* (Washington, DC: The Brookings Institution), 68.

13. Ibid.

14. Hamilton, 59.

15. Daily FX volume in Canada averaged $22 billion (U.S.) in 1992, a 47 per cent increase from $15 billion daily in 1989. Canadian-U.S. dollar trading accounted for 67 per cent of the total in 1992. Average daily FX volumes in other countries in 1992 were: $303 billion (U.S.) in Britain; $192 billion (U.S.) in the United States; and $74 billion (U.S.) in Singapore. See Greg Ip, "Forex trading is boom sector in Canada's financial markets," *The Financial Post*, December 22, 1992.

16. On this see Hamilton, Chapter 2.

17. *The Economist*.

18. E. Compton *The New World of Commercial Banking* (Lexington, MA: Lexington BOoks, 1987), 87.

19. See Economic Council of Canada.

20. Recalling the great Austrian economist Joseph Schumpeter, the Economic Council of Canada (31) distinguishes between *invention* and *innovation*. "Invention -- a rare occurrence -- is the introduction of previously unknown products or processes. Innovation is more evolutionary. It often involves the adaptation of an existing product or process, with the novelty flowing from the new use that is made of it. The spinning wheel, the telephone and computers are inventions because they are revolutionary in their impact. Some might even include interest-rate and currency swaps in that category, although they are treated here as innovations."

21. See Economic Council of Canada.

22. Confidential interview, November, 1992.

23. Economic Council of Canada, 70.

24. Ibid.

25. Ibid., 72.

26. Ibid., 74.

27. See MacIntosh, 271.

28. Matthew Fraser, *Quebec Inc.* (Toronto: Key Porter Books Ltd., 1987), 97.

29. While a professor at the Ecole des Hautes Etudes Commerciales in the late 1960s, Parizeau chaired the Committee on Financial Institutions, a task force set up by the provincial government. The committee's 1969 report (Quebec (1969)), now universally known as "the Parizeau report" advocated regulation by function rather than by type of institution.

30. Confidential interview, December, 1992.

31. See A. Ross, "Trust Me: in defence of propritetorship." *Canadian Business* (May 1983): 50.

32. Ibid.

33. Patricia Best and Ann Shortell, *A Matter of Trust* (Markham, ON: Penguin Books Canada Ltd., 1986), 367.

34. The federal proposals would have, nevertheless, affected Jackman in at least two respects. First, the imposition of a 10 per cent ownership limit might have forced National to cede its ownership in Premier Trust Co., a tiny, but nonetheless federally-chartered, trust company through which National runs part of its mortgage business. In addition, had the new business powers proposed in White Paper been attractive enough for National to convert to a federal charter, Jackman would have had to dilute his holdings to do it.

35. Cited in A. Taylor, "Structure by default: Canada's approach to its Capital Market." *Business Quarterly* 49, No. 2 (1984): 23.

36. Cited in Ross, 50.

37. See Canadian Bankers' Association, *The Level Playing Field Concept* (Toronto: Canadian Bankers' Association, 1983).

38. Ibid., 14.

39. Confidential interview, November, 1992.

40. Interview, March, 1991.

41. Ibid.

42. Ibid.

43. See Jim Daw, "Ottawa plans study of financial services," *The Toronto Star*, December 13, 1983.

44. Popowich, then barely 26 years old, was seen as a rising star in the Liberal party and had articulated political aspirations of his own. Before joining MacLaren, he had served as a special adviser to Energy Minister Marc Lalonde. But his career was abruptly cut short in 1988, when, at the age of 31, he was forced to resign from his vice-president's job at the Toronto Stock Exchange. In a press release, the TSE said at the time that Popowich resigned after admitting that he did not in fact have a Master's degree from the London School of Economics as indicated on his resume. See Jonathan Ferguson, "Trouble-shooter ousted from TSE," *The Toronto Star*, February 20, 1988.

45. The other members of the committee were: Betty Kennedy, the Toronto broadcaster and wife of the heir to the Simpson's department store chain; Richardson Greenshields of Canada Ltd. president, Frank Lamont; the Hudson Institute's Marie-Josee Drouin; Donald Bean, president of investment dealer Wood Gundy Inc.; Raymond Blais, president of the Confederation des caisses populaires et d'economie Desjardins du Quebec; Larry Clarke, chairman of Spar

Aerospace; Norman Bromberger, CEO of the Saskatchewan Central Credit Union; and Ed Crawford, president of Canada Life Assurance Co.

46. Alan Toulin, "Advisory group on finance has to deal with itself first," *The Toronto Star*, January 21, 1984.

47. Ibid.

48. Confidential interview, November, 1992.

49. See R. McQueen, "Four Into One -- won't go yet." *Canadian Business* (April 1984): 91.

50. Confidential interview, November, 1992.

51. Popoff's 1979 Queen's University dissertation was titled "The Dynamic Econometric Model of Corporate Financing Behaviour."

52. Confidential interviews.

53. Confidential interview, November, 1992.

54. Confidential interview, November, 1992.

55. The papers, in chronological order, were: *Canadian Financial Institutions: Trends and Policy Perspectives*, January, 1984; *Canadian Financial Institutions: Some Policy Issues*, January, 1984; *Potential Conflicts of Interest in the Financial System*, February, 1984; *Regulatory Change and Competition in the Financial System: Questions of Concentration and Internationalization*, March, 1984; *The Structural Evolution of Financial Markets and Institutions: The Implications for Regulation*, April, 1984; *Solvency of Financial Institutions and the Public Interest*, May, 1984; *Regulation of the Financial System: Federal-Provincial Issues*, May, 1984.

56. Confidential interview, November, 1992.

57. Confidential interview, November, 1992.

58. Department of Finance, "Financial Institutions: Trends" (1984b), 28.

59. Ibid., 24.

60. Confidential interview, November, 1992.

61. Department of Finance, "Financial Institutions: Trends" (1984b), 28.

62. An informative comparison between Quebec's approach to securities regulation and those adopted by other jurisdictions can be found in R. Schultz and A. Alexandroff, *Economic Regulation and the Federal System*, (Toronto: University of Toronto Press, 1985).

63. This issue is discussed in Department of Finance, (1984c), 9.

64. Department of Finance (1984c), 24.

65. A good illustration of this phenomenon is offered in a report by the Economic Council of Canada, *A Framework for Financial Regulation* (Ottawa: Ministry of Supply and Services, 1987), 9:

> With the new instruments it becomes more and more difficult to determine what is a mortgage, what is a commercial loan, what is a deposit, and what is an investment in a security. Distinctions based upon the composition of liabilities are becoming imprecise and ineffective. Trust companies have only limited powers to enter commercial lending activities, but they can offer loans to businesses secured by real estate and call them mortgage loans.

66. Department of Finance, "Financial Institutions: Trends".

67. See Department of Finance, "Regulatory Change and Competition".

68. Department of Finance, "Solvency of Institutions", 1.

69. Confidential interview, December, 1992. The "trustco" problem, which was discussed in Chapter 3, relates to the fact a financial holding company is not subject to regulation, making it difficult for regulators to accurately gauge the health of the regulated financial institution it owns. Until recently, holding companies have not been required to provide regulators with any information on their activities. The holding company structure creates the potential for conflicts of interest, as was seen our earlier discussion.

70. Confidential interview, November, 1992.

71. Confidential interview, November, 1992.

72. Confidential interview, December, 1992.

73. Confidential interview, November, 1992.

74. Best and Shortell, 297.

75. Department of Finance, *A New Direction for Canada: An Agenda for Economic Renewal* (Ottawa: Ministry of Supply and Services, 1984).

76. Ibid., 38.

77. Ibid., 37.

78. Confidential interview, November, 1992.

79. Confidential interview, November, 1992.

80. Confidential interview, December, 1992.

CHAPTER 5

STRIKE ONE: THE DERAILMENT OF THE GREEN PAPER

On the morning of Monday, April 15, 1985, Minister of State for Finance Barbara McDougall strode purposefully into a conference room at the Skyline Hotel in Ottawa to unveil a bold, new blueprint for the structure of Canada's financial system. To display her solidarity with the financial industry, McDougall had invited representatives of about two dozen of the country's leading, non-bank institutions to assist at the occasion. Among the group was National Trustco's Hal Jackman, whom McDougall had come to know intimately during her years of work for the Rosedale Tories, before securing her 1984 nomination as the party's candidate in the neighbouring St. Paul's riding. Most of those present at the predominantly male gathering heaped effusive praise on McDougall and the visionary initiative she was about to launch. The lone voice of dissent was that of CBA president Robert MacIntosh, the *only* bank representative in attendance. He described the banks' marginal status at the gathering as "typical" of the treatment they got from Ottawa, and made an "acid comment" about McDougall's initiative "that the Minister didn't like very much."[1]

What provoked MacIntosh's vitriol was the fact that McDougall's proposals did not include the banks. Trust and insurance companies were to be given the power to get into banking and securities dealing, as well as each other's businesses. But the same broad scope of activity was to be denied the banks, at least until the next *Bank Act* revision, some five years away. The government rationalized the exclusionary tone of its proposals by claiming that "the chartered banks *as a group* have not been pressing for new powers."[2] MacIntosh was incredulous. Strictly speaking, the government was not incorrect; despite the consensus expressed by the Financial Institutions committee, the CBA had not articulated a joint industry position on depillarization, since there was disagreement among the banks on how to proceed. But the events of the previous two years, including the Toronto Dominion Bank's controversial move into the securities business in 1983, had amply indicated that the banks were embracing the concept of depillarization. In response to the government's assertions, which painted the banks in Luddite shades, an incensed CBA said simply: "This, of course, is not and never has been the case."[3] The incident offered a telling example of the poor relations that existed between the banks and policy-makers.

McDougall's own comments intimated that the title of the green-covered document she tabled that morning -- *The Regulation of Canadian Financial Institutions: Proposals for Discussion*[4] -- was misleading. As far as the Minister was concerned, the Green Paper's "proposals" were not really proposals at all; rather, they comprised the policy she intended to implement. "The details of the paper are negotiable; the principles are not," she declared at the time.[5] McDougall set a tight schedule for the passage of the new rules into law, requesting responses from the industry by mid-summer, a report from the House of Commons Finance Committee by September and draft legislation by October to "ensure timely passage of (the) necessary legislative reforms."[6]

The Green Paper's proposals can be classified into two categories: those touching on *deregulation* of the financial sector to enhance competition and the international competitiveness of Canadian institutions, and those falling under the rubric of *re-regulation*, aimed at ensuring the soundness and stability of the system and providing consumers with greater protection. But the latter aspect was essentially lost on the media and other observers. The new government was still roundly identified as a "neo-conservative" administration, inspired by the policies of Reagan and Thatcher and with a bent for deregulation. The government's stated, economic objectives coloured, therefore, the public's perception of the Green Paper. In a front page headline, sandwiched between a story on the now embarrassing state welcome given Nicolae Ceausescu on his 1985 Canadian visit and another on Princess Michael of Kent's Nazi lineage, *The Globe and Mail* referred only to McDougall's "deregulation paper;"[7] the ensuing story did not even note the measures the government proposed for strengthening the regulatory apparatus. In the same vein, Patricia Best and Ann Shortell asserted that: "the Green Paper was a clear illustration of Ottawa's mindset in 1984 and 1985, while financial institutions were floundering on all sides. Underpinning the federal government's new direction...was the conviction that free enterprise should be allowed to prevail."[8]

While the Green Paper proposed that more scope be given to financial institutions to offer a wider range of services, its implementation would not, properly speaking, have resulted in the depillarization of the financial system. Regulation by type of institution was to be preserved and the government was eager not to be seen as endorsing the principle of one-stop financial services shopping, or universal banking. Each type of institution was to retain a core function that it alone could perform, although it could be linked to other types of institutions through a common parent. Trust companies, for instance, would alone be able to perform fiduciary activities and would be able to increase their commercial lending only indirectly through an affiliated "Schedule C" bank. The government was obviously aware that an outright endorsement of universal banking could backfire if one-stop shopping too easily became associated with "tied-selling," where, for instance, an institution coerces borrowers into buying mortgage or car insurance at a captive insurance company. While commonly-owned institutions were to be given "networking powers" that would enable them to sell each other's products and services, the technical supplement to the Green Paper stipulated that:

> The inference should not, however, be drawn that the government is promoting such arrangements or the concept of "one-stop shopping". The proposed changes only permit such development (*sic*) since there seems to be no fundamental reason to prevent them. Customers would always have the option of diversifying their purchases of financial services among several companies.[9]

The crux of the Green Paper was embodied in the financial holding company (FHC) concept. Any federally-regulated institution (except a Schedule A or B bank) was to be allowed to establish an FHC, incorporated federally, through which it could acquire or establish an institution in any one of the four pillars. However, because individual ownership in Schedule A (now called Schedule I) banks was limited to ten percent, FHC's were to be allowed to enter the field of commercial lending by setting up a Schedule C bank, which could be closely-held. As well, because the provinces set the ownership rules for the securities industry, FHC's could only acquire equity in an investment dealer to the extent permitted by provincial laws.

The Green Paper also proposed a number of measures to control self-dealing and monitor conflicts of interest. The most important of these was a ban on all non-arm's length transactions, which a new super-regulatory agency was to have the power to define and monitor. In addition, it was proposed that each institution falling under an FHC's umbrella be a distinct corporate entity with different directors and financial statements. Where financial institutions with a common parent entered into networking arrangements to sell each other's products, "Chinese walls" were to be erected to prevent the seepage of sensitive and confidential customer information between the affiliated institutions. Further, to guard against the acquisition of a financial institution by unseemly individuals, the government proposed for the first time to equip the Minister with the power to veto share transfers above 10 percent.

On the supervisory side, where the government seemed less fixed in its proposals than on the FHC concept, the Green Paper foresaw a merging of the Office of the Inspector-General of Banks and that of the Superintendent of Insurance into a single, super-regulatory agency with enhanced powers. Included among these was the right to summon records and accounts from FHC's and their member firms, the ability to issue cease and desist orders to halt controversial activities, to veto changes in control of an institution, to seize control of an institution's assets on its own initiative and the power to supeona information on the ownership of an FHC.

Conspicuously absent from the list of proposed controls were ownership restrictions, such as requirements for wide share distribution or a prohibition on the ownership of financial institutions by non-financial companies. While the *Bank Act* requires that Schedule I banks be widely held, and limits bank-commercial links to 10 percent, the government did not see fit to impose similar restrictions on non-bank financial institutions, despite that fact that they were to enjoy the same (and in some instances greater) powers as the banks. Consequently, most observers saw the proposals as clearly favouring the trust companies, and, in particular, the small coterie of industrial conglomerates such as Brascan and Power Corp. that controlled the biggest trusts.[10]

To be sure, the trust industry stood to gain handsomely from the reforms, while the banks, by their exclusion, were the clear losers. McDougall's apparent "anti-bank" stance and the government's bias in favour of competition further worked to the trusts' advantage. But the Green Paper's silence on the ownership issue, was not in itself an endorsement of the principle of closely-held ownership. As we noted in the previous chapter, it was more a recognition on the part of Roy MacLaren, Mickey Cohen and, subsequently, Barbara McDougall, that rolling back existing shareholder rights under which hundreds of owners had bought into the trust industry was not a workable proposal. The belief that close ownership was not deleterious *per se* to the public interest further entrenched policy-makers' in their conviction that uniform ownership rules for banks and trusts were not necessary. Rather, Cohen's objective was to bring previously unregulated "trusctos" into regulators' purview. This goal was to be accomplished by the FHC concept.

When financial industry observers cite the "brilliance" of Mickey Cohen, it is most often in the context of the innovative framework envisioned by the Green Paper and the FHC structure. One has only to recall our earlier discussion of the demise of Central Guaranty Trustco Ltd. and Standard Truscto Ltd. to appreciate the salutary impact Cohen's proposals would have had on the financial industry and, by extension, the federal deposit insurance fund. The Green Paper proposed to require the creation of a federally-incorporated financial holding company where a federally-regulated financial institution was among two or more financial institutions that shared a common "significant" shareholder.[11] Hence, the controlling shareholder of a federally-chartered trust company and, say, an insurance company registered in Alberta, would be forced to incorporate an FHC and transfer its stakes in both institutions to the new entity. Further, the FHC was to remain "inactive," ie. it would have been "forbidden (from having) direct financial dealings with the general public involving its assets and liabilities and could not issue debt. Generally, it would be limited to holding equity in federally or provincially regulated financial institutions."[12] For all practical purposes then, a financial conglomerate such as Trilon Financial Corp. would have had to either become an FHC, submitting itself to federal regulation and giving up its own merchant banking activities, or transfer its ownership in Royal Truscto Ltd. and London Life Insurance Co. to an inactive, upstream holding company if it wished to continue as a, henceforth federally-regulated, merchant bank.

The FHC structure would have eclipsed several major problems cited in the collapses of Central and Standard. First, the requirement that an FHC remain inactive would have prevented the unregulated activities of a "trustco" from jeopardizing the financial health of its regulated operating company. It would have essentially eliminated the potential for self-dealing, since an "inactive" FHC was to have no business of its own. In its technical supplement to the Green Paper, the government further stated that:

> The primary purpose of requiring financial holding companies to be inactive...would be to prevent any possibility of "contagion" of operating financial institutions arising from difficulties that a levered holding company could encounter. As well, it would maintain a clear capital structure for the group of related financial institutions and minimize supervisory difficulties in respect of double counting of capital.[13]

The prohibition on the issuance of debt by FHC's would have curtailed the incidence of highly-levered parents draining their operating units for dividends to support their own unwieldy debt burdens. This problem reached epidemic proportions in the late 1980s and early 1990s. The said prohibition would have also given greater comfort that the capital base of an operating financial institution was in fact "hard" equity capital, not "illusory" capital that a parent company had borrowed and ultimately had to repay. The Green Paper also proposed to equip regulators with the ability to place controls on the declaration of dividends by FHC's, complementing their existing power to do the same with respect to operating financial institutions. Had such a power been in effect between 1990 and early 1992, regulators might have chosen to use it to halt Royal Trustco from paying out $361 million in dividends while earning a meagre $66 million in profit.

Of course, a healthy FHC would ostensibly earn profits, which, unless paid out as dividends or reinvested in its operating units, would have to be otherwise employed. To accommodate this situation, while at the same time retaining the stipulation that an FHC remain inactive, the Green Paper proposed allowing an FHC to invest its retained earnings in liquid assets, such as federal treasury bills.[14] Under no circumstances, however, was an FHC to engage in portfolio investment, such as the aggressive securities trading that ultimately led to the demise of the Belzberg's First City Financial Corp.

In addition to bringing a whole group of institutions that previously eluded regulators' influence under federal supervision, the FHC concept would have accomplished another of Cohen's key, but unstated, objectives: the extension of the federal government's jurisdiction over the financial system. By requiring FHC's with stakes in provincially-chartered institutions (as all investment dealers were) to submit to federal regulation, Ottawa would have in fact been bringing provincial institutions under its supervision. Of course, calls for Ottawa to assert its constitutional right to regulate banking, broadly conceived as any activity performed by financial intermediaries such as deposit-taking or lending, had proliferated since the Porter royal commission first recommended it in 1964. But no federal government had displayed the resolve necessary to withstand the wrath of the provinces until Cohen proposed the FHC concept. The latter prompted Thomas Kierans, then president of provincially-regulated investment dealer McLeod Young Weir Ltd. to label the Green Paper a jurisdictional "power grab" on Ottawa's part.[15]

In this respect, then, the Green Paper was perhaps doomed before it even got off the ground. Thomas Courchene, a Queen's University economist who was a self-described "scribe" to the Senate banking committee throughout the debate on financial reform, properly noted that the "provinces were incensed" by the Green Paper. "The end result," Courchene added, "was to set in motion a legislative free-for-all at the provincial level."[16] One prominent trust industry representative attributed Ottawa's subsequent abandonment of the of the FHC concept to "the provinces' objections, basically the Province of Quebec. It (the Green Paper) would have required all the big players to submit to federal regulation including the Laurention Group and Power Corp. and Quebec objected. It was as simple as that."[17] The Quebec government at one point even threatened to take Ottawa to court over the matter.[18] It was thus that a senior federal bureaucrat described the unravelling of the FHC proposal.

> The Green Paper was an example of structure triumphing over pragmatism. The notion that you were going to regulate all of these holding company structures in which there was a mix of federal and provincial institutions didn't fly constitutionally, (since securities regulation was considered a provincial power), and it didn't fly in terms of federal-provincial relations. It was a great structure on paper, but if you asked if you could get there from here, the answer was no.[19]

Yet if the crux of the Green Paper lay in the enhancement of Ottawa's regulatory muscle through the FHC principle one wouldn't have known it from the media reaction to McDougall's proposals. For the business press, which was largely the only branch of the media to cover the proposals, the Green Paper amounted to the state's blatant encouragement of closely-held, commercially-linked financial conglomerates. The media focused almost exclusively on the carrot (wider business powers) McDougall was dangling in front of the Brascans and Power Corp.'s and not on the stick (regulation of the trustcos) she had behind her back. Nor did the government appear to go out of its way to stress the regulatory implications of FHC structure, perhaps out of a desire to avoid provoking provincial sensibilities. But had it done so, the Green Paper might have been able to withstand the subsequent attacks it suffered in the wake of the Labour Day failure of the Canadian Commercial Bank, of which more later.

To some extent, the media's focus was understandable in as much as the press merely mirrored the reactions of the banks and trust companies. Neither group made reference, in public at least, to the enhancement of Ottawa's regulatory purview implicit in the FHC proposal. Instead, the Canadian Bankers' Association immediately labelled the proposals unfair, as trust and insurance companies were to be given the power to enter the domain of commercial lending, but the banks were to be prohibited from selling insurance or performing fiduciary functions through an FHC. The banks decried most loudly the fact that no ownership restrictions were placed on trust or insurance companies, arguing that tougher ownership rules were the only way to control the self-dealing practices which they maintained had led to the failure of so many trust companies in the early 1980s.[20] In a statement issued the day the Green Paper was tabled, the TD Bank berated the government for "deluding itself into believing it can solve this issue by providing more regulation and controls on self-dealing...., regulations are always slow, subject to political interference and after the fact."[21]

In their untiring quest to garner popular support for their cause, the banks attempted to couch their demands in language that was congruent with "the public interest." The CBA even went so far as to call one of its briefs on financial sector reform *Responding to the Public Interest*.[22] It further challenged the Green Paper's proposals on the grounds that the exclusion of the banks would deny broader access to financial services to almost 1.5 million Canadians living in 752 communities served only by a bank.[23] Therefore, the CBA argued, the Green Paper would have resulted in the unequal treatment of consumers. To undermine the belief, held by about 40 percent of Canadians,[24] that the banks were "already too big", the CBA asserted that the Big Six were only marginally bigger than the country's six largest financial conglomerates. The latter group held $162 billion in Canadian dollar assets at December, 31, 1984, while the Big Six banks had $195 billion.[25]

The CBA's heavy emphasis on producing rigorous, in depth studies to buttress its policy demands reflected both MacIntosh's academic inclinations and the organization's sense that its access to policy-makers was limited at best. One CBA official described the approach established by MacIntosh this way: "They (the trust companies and financial conglomerates) did it (attempted to influence public policy) the old way, by discreetly lobbying behind closed doors. Our view was largely that that was out for us. It didn't work; it backfired all the time; the bureaucracy didn't really hear us. So the best way for us to proceed was to have a solid position paper on any issue."[26] Under MacIntosh, then, the CBA placed less emphasis on directly approaching policy-makers[27] (cabinet ministers or individual MPs), but rather chose to address them through the media or in other public forums, such as Parliamentary committee hearings. Another senior CBA official acknowledged the weaknesses in the strategy the group adopted after the Green Paper was tabled:

> We didn't tend to be great operators at the grass roots level; we were pretty arcane. But that wasn't our power base; the PM wasn't our power base....And the amount of work we used to do back then with individual MPs was very minimal. We should have seen that MPs in this particular area tended to be pretty powerful....I remember an MP commenting to me: "You know you guys only come when you're up against the wall, whereas the others have cultivated their relationships and, of course, they feed our campaigns. You people are absent until the end." One of the things that we have very consciously done in the recent past is that we've become much closer to the grassroots of the process.[28]

The above discussion should not be taken to mean that the banks' were wholly ineffective in their attempts to alter the government's policy, however. Their very vocal public opposition to the Green Paper was, in itself, a political danger signal for a newly-elected government desirous of preserving its popularity with the electorate. The appearance of policy gridlock created by the banks' repeated, public attacks on the Green Paper clashed with the "can-do", energetic image the government wanted to project. One bank lobbyist explained:

> Politically, it made it much more difficult for them. They realized to get the Green Paper through you couldn't have major opposition from a major part of the industry. It just doesn't serve you politically to have a major loser in a piece of industrial legislation, simply because, in Parliamentary hearings, the media, you're given a platform as a loser that you don't get if you seem to have been dealt with fairly. The media don't give the banks sympathy, but they do give them lineage. So (the banks' public opposition) didn't serve (the government) well in terms of the public's perception of them being able to engineer major legislative change.[29]

The trust industry's response to the Green Paper was, in contrast to the banks' boisterous attacks, surprisingly low key. This, in part at least, stemmed from the fact that the Trust Companies Association of Canada was still a poor cousin to the CBA, without the staff or resources to mobilize a significant public relations campaign. In 1985, it was still a Toronto-based organization, headed by Bill Potter, with little experience in advocating public policy or lobbying. But it took a major step towards becoming a more effective lobbyist that year when it hired consultant John Evans to draft its response to the Green Paper.

The Seattle-born Evans, a former Liberal MP who launched his own consulting firm after losing his Ottawa Centre seat in the 1984 election, was uniquely suited to the lobbying business. Gregarious and affable, he possessed a rare combination of assets: a profound knowledge of financial markets obtained through an academic career, experience in the workings of government from both the political and bureaucratic perspectives and numerous and valuable governmental connections gained on the Ottawa circuit. After graduating from the University of Washington with a finance Ph.D. in 1968, Evans spent two years as a finance professor at the University of North Carolina before joining the commerce faculty at the University of British Columbia in 1970. In 1975, he moved eastward to a senior job in the federal Department of

Consumer and Corporate Affairs, where he became Director of Consumer Research and Program Evaluation. Four years later, he was elected to the House of Commons, serving as chairman of the Commons Finance Committee between 1980 and 1982 and Parliamentary Secretary to Finance Minister Allan MacEachen. As a lobbyist/consultant, Evans won the TCA contract and essentially became the organization's de facto Ottawa representative. He later went on to become TCA president in 1987, moving the group's headquarters to Ottawa at the same time.

The FHC concept proposed by Mickey Cohen had been an idea close to Evans' heart since the early 1970s, when, as an adviser to the Economic Council of Canada, he had advocated a greater federal role in the regulation of all deposit-taking institutions. His reaction to the Green Paper was, not surprisingly, enthusiastic and he pressed McDougall to move expeditiously in implementing most of the proposals. The TCA's aim was simply to ensure that the regulation of FHC's did not become too onerous, while pushing to reverse the proposed ban on all non-arm's-length transactions. The latter, Evans charged, was redolent of overkill and would "hurt growth and constrain competition."[30] Evans further made what amounted to a startling assertion for a former public official who had witnessed the Crown Trust fiasco. He told a Toronto conference in May, 1985: "I have never seen evidence that a financial (institution) failure was a result of self-dealing."[31]

That was certainly not the message Canada Trust president Merv Lahn was spreading. Even though his company had been swallowed by Genstar, Lahn was unremitting in his calls for the imposition of wide ownership limits on trust companies. As the head of the largest member of the Trust Companies Association, Lahn pushed to have the group take a similar stand in its response to the Green Paper. His pleas fell on deaf ears. With the association's next biggest members -- Royal Trust, Montreal Trust, National Trust and Central Trust -- all under the wing of dominant shareholders the TCA came out strongly in favour of the Green Paper and made the defence of closely-held ownership a *cause celebre*. Lahn's reaction was to pull Canada Trust out of the organization. Having lost one member that alone accounted for about a quarter of the trust industry's assets, and which paid dues proportionate to its size, the TCA became ever more dependent on Royal Trust. The latter's importance propelled it into a position of utter dominance within the organization, leading several observers to label the TCA as a "mouthpiece for Royal Trust."[32]

The initial momentum generated by the tabling of the Green Paper, the most widescale blueprint for reform in decades, worked in the trust companies' favour. If anyone needed confirmation that McDougall's paper was a blow to the banks, the market provided it. Three days after the neophyte minister unveiled her proposals, *The Globe and Mail* observed that, "sensing the shifting fortunes (of the trust companies), investors have bid up the price of trust company shares likely to benefit from the proposals. Bank stocks, meanwhile, have languished," reflecting the sense that the Big Six would face a "long-term competitive disadvantage" if the Green Paper survived into law.[33] Wood Gundy Inc. analyst Edna Chapman told *The Globe*: "They're putting the banks in a glass cage and they'll have to watch the world change around them."

Within days, however, the ground began to shift. If the banks' vocal, public opposition to the Green Paper and the provinces' rejection of the document did not in themselves doom the proposals, events exogenous to the policy process did. The first such trouble spot emerged in Alberta, where, under the full glare of the national media spotlight, the Canadian Commercial Bank was experiencing a crisis of investor confidence and deposit seepage. The government's initial response to the bank's problems had come the previous March, three weeks before McDougall tabled the Green Paper, when it hobbled together a $255 million bailout package made up of money from Ottawa, the Alberta government and the Big Six banks. Siding with her deputy Mickey Cohen, McDougall, it later came to light, initially opposed the bailout. She had been "inclined to liquidate the bank" only three days before she announced the rescue package on March 25.[34] But her protestation was squelched by Finance Minister Michael Wilson and the Prime Minister, who sided with Bank of Canada governor Gerald Bouey. The latter "strongly argued for the saving of the bank",[35] in what became an almost fanatical attempt on Bouey's part to avoid the slightest besmirchment of the Canadian financial system in the eyes of foreigners, whatever the cost.[36] At every opportunity, Bouey reiterated to the media that the central bank "stands ready to provide the Canadian Commercial Bank with whatever liquidity support it may require."[37] That support would eventually total a staggering $1.4 billion before the CCB episode had run its course.

The use of taxpayers' money to bail out the CCB prompted a review of the government's actions by the House of Commons Finance Committee, promising still more negative publicity for McDougall and her cabinet cohorts. With an overwhelming majority of Tories among the committee's permanent members, the government might have expected a hearty endorsement of its intervention to save the CCB. But the committee's report, tabled in June, instead depicted a regulatory system in need of serious and thorough rethinking. Without directly mentioning the Green Paper, the report signalled that the committee had no intention of becoming a rubber stamp for government proposals. Rather, the report was a harbinger of the activist role the committee sought to play in the formulation of public policy, offering itself as a sort of alternate "chamber of sober second thought" and check on government.

What prompted the committee's adoption of this activist stance was the resolve of its members, a unique group of maverick and ambitious MPs,[38] to avoid languishing in obscurity on the government or opposition backbenches. Traditionally, committee members from the government side of the House had used their positions to build a profile that might one day win them a seat at the cabinet table. And the surest way to establish oneself in the eyes of the Prime Minister and his advisers was through loyalty, as an advocate and defender of the government's policies. The Tory MPs who joined the finance committee during the First Session of the Thirty-third Parliament, however, broke with this tradition. Perhaps discounting their chances of making it into the cabinet in light of Mulroney's record-sized, 211-member caucus, (or perhaps as a way to stand out from their other 200 or so colleagues), the group led by Mississauga South MP Donald (Don) Blenkarn soon emerged as a foil to the cabinet and the bureaucracy.

Ironically, the Prime Minister himself was largely responsible for this development. The Conservative wave that swept the country in September, 1984 had carried more Tories to victory than Mulroney knew what to do with. Of the 211 Conservative MPs, only 40 would make in into the cabinet and another 30 or so would be appointed Parliamentary Secretaries, the title given to "understudies" to a cabinet minister. A handful might be kept busy as whips or deputy whips or speakers or deputy speakers. But that still left more than 125 Conservative backbenchers with no role on the Tory team except to dutifully toe the party line on House votes.

The Prime Minister and his advisers immediately recognized that such circumstances constituted fertile soil for the seeds of caucus revolt. Shortly after the election, therefore, Mulroney commissioned Newfoundland MP James McGrath to conduct a study on House reform, with a special mandate to look at ways to augment the role of individual, backbench MPs. The result was a series of recommendations, embraced and adopted by Mulroney, to strengthen the authority and independence of Parliamentary committees. Perhaps the most significant among them was the suggestion that:

> each standing committee have before it the full departmental policy array to review and to report on, including, but not restricted to the following: the reasons for a department's statutes; the statutes themselves; a department's objectives in relation to its statutory mandate; the activities carried out in pursuit of these objectives; a department's immediate and long-term expenditure plans for these activities; and the achievements of the department measured against its objectives.[39]

In short, a House committee would henceforth be able to initiate investigations on its own, i.e. set its own agenda, without first obtaining a special order from the House to do so.

Among the other proposals adopted were those giving committees the authority to compel witnesses and review draft legislation, and the autonomy to hire their own staff and make expenditures.[40] Standing committees[41] also acquired the power to summon for questioning deputy ministers and other officials appointed by a cabinet Order-in-council, including regulators.[42]

Needless to say, the reforms, to the extent that they were exploited, went a long way toward improving the efficacy of individual MPs. The revamped committee structure provided an outlet for members, whose talents might otherwise have gone untapped on the backbenchers, to contribute to the workings of government. But, perhaps more importantly, the changes upset the existing distribution of authority within the policy-making process. Politics is, after all, mostly about power and the reforms enabled a savvy committee chairman to select or frame issues in a manner to suit his or her agenda and garner publicity for the committee and its activities. The time appeared ripe for the emergence of a Canadian counterpart to Lloyd Bensten, then the powerful chairman of U.S. Senate Finance Committee, or Dan Rostenkowski, the tenacious head of the Ways of Means Committee of the U.S. House of Representatives.[43]

The sole Canadian committee head to come close to attaining the profile of a Bensten or Rostenkowski was Finance Committee chairman Don Blenkarn. The Mississauga lawyer had first been elected to the House in 1972, but was defeated two years later. He regained his seat in 1979, the same year Michael Wilson successfully carried the Tory banner for the first time. Blenkarn might have made it into the cabinet had it not been for Wilson's previous career as an executive vice-president at investment dealer Dominion Securities Inc., which made him an obvious cabinet choice. The proximity of the two members' ridings (Wilson represented nearby Etobicoke Centre) in itself dimmed Blenkarn's chances of winning a cabinet post, since Prime Ministers have by convention strived to maintain a regional balance at the cabinet table.[44] Notwithstanding our earlier discussion, Blenkarn's attempts to fashion the Finance Committee into an alternate power base to the cabinet and bureaucracy were seen by some as a way of gaining the Prime Minister's attention and respect. For example, one financial industry lobbyist, who routinely crossed paths with Blenkarn during the long imbroglio over financial sector reform, asserted that:

> Don was trying to get into the cabinet on the back of competence, on the back of hard work, of proving himself as an expert. Unfortunately, Canadian politics and the appointment of people has very little to do with competence. It has to do with your ability to be a politician, not a policy-maker. And even more so, in this country, it's geography over competence that determines the composition of the cabinet.[45]

Still, Blenkarn was successful in establishing his committee as a force to be reckoned with, wielding a heretofore unprecedented amount of influence over the development of government policy. Of course, the rigour, hard work and sheer talent of Blenkarn and the rest of the committee's members were largely responsible for this success. But Blenkarn's "folksy" personality, his forthrightness and predilection for hyperbole gained him a loyal following both inside and outside of Parliament. One bank lobbyist commented that:

> He did shift the ground (on financial sector reform). The bureaucracy were really unhappy with him. He was influential (in derailing the government's agenda) because he was powerful in the caucus, very powerful. They listened to him, they admired him. He's also very bright. People underestimated him because he tended to heave wind, but, boy, he's not stupid. He had leadership and the government was afraid to put him down.[46]

The idea of an activist committee system was also greeted enthusiastically by the media, which are adversarial by nature and quick to seize on the slightest indication of conflict. The Finance Committee offered one of the first inklings that conflicts would proliferate between itself and the government with its June, 1985 report on the CCB bailout. Although the Tories on the committee did support the government's decision to inject funds into the ailing bank,[47] the committee's report cast a heavy cloud of doubt over the adequacy of the existing regulatory apparatus and the performance of Inspector-General William Kennett and his staff. "Events have shown that (the CCB's) management accepted risks beyond the realm of prudence," the committee concluded. "The question then becomes whether supervision in this instance was adequate."[48] Considering that the report was released while attempts were ongoing to preserve the CCB as a going concern, the committee was disarmingly forthright in its assessment of the situation. One suspects that had the CCB already been in liquidation when the committee completed its proceedings, Blenkarn's group would have delivered an even more damning rebuke to the CCB's managers, auditors and regulators (and, indirectly, the government).[49]

For the government, the committee's report was a cold shower presageing the political crisis that was to erupt when McDougall was finally forced to shut down the CCB and Northland three months later. The Labour Day seizures of the two institutions, the first banks to fail in more than sixty years, extinguished any remaining flicker of hope that McDougall's Green Paper would survive into law. The management and regulatory lapses that precipitated the collapses served to shift the focus of the policy debate, especially in the media. The latter had interpreted the Green Paper as an attempt by the new government to invigorate competition by promoting the formation of financial conglomerates. For McDougall, it was too late to dispel those notions; a new policy was needed to address the solvency concerns raised by the crisis.

The Minister did maintain a brave face in public, however, vowing to press forward with her proposals. "We have been ploughing down this road all the time, we haven't stopped...," she told *The Financial Post*'s Sonita Horvitch.[50] But her comments belied the reality of the situation. The fact remained that, whereas articles on financial sector reform had been relegated to the business pages, the bank failures were front page news. The unfavourable media spotlight forced the government to change tack. "That was the death of deregulation," one lobbyist recalled.[51] "From that moment on, the emphasis was on re-regulation." A bank representative added:

> The overwhelming notion precipitated by the media was that, well, you can't go ahead bringing in all these new laws giving people a hell of a lot of new powers without understanding why we're getting the failures we're getting. You better make sure this is not going to further weaken companies....I think those sentiments were all internalized (within the government) and not explicitly stated. But they (policy-makers) made their judgements about whether or not they could

> move and there was a recognition that until you had done the soul-searching...you wouldn't have had the political acceptance you needed.[52]

In a 1990 article, *The Economist* aptly noted that "public policy concerns about issues such as concentration of financial power, conflicts of interest, unfair competition, and the protection of investors and depositors ebb and flow with fashion and disaster."[53] In this case, a "disaster" focused public concern on consumer protection and solvency, forcing the Minister to take quick action to restore confidence in the financial system. McDougall's immediate response to the CCB and Northland debacles was to promise compensation for uninsured depositors,[54] and propose legislation to equip regulators with "broad" new powers to police the sector.[55] The first vow was fulfilled with legislation passed in October, 1985; the second was partially met when McDougall tabled draft legislation in early December, 1985. A bill was then proposed that would have required ministerial approval for changes in ownership of more than 10 percent of a trust or mortgage company. The bill also would have empowered the Inspector-General of Banks and the Superintendent of Insurance to issue "cease-and-desist" orders to stop institutions from engaging in practices deemed to be too risky. Finally, the draft legislation would have allowed trust and insurance regulators to substitute questionable real estate appraisals that institutions used to justify their lending practices with revised values.[56]

McDougall did not endeavour to rush the draft legislation through Parliament, however. There were good reasons for her reticence. As part of the government's strategy to contain the damage from the CCB and Northland debacles, McDougall had on September 29 appointed Willard Estey, then a Supreme Court Justice, to chair a one-person public inquiry into the failures and "to make any consequential recommendations for changes in the control of the banking industry in Canada."[57] Two months later, she also commissioned Warren

Chippendale, chairman of consultants Coopers & Lybrand to study the operations of the Inspector-General's office. To proceed with a massive overhaul of the regulatory apparatus before Estey and Chippendale made their pronouncements on the adequacy system risked placing the government in a potentially embarrassing situation down the road if the two came out with recommendations contrary to Ottawa's measures.

Eighty-five witnesses were paraded before the Estey commission, which sat from October 2, 1985 through to May 22, 1986, generating a total of 13,656 pages of testimony.[58] What emerged during the hearings, which riveted the attention of both the press and broadcast media, were countless painstaking accounts of how the banks' managers adopted "creative" accounting tactics to disguise their difficulties. The banks continued to accrue interest on loans well over 90 days in arrears and capitalized interest (added it to the loan's principal) based on future value appraisals of the real estate backing the loan, instead of the property's much lower, actual market value. Sour loans were routinely "rolled over" by issuing a new loan to pay off the one in default, allowing the bank to avoid taking a loan loss provision. Auditors and regulators took umbrage with these accounting practices, which artificially boosted the banks' reported profits, but ultimately refrained from taking stiffer action. Then Deputy Inspector-General Don Macpherson, who spent more time on the stand than any other witness during the Estey commission's proceedings, made headlines with his description of regulators' "wink-and-nod" approach to supervision, the tendency to rely on gentle nudges or "moral suasion" to bring recalcitrant institutions into line.[59] Macpherson told the commission in October, 1985 that regulators have only "a few strings in the bow" to deal with ailing institutions. As a result, while the IG's office was "certainly aware of the (banks') problems...(,) we were prepared to allow them to find a way out of the problems for as long as we could."[60]

With revelations such as these splashed across the headlines on a daily basis during the fall of 1985, it was no surprise to see the House of Commons Finance Committee weigh in with its own proposals for an overhaul of the regulatory system in early November.

> Recent events would indicate that the traditional "gentlemen's approach" to financial supervision is no longer appropriate in an environment of increased risks, frequent and significant economic shifts and intense competition. A more assertive supervisory approach is required, together with the requisite enforcement powers to get the job done. The traditional "reactive" mode of regulation must give way to a "pro-active" mode.[61]

In short, the Commons Finance Committee presented the government with a staggering 134 recommendations, systematically rejecting most of the Green Paper's proposals, including the FHC and Schedule C bank concepts. Unlike the Green Paper, which led off with the deregulatory aspects of the government's proposals, the committee's report began with forty-nine recommendations aimed at fortifying the regulatory apparatus.[62] The crux of its proposals centred on the creation of a new super-regulatory agency, to be called the National Financial Adminstration Agency (NFAA), through the merger of the of the IG's office, the Superintendent of Insurance and the CDIC.[63] The NFAA was to be a tri-partite body, with a board comprised of representatives from the federal and provincial governments and the financial industry. In order to palliate lapses uncovered by the CCB and Northland fiascos, as well as the earlier trust failures, the new agency was to adopt a more aggressive "on-site" inspection system, in contrast to regulators' habit of visiting only institutions in trouble; it would have the power to appoint at least one of an institution's two auditors and enforce accounting standards with respect to the treatment of non-accrual loans.

Furthermore, the NFAA was to have "broad powers to inspect institutions without notice, to appraise asset values, to issue cease and desist orders and to initiate prosecutions for conflict of interest and self-dealing offences."[64] It proposed criminal penalties for infractions. The Finance Committee rejected, however, the Green Paper's proposed ban on all non-arm's length transactions. Instead, financial institutions would be allowed to engage in some unharmful non-arm's length transactions, subject to the approval of the NFAA.

While the Finance Committee agreed with the Green Paper's aim of expanding the business powers of all domestic (and foreign!) financial institutions, it opted for strict ownership regulations. Based on a sliding scale, the committee proposed that *any* financial institution (including banks) with domestic assets of less than $20 billion, could be closely-held. At that point, however, any individual stake would be limited to 50 percent. Individual holdings in financial institutions with assets in excess of $30 billion would be limited to 25 percent, while once an institution surpassed the $40 billion threshold a 10 percent ceiling on individual stakes would apply.[65] In an apparent recognition of the increasing need for reciprocity to help domestic banks, trusts and insurers crack foreign markets, the committee's proposals were to apply equally to Canadian and foreign-owned financial institutions.

The committee's recommendations were not intended as an endorsement of the principle of closely-held ownership. That, however, was how they were interpreted by many observers and the media. The committee explicitly stated in its report that it was

> concerned about the increasing trend towards non-financial ownership of financial institutions and feels concentrated ownership, particularly that of large financial institutions, should be limited.[66]

It also called on the government not to approve the proposed merger between Canada Trust and Canada Permanent Trust until a new ownership policy was in place. Still, had the committee's ownership proposals been implemented, three of the Big Six banks could have come under the wing of a dominant shareholder.[67] There was also a practical question of whether or not the ownership thresholds were to be indexed upward with inflation. Clearly, the committee believed its proposals would have eventually limited the growth of closely-held, commercially-linked financial conglomerates. But the New Democrats on the committee dissented, preferring a more direct measure. Nelson Riis and Simon de Jong called for the imposition of wide-ownership rules on all federal financial institutions.[68] Asked whether commercial ownership of financial institutions was "a worry", Riis told *The Financial Post*:

> You bet it is. When you look at emerging corporate concentration in the financial services industry, if the Blenkarn Report recommendations were introduced, it would be a tremendous opportunity to tie up the entire corporate financial world in the hands of a handful of families. And that's why I've opposed strenuously some of the recommendations in the Blenkarn Report.[69]

The Finance Committee's decision not to take a tougher stance on the ownership issue was all the more curious considering that one of the most compelling of the 101 testimonies it heard came from Bernard Ghert.[70] Then President and CEO of developer Cadillac Fairview Corp., Ghert had delivered a categorical denunciation of commercial-financial links. His testimony was considered all the more credible, and troubling, given that one of Cadillac Fairview's largest shareholders was the Reichmann family, then the Bronfmans' partner in the country's premier commercially-linked financial conglomerate, Trilon Financial Corp. Ghert himself was director of a Trilon subsidiary, Wellington Insurance. His aversion to commercial-financial links, which stemmed from his own academic inclinations, were, however, understandable considering the other company Ghert kept: Canada Trust's Merv Lahn was on Cadillac's board and Ghert was on the trust company's executive committee.

The core of Ghert's argument against closely-held ownership of financial institutions, and the mixing of financial and commercial activities under the same corporate roof, was that the absence of ownership restrictions would lead to excessive concentration in the financial, and real, sectors of the economy. Ghert's submission, which was actually ghost-written by University of British Columbia business professor and competition policy expert William Stanbury, asserted that such concentration could threaten the democratic fabric of the nation, as those with disproportionate economic power would consequently wield disproportionate political power.

> It is conceived, in the absence of any controls over conglomerate ownership (with the possible exception of the major chartered banks), that within a decade or so both the financial and non-financial sectors will be dominated by less than a dozen very large "groups" which will span both sectors as is the case in Japan. These groups could wield enormous economic power. The concern for public policy is not simply that those with such power will earn excess profits. Rather **the concern is that these large groups will have the ability to earn an acceptable level of profits (e.g. sufficient to prevent a takeover) and be able to use their power to achieve objectives other than increasing the shareholders' wealth.** This power may be used to alter the behaviour of other firms involuntarily, e.g.,
>
> * by advancing the interests of some customers or suppliers and/or by penalizing others;
>
> * by undermining the position of rivals in ways inconsistent with maximizing the wealth of one's own shareholders;
>
> * by providing excess rewards, pecuniary or otherwise, to the top management coalition that effectively controls the corporation; or
>
> * by using economic power to influence public policy via the political process, i.e, expenditures on lobbying, advocacy advertising, public relations, campaign contributions, and the ability to redirect corporate locational decisions.[71]

Ghert's argument was unwittingly amplified and seized on by the business media; the latter were unrelenting, in late 1985 and early 1986, in their focus on tobacco conglomerate Imasco Ltd.'s stalking of Canada Trust parent Genstar Corp. and the burgeoning merchant banking activities of Trilon and other companies within the Edper-Bronfman group. These developments prompted a rethinking of the ownership issue by the Commons Finance Committee. At the initiative of Tory crusader Paul McGrossan, then the Member of Parliament for Scarborough Centre, the committee reconvened for three public hearings on April 21, June 2 and June 11, 1986, as well as a handful of in camera proceedings. After hearing the "theoretical" arguments advanced earlier by Ghert, McCrossan and his cohorts now wanted evidence; Ghert was called back before the committee to provide them with some.

Ghert's evidence came via discussions he had had with Toronto Dominion Bank chairman Richard (Dick) Thomson and Austin Taylor, chairman of investment dealer McLeod Young Weir. Taylor apparently related the story

> of a financing deal with a Brascan company that was cancelled at the last moment, then revived with one of the Brascan group acting as broker. A brokerage firm had negotiated a stock issue with Royal Trust; at the last moment (chief Edper-Bronfman strategist) Jack Cockwell stepped in and said, "Don't go ahead with it, we can do this ourselves."...The story attributed to Thomson had more substance. Apparently Royal Trust was providing financing for a company, with Toronto Dominion and others. At the last moment, word came down from the Edper-Brascan boys to back out. The reason: the company receiving the money, a paper company, was a competitor of another company in the Edper-Brascan group.[72]

When Merv Lahn appeared before the committee he told of an arrangement between Genstar and its trust subsidiary under which the latter provided a guarantee on an equipment leasing contract signed by its parent. The arrangement, although hardly scandalous, did raise eyebrows since Genstar appeared to be using its influence over the trust company to force the latter to put depositors' money at risk for its parent's benefit. (The guarantee ostensibly allowed Genstar to lease the equipment on better terms.) The incident was seized on by the committee in its supplementary report, tabled in late June.

> In one case it was established that after having been refused a related party transaction by the Superintendent of Insurance, a company completed transactions which did not require the approval of the Superintendent. In this specific example involving Genstar and Canada Permanent, it appears that the depositors were in fact fully protected under the new arrangement. However, in its in camera evidence, the Committee learned of examples of transactions involving a

> third party in which the interest of depositors did not appear to have been so well protected.[73]

To respond to Ghert's testimony, Brascan president Trevor Eyton and the group's chief financial strategist Jack Cockwell were called before the committee. The duo downplayed the self-dealing scares raised by Ghert and other earlier witnesses, holding out Royal Trust's Business Conduct Review Committee, a sub-committee of the board of directors empowered to vet all related party transactions, as insurance against any abuses by dominant shareholders. But they did not have a receptive audience; to the committee, Eyton's motives were suspect. It didn't help Eyton's case that he was already in the news over his business dealings with former cabinet minister Sinclair Stevens.[74] At the same time, the Bronfman operatives' patrician demeanour and evident indignance at being compelled to appear before the committee grated on Blenkarn and his colleagues, who believed in the rightness of their cause. At one point during the hearing, Blenkarn denounced the "arrogance" of Cockwell's assertions, while Nelson Riis remarked that "Eyton sounded like a feudal lord."[75] One trust lobbyist insisted that the Brascan representatives, who appeared to be openly disdainful of the democratic process, alienated MPs, bureaucrats -- and cabinet ministers.

> They were not politically astute. I don't know who their advisers were, but they were not the best. They had very little experience dealing with Ottawa, or bureaucrats and politicians, period. And it showed.[76]

When it tabled its supplementary report in late June, the committee amended its original recommendations, proposing now that institutions be required to give the NFAA 30 days prior notice of "any direct or indirect related party transaction," special or extraordinary dividend to parents, or "any inter-affiliated transaction involving the issuance or acceptance of common or preferred shares or subordinated debt."[77] Fittingly, however, the kicker of its report was nestled in the second last paragraph; the committee was now recommending that non-financial companies be prohibited from owning "directly, indirectly, or beneficially" more than 30 percent of a financial affiliate.[78]

To be sure, the evidence offered by Ghert and Lahn did not present the committee with the smoking gun it was looking for; there were no horror stories to match the by then three-year-old stories of Leonard Rosenberg and others of his ilk. Still, the potential dangers and abuses inherent in the transactions the committee heard about were sufficient to warrant a tougher stand on the ownership issue.

If there were still any doubt, the Green Paper was definitively relegated to the ash heap of history by June, 1986 after the Finance Committee delivered its supplementary report and McDougall was replaced as Minister of State for Finance by Tom Hockin. While some observers viewed McDougall's subsequent appointment to the privatization and status of women portfolios as a promotion, the overwhelming sentiment in banking circles was that she was shifted out of the junior finance ministry "because she had spent her political capital," according to one bank representative.[79]

> She had been there during the CCB-Northland failures. There was a very, very tricky situation in our industry when we advanced money (to bail out the CCB) late in the day at the government's request, having been told that if they went under we would be kept whole. Then they backed away from it...So, McDougall might have had a higher profile in the government than Hockin. But high profile had become a very negative thing. With the banks, she was a very, very bad odour. To this day, people haven't forgotten it. We were effectively given a commitment which was broken -- and it was big bucks, too.[80]

Whereas McDougall had been unbending in her rejections of the banks' demands for greater powers, on an equal footing with other financial institutions, the 48 year old Hockin was more inclined to consider their position. His openness was explained by the growing importance accorded by the Mulroney government to the negotiation of a Free Trade Agreement with the United States. An internationalist himself, (the London, Ontario native was once a teaching assistant to Henry Kissinger while completing his Ph.D. at Harvard University), Hockin had in 1985 co-chaired a special House and Senate committee on Canada's international relations and trade policy. One of the central and most innovative features of the government's proposed treaty was free trade in services, including financial services. It was clear to the government that all Canadian financial institutions, except the banks, were dwarfed by their American counterparts. Thus, assuring a strong Canadian presence in the financial sector meant strengthening the banks. The new Minister spoke of the "need to arm all our financial institutions, including the chartered banks, with the powers to compete in rapidly changing world financial markets." At the same time he stressed that the government was not undertaking "an exercise in deregulation. It's an exercise in re-regulation and our regulations have to be smarter and more effective."[81] The change in tack that had McDougall had only subtly expressed after the bank failures became, under Hockin, blatant.

But as a rookie minister, with no previous experience in government, Hockin was seen by industry representatives as indecisive. "He meant well, but he never had a strong view of his own," one bank lobbyist remarked.[82] "He tended to go along with whatever his staff told him, or (Finance Minister Michael) Wilson." Thus, as the political fallout surrounding the bank failures began to die down, and with Hockin still learning the ropes, the time was ripe for the bureaucracy to reassert itself in the formulation of an alternative to the Green Paper. A new Deputy Minister of Finance, Montreal lawyer and Mulroney friend Stanley Hartt, had been appointed to replace Mickey Cohen. The latter, who had defected to the private sector in the summer of 1985, had provided the intellectual underpinning to the Green Paper's proposals.

Hartt, who did not share Cohen's deep interest in financial reform and was more interested in pressing his own agenda on tax reform, felt under no obligation to defend the policies of his predecessor.

Hartt was nevertheless influential in setting the tone for financial sector reform. Coming from the private sector, Hartt was able to "shake up people in the bureaucracy, which was quite entrenched in the notion that you had to bring in more competition and push down the banks," according to one lobbyist.[83] "He didn't get involved in the details (of financial sector reform) so much, but he was important in that he was prepared to challenge some fairly entrenched thinking in the bureaucracy." Hartt put Associate Deputy Minister and Duke University economics Ph.D., Fred Gorbet, in charge of fashioning an alternative policy to the Green Paper.

Time was of the essence. Ontario had tabled its own trust legislation in December, 1985,[84] advocating tougher supervision and the application of an "equals approach" that would require trust companies operating in the province to observe Ontario's rule in *every* jurisdiction in which they did business. Under the Liberal government of David Peterson, Ontario had also proposed, in June, 1986, to partially open up its securities industry to other domestic and foreign financial institutions. In addition, reform was proceeding apace in Quebec. Ottawa risked seeing its hand forced by developments elsewhere, thwarting its desire to reassert a federal role in financial institutions regulation.

Ottawa was, however, prevented from moving ahead with the announcement of its own policy by two factors. First, Supreme Court Justice Willard Estey had not yet tabled his report on the CCB-Northland debacle. Second, the federal government had been caught completely off guard by Ontario's June announcement and was wholly unprepared to respond in short order. The government needed to await Estey's input into any overhaul of the regulatory apparatus.

Estey finally delivered his report to the government in August, 1985, painting a dreary picture of regulators apparently without the "will to act" when it was needed. The government pored over the report for two months, to make sure that its own soon-to-be released proposals would stand up to Estey's criticisms, before making it public on October 24.

The second outstanding piece of business -- responding to Ontario's move -- was more problematic. To accommodate Ontario's proposals, the *Bank Act* would have to be amended to allow the banks to invest in securities dealers. But to do that, without at the same time allowing banks to diversify across the pillars, seemed an untenable proposition if wider powers were to be granted to non-bank institutions. The situation was not made any easier for Ottawa by its tenuous relations with the Peterson government. The quagmire forced Michael Wilson to take over the file on financial reform.

NOTES

1. The events were described in confidential interviews with some of those who present at the time.

2. Department of Finance, *The Regulation of Canadian Financial Institutions: Proposals for Discussion*, (Ottawa: Ministry of Supply and Services, April 1985), 85. (Henceforth, "the Green Paper.") Our emphasis.

3. Canadian Bankers' Association, *Preliminary Comments on "The Regulation of Canadian Financial Institutions: Proposals for Discussion"* (Toronto: Canadian Bankers Association, July, 1985), 6.

4. Department of Finance.

5. Cited in Martin Mittelstaedt and Bruce Little, "Trusts are chief beneficiaries of revamped banking rules," *The Globe and Mail*, April 16, 1985.

6. Department of Finance.

7. Marin Mittelstaedt, "Deregulation paper gives banking powers to trusts," *The Globe and Mail*, April 16, 1985.

8. Patricia Best and Ann Shortell, *A Matter of Trust* (Markham, ON: Penguin Booksss Canada Ltd., 1986), 361.

9. Department of Finance, *The Regulation of Financial Institutions: Proposals for Discussion, Technical Supplement*, (Ottawa: Ministry of Supply and Services, June 1985).

10. See Mittelstaedt and Little and Mittelstaedt.

11. The FHC requirement would have applied to any shareholder that owned more than 10 per cent of two financial institutions, at least one of which was federally-regulated.

12. Department of Finance, Green Paper, 32-33.

13. Department of Finance, Green Paper, Technical Supplement, 13. The technical supplement described the "double-counting problem" as the situation that arises "when capital is counted once as an investment by the parent corporation supporting its own liabilities and once as capital supporting the activities of a subsidiary. Where the parent corporation is inactive, the capital unambiguously supports the activities of the subsidiary."

14. Department of Finance, Green Paper, Technical Supplement, 15.

15. Cited in Dennis Slocum, "Federal Paper termed a slap on co-operation on regulation," *The Globe and Mail*, May 24, 1985.

16. Thomas Courchene, "Crumbling Pillars: Creative Destruction or Cavalier Demolition?", prepared for the Conference on Deregulation and Reregulation, Lethbridge, Alberta, September, 1989, 23.

17. Confidential interview, December, 1992.

18. See Giles Gherson, "Financial reforms risk getting bogged down," *Financial Post*, July 20, 1985.

19. Confidential interview, November, 1992.

20. See Canadian Bankers' Association, 21-29.

21. Mittelstaedt.

22. Canadian Bankers' Association, *Financial Services Industry: Responding to the Public Interest*, (Toronto: Canadian Bankers' Association, July, 1985).

23. Canadian Bankers' Association, *Preliminary Comments*, 10.

24. The information is contained in the results of a poll (see Ibid., chart 5) commissioned by the CBA in June, 1985. It showed that while 59 per cent of Canadians believed that the banks would bring more competition to the market if they were given the same powers as the Green Paper envisioned giving other financial institutions, a significant number of Canadians (37 per cent) thought the banks were "already too big" and should not be allowed to get bigger.

25. Ibid., chart 2. The six largest financial conglomerates cited by the CBA were Trilon Financial Corp. ($55.3 billion), Power Financial Corp. ($32 billion), E-L Financial Corp. (27.9 billion), Desjardins Group ($19.9 billion), Genstar Financial Corp. ($17.5 billion), Laurentian Group ($9.2 billion).

26. Confidential interview, November, 1992.

27. The CBA did, however, keep in close contact with the bureaucrats responsible for financial sector policy, although bank lobbyists maintained their influence with this group was minimal.

28. Confidential interview, November, 1992.

29. Confidential interview, November, 1992.

30. Slocum, "Federal paper."

31. Ibid.

32. Confidential interviews.

33. Martin Mittelstaedt, "Banks languish, trusts soar in wake of proposals," *The Globe and Mail*, April 19, 1985.

34. See Bruce Little, "Memos reveal Mulroney involved in CCB bailout," *The Globe and Mail*, October 24, 1985. McDougall's opposition was revealed in a confidential memorandum presented to the Estey inquiry into the CCB's collapse. The memo, prepared by then Assistant Inspector-General of Banks Donald Macpherson, gave a detailed run-down of the interchange between McDougall, Finance Minister Michael Wilson, the Prime Minister's Office, the Inspector-General's office and Bank of Canada governor Gerald Bouey during the week leading up to the bailout.

35. See Ibid.

36. Bouey's crusade to protect the international reputation of Canada's banking system even led the normally circumspect central bank governor to resort to "manipulating" the media. On January 25, 1985, the day CCB chairman Howard Eaton officially resigned and speculation mounted about the bank's stability, Bouey took the unprecedented step of telephoning *The Globe and Mail*. Bouey explained his intervention by saying: "We want to assure people from far off, in other countries, that nothing terrible is happening to our banking system at all....If it (the CCB) required any liquidity support, the Bank of Canada would provide it." As a result of the call, which apparently came only shortly before the paper went to press, *The Globe* led with a

front page headline that said "Alberta bank in no danger, Bouey states," instead of leading off with Eaton's troubling and confidence-razing resignation. The episode is recounted in Arthur Johnson, *Breaking the Banks* (Toronto: Lester & Orphen Dennys Limited, 1986), 211-212.

37. See Bruce Little, "Bouey vows continued aid to ailing CCB," *The Globe and Mail*, April 19, 1985.

38. The committee was composed of seven permanent members and about a dozen "alternate" members who participated in the committee's proceedings. Among the group were Progressive Conservative chairman Don Blenkarn and vice-chairman Louis Plamondon. Several members had backgrounds that gave them useful insights into and perspectives on financial services issues. Former Liberal cabinet minister Donald Johnston was a recognized tax lawyer; Raymond Garneau had been Quebec's finance minister and president and CEO of the Montreal City and District Savings Bank (now the Laurentian Bank); Liberal Aideen Nicholson, considered one of the hardest working MPs on the opposition benches, was an economist; Tory Paul McCrossan, who took up the ownership cause with particular zeal, was an actuary; McCrossan's ally on the ownership issue, Tory Bill Attewell, had been a vice-president of corporate planning at Guaranty Trust Co. when it was owned by the McCutcheon family. The committee's membership was rounded out by: New Democrats Nelson Riis, Steven Langdon and Simon de Jong; Progressive Conservatives Claude Lanthier, Norman Warner, Murray Dorin, Geoff Wilson, George Minaker, Shirley Martin, Jim Jepson, Bernard Valcourt, Robert Toupin, and Nic Leblanc.

39. Cited in C.E.S. Franks, *The Parliament of Canada* (Toronto: University of Toronto Press, 1987), 181.

40. *Ceteris paribus*, the size of a committee's budget is a determining factor in its ability to successfully pursue its own agenda. As Stevie Cameron notes in *Ottawa Inside Out* (Toronto: Key Porter Books Limited, 1989), 116:

> The only committee that seems to have been successful in establishing itself as a powerhouse is the House Finance Committee, run by Tory maverick Don Blenkarn. Blenkarn and his colleagues have not hesitated to thump the government over credit card interest rates, tax reform, and the rules governing financial institutions. But look at their budget. This committee has more money than any other; in 1987, it spent $720,000, and that was without any travelling costs. Just to give you an idea, the Committee on Elections, Privileges and Procedure, which does such things as grill the government about lobbyists and patronage appointments, spent $58,100.

41. "Standing" committees, such as the House of Commons Standing Committee on Finance, Trade and Economic Affairs, (Finance Committee), are permanent in nature and are distinguished from "legislative" committees, which are struck to review specific pieces of legislation before the House.

42. Franks, 182.

43. The implementation of the McGrath committee's proposals brought with it the inevitable comparisons to the U.S. Congressional committee system. Stevie Cameron (114) comments, for instance, that the McGrath group envisioned committees "much like the powerful ones that exist in the United States Congress." However, the inspiration for the reforms might be more properly seen as the British House of Commons, which in 1979 adopted reforms strikingly similar to the ones implemented in Canada in 1985. Franks (180) notes that the "British committees have already proved to be more independent of the government, less partisan, more purposeful, and more satisfying to members."

44. If anything, the Toronto region is more likely than not to be underrepresented in the cabinet, in proportion to its population, given the rest of the country's antipathy toward the nation's leading metropolis.

45. Confidential interview, December, 1992.

46. Confidential interview, November, 1992.

47. Liberal Aideen Nicholson dissented with the majority in her opposition to the government-led bail out, commenting: "I didn't want to see public money used because I think the banks are very prosperous and they have a very strong interest in maintaining confidence in the system." See David Stewart-Patterson, "Everyone involved looks bad, House CCB investigation says," *The Globe and Mail*, June 13, 1985.

48. Cited in Ibid.

49. Obviously sensitive to the confidence-damaging potential of the committee's report, Blenkarn was quick to qualify its contents by stressing that the CCB was "very safe, perhaps safer than any other institution at this point." (See Ibid.) If Blenkarn's predictive abilities proved inaccurate on the CCB's stability, the Mississauga lawyer was perceptive in asserting that: "There might be some grounds for some lawsuits." (See Ibid.) In fact, in 1987, CCB's liquidator sued CCB's auditors, managers and directors for $294 million, alleging that negligence on the defendants' part allowed the CCB to continue operating for two years after it was technically insolvent. The parties settled out of court for $82.5 million in 1990 with auditors Ernst & Young (the successor to Clarkson Gordon) and Peat Marwick Thorne and certain directors and officers. See Konrad Yakabuski, "Deal allows bank liquidation to proceed," *The Toronto Star*, November 3, 1990. More than 90 per cent of the settlement was reputed to have been picked up by the accountants and their insurance companies. The two accounting firms also agreed to pay $43.2 million to settle a similar suit launched against them by the liquidator of the Northland Bank. The settlements remain the largest of their kind in Canada and sent shock waves through the accounting profession, which saw them as a harbinger of things to come. (Ironically, the liquidators who launched the suits were rival accounting firms. CCB's liquidator was Price Waterhouse Inc., while the Northland's liquidator was Deloitte & Touche Inc.) In the U.S., suing auditors of failed financial institutions has become a primary means for government regulators to recoup losses on such failures, although the symbolic worth of such suits far exceeds their actual monetary benefit. The biggest such settlement came in November, 1992 when Ernst & Young agreed to pay a record $400 million to settle about a dozen negligence

suits brought by the Federal Deposit Insurance Corp. See John Cushman Jr., "Accountants pay $400 million to U.S. over S. & L. audits," *The New York Times*, November 24, 1992.

50. Cited in Sonita Horvitch, "Waiting for McDougall," *The Financial Post*, April 5, 1986.

51. Confidential interview, December, 1992.

52. Confidential interview, November, 1992.

53. "Survey of international banking," *The Economist*, April 7, 1990.

54. The reimbursement of uninsured depositors, discussed in Chapter 3, cost the federal treasury about $875 million.

55. See Bruce Little, "Bank failures prompting tighter rules," *The Globe and Mail*, September 3, 1985.

56. See Giles Gherson, "Financial reforms proceed at cautious pace," *The Financial Post*, December 7, 1985. At the same time that she tabled the draft legislation, McDougall carried through with another promise (one she had made to the chartered banks) to appoint private sector representatives to the previously all-bureaucrat board of the Canada Deposit Insurance Corp. She also raised deposit insurance premiums from 3 cents for every $100 of insured deposits to 10 cents. In addition to the four ex-officio, public sector board members (consisting of the Inspector-General of Banks, the Superintendent of Insurance, the Governor of the Bank of Canada and the Deputy Minister of Finance), McDougall appointed four private sector board members and chose Ronald McKinlay, a career accountant, to become CDIC chairman. The banks, however, lambasted McDougall for ignoring their demand that the private sector representatives be people with experience in financial institutions (the banks recommended retired bankers and trust executives). One bank lobbyist recalled the episode "to show how little advocacy power we had. We lobbied for bank representation; they vetoed it, they ignored us. McKinlay kept telling us they would put a retired banker on the board, but they never did." In this respect, the banks had an ally in former Supreme Court Justice Willard Estey who repeatedly pressed the government to appoint board members with experience in the industry. Pointing to the U.S. Federal Deposit Insurance Corp. in particular, Estey told *The Toronto Star* in March, 1992 that: "No other jurisdiction I've investigated has excluded that kind of know-how from its (regulatory) agency." See Konrad Yakabuski, "Bank bill not tough enough, Estey says," *The Toronto Star*, March 6, 1992.

57. *Report of the Inquiry into the Collapse of the CCB and Northland Bank* (Ottawa: Ministry of Supply and Services, August, 1986), iii. (Henceforth, the "Estey Report").

58. Estey Report, 641.

59. See Konrad Yakabuski, "Key bank regulator's retirement to trigger overhaul," *The Toronto Star*, November 28, 1991.

60. Cited in Alan Toulin, "Ottawa can't police banks, inquiry told," *The Toronto Star*, October 31, 1985.

61. House of Commons Standing Committee on Finance, Trade and Economic Affairs, *Canadian Financial Institutions*, Eleventh Report to the House, (Ottawa: Ministry of Supply and Services, November 1985), 28. (Henceforth, the "Blenkarn Report").

62. These are contained in Ibid., 32-50.

63. The merger of the CDIC with the IG's office, which was later advocated by Estey, has long been one of Blenkarn's personal priorities. The rationale for combining the two is that the CDIC, which must reimburse insured depositors, has a direct financial stake in ensuring the prudential management of deposit-taking institutions. It was thought that where the IG had been reticent about intervening in an institution's affairs, out of fear of liability, the CDIC would be more pro-active in disciplining institution's because it had money riding on it. Blenkarn also saw the super-regulatory agency as a way of bringing provincial institutions under federal supervision. For instance, he told Patricia Best and Ann Shortell (360) that: "In my view we would say, 'Lookit, provinces, you shouldn't have been in this business in the first place, and if we're going to use the credit of Canada (CDIC) to cover you, we're going to supervise you too. If you fellows don't want to be supervised by us -- don't. And we won't insure you. We're taking that funny little (CDIC) sticker off your door.'" The jurisdictional power grab implied by the Finance Committee's proposals, however, made it highly unlikely that they would survive in the face of provincial opposition. But the committee's report was nevertheless a watershed in that it did serve to undermine the Green Paper.

64. See Bruce Little, "Criminal penalties urged for directors," *The Globe and Mail*, November 7, 1985.

65. The committee's regulations on ownership are contained in the Blenkarn Report, (Commons Standing Committee, 51-68).

66. Ibid., 55.

67. Based on an analysis by Burns Fry Ltd. analyst Hugh Brown, a single shareholder could own 25 per cent of the Toronto Dominion Bank (which then had domestic assets of $30 billion) or the Bank of Nova Scotia (also $30 billion in domestic assets). A single shareholder would have been able to own up to 75 per cent of the National Bank, which then has domestic assets of $14 billion. See Sonita Horvitch, "The giants could get bigger," *The Financial Post*, November 16, 1985.

68. The duo's dissenting opinion is contained in the Blenkarn Report, (Commons Standing Committee, 145-151).

69. Giles Gherson and Sonita Horvitch, "The push to raise new financial pillars," *The Financial Post*, April 5, 1986.

70. Cadillac Fairview Corporation Ltd., *Brief on the Green Paper: The Regulation of Canadian Financial Institutions* (Toronto: Cadillac Fairview Corp. Ltd., August, 1985).

71. Cadillac Fairview, 13.

72. Patricia Best and Ann Shortell, *The Brass Ring: Power, Influence and the Brascan Empire* (Toronto: Random House of Canada Limited, 1988), 337.

73. House of Commons Standing Committee on Finance, Trade and Economic Affairs, *Fifth Report*, First Session of the Thirty-third Parliament, (Ottawa: Ministry of Supply and Services, June 26, 1986). (Henceforth, "Fifth Report".)

74. While a public inquiry into the Sinclair affair later absolved Eyton of any conflict of interest, much publicity was accorded to his dealings with the former cabinet minister, who appointed Eyton to the board of the now defunct Canada Development Investment Corp.

75. Best and Shortell, 342.

76. Confidential interview, December, 1992. Federal politicians and bureaucrats were apparently not the only ones alienated by the Brascan group's representatives. One trust industry representative attributed Ontario's adoption of onerous measures in its 1987 *Loan and Trust Corporations Act* (such as an "equals approach" that requires trust companies operating in Ontario to observe Ontario's restrictive rules in *every* jurisdiction in which they operate) to the bad blood between Royal Trustco and the Ontario government. The trust representative asserted that representaitves of Royal Trustco "caused Ontario to move prematurely with (the new legislation). They went in and gave the minister and (then premier) David Peterson hell in no uncertain terms (over the proposed legislation's restrictive measures) and as soon as they left David got on the phone and told them to table the xeroxed copy of the draft legislation that afternoon."

77. Commons Standing Committee, *Fifth Report*, 28:3-4.

78. Ibid., 28:5.

79. Confidential interview, November, 1992.

80. Ibid. The Big Six contributed \$60 million to the ill-fated \$255 million bailout of the CCB at what they maintained was the behest of the government and Bank of Canada Governor Gerald Bouey. When the bank failed, a court ruled that the banks' contribution was effectively an equity investment and not a loan, meaning that the Big Six could not claim to be creditors. Led by the Bank of Montreal, the banks appealed the ruling in a case that eventually reached the Supreme Court of Canada. The top court ruled in the banks' favour in November, 1992, although they are only expected to recoup about a quarter of their investment. See Alan Freeman, "Alberta, six banks become CCB creditors," *The Globe and Mail*, November 20, 1992. The Big Six participated in the bailout on a pro-rata basis with the Royal Bank advancing \$15.6 million; CIBC, \$13.8 million; Bank of Montreal, \$11.4 million; TD, \$7.8 million; Bank of Nova Scotia, \$7.8 million; and National Bank, \$3.6 million.

81. See Sonita Horvitch, "Full speed on financial reform," *The Financial Post*, August 30, 1986 and Sonita Horvitch, "Minister Hockin eager to get services legislation in place," *The Financial Post*, September 20, 1986.

82. Confidential interview, November, 1992.

83. Confidential interview, November, 1992. One lobbyist recalled "a famous story about how Stanley once took (a senior bureaucrat) up to a window on the top floor of the Finance building in Ottawa and said: 'I want you to look out the window; there's a whole world out there.'"

84. See Barry Critchley, "Key financial issues 'need rethinking'," *The Financial Post*, December 28, 1985.

CHAPTER 6

TURF WARS: ONTARIO, OTTAWA AND THE SECURITIES INDUSTRY

Barbara's a good friend, but she wasn't exactly friendly when I talked to her this morning.

-- Monte Kwinter, June 11, 1986[1]

I don't talk about private conversations in public.

-- Barbara McDougall, June 12, 1986[2]

On June 11, 1986, Ontario's Liberal Consumer and Commercial Relations Minister rattled Bay Street to a degree none of his Tory predecessors in over four decades had ever dared. With Ontario Securities Commission chairman and chief regulator Stanley Beck at his side, Monte Kwinter called a Toronto news conference to unveil bold new rules to govern the ownership of investment dealers in the province. As of year end, Kwinter told a stunned audience of reporters and stock brokers, banks, other financial institutions and that foreigners would be able to own up to 30 percent, instead of 10 percent, of a dealer operating in the province. Further, wholly-owned foreign brokers, including such Wall Street giants as Goldman Sachs and Salomon Bros., would be able to compete directly for the business of average Ontarians, subject to a cap on their market share.[3]

No one was more surprised by Kwinter's ground-breaking announcement[4] than Barbara McDougall, the federal Minister of State for Finance, who was still trying to stickhandle her way through the miasma of the CCB-Northland failures and rescue her year-old proposals for financial sector reform. Ontario's announcement constituted an enormous irritant for the federal government, which was just then embarking on negotiations with the United States to conclude a comprehensive free trade agreement, the first in the world to incorporate basic rules for transborder trade in services. Included in the latter category were financial services.

Establishing new rules for Canada-U.S. trade in financial services had already proved to be one of the most difficult issues with which negotiators had grappled. A "turf war" between the Office of the U.S. Trade Representative and the Treasury Department over authority to negotiate this part of the agreement[5] threatened to jettison the talks before they got started. Political scientist Gilbert Winham noted that, with neither side willing to make substantial concessions, the decision to include financial services in the agreement at all, came only as a last minute compromise.[6]

Ontario did not help matters. Its June, 1986 announcement deprived Canadian negotiator Bill Hood of an important, if not the most important, bargaining chip in the area of financial services. Allowing foreign-owned dealers and banks entry into the province's securities industry left Ottawa with little leverage in its attempts to gain better access to the U.S. market for Canadian financial institutions, frustrated by U.S. regulations prohibiting inter-state banking and the conduct of investment and commercial banking within a single institution.[7]

Needless to say, paranoia set in among the policy-makers ensconced by the banks of the Rideau River, and the vitriol began to spew forth. Not that it took much to provoke federal policy-makers. "The bad blood between Ottawa and Queen's Park was legendary," a lobbyist who dealt with both governments recalled. "They hardly talked to each other, the bureaucracies that is."[8] Hence, if Ontario's move, under the "protectionist" Liberal regime of David Peterson, was not interpreted in Ottawa as an outright attempt to sabotage the Canada-U.S. free trade negotiations, it was seen as revenge for the federal government's promise to turn Montreal and Vancouver into global banking hubs.[9] Kwinter intimated as much when asked, after making his June announcement, how much he had consulted with Ottawa on the matter: "About as much as took place when they decided to make Vancouver and Montreal international banking centres."[10] For her part, McDougall made no attempt to disguise her displeasure. "I do things my own way and that includes consultation," she told *The Globe and Mail*'s Bruce Little.[11] McDougall added that she was "just a little bit surprised that there was not some discussion about whether it might have been worth exploring whether there's a quid pro quo on the other side. I think that is a conversation that would have been useful to all of us."

That two governments within the bosom of a single state could wage such a mutually-destructive war is unlikely to shock any seasoned observer of Canadian federalism. In what is essentially a zero sum game, post-War federal-provincial relations have largely been characterized by an unending series of jurisdictional power grabs. Each level of government has endeavoured to expand its sphere of influence, and at the same time block incursions into its own jurisdictional domain, (except where the incursion is in the form of federal money, without which certain provinces could not *afford* to keep the powers they have).

Federal-provincial conflicts in securities matters trace their roots to 1867, and the constitutional divvying up of powers that paved the way for Confederation. The provinces' authority to regulate the industry is ostensibly derived from section 92(13) of the *Constitution Act, 1867*, which deals with "Property and Civil Rights." The latter were interpreted by the judiciary "to include contracts, dealings with property and the regulation of businesses, trades and professions."[12] In fact, however, the securities industry is regulated at the provincial level, not, as Toronto lawyer Cally Jordan notes "from lack of regulatory authority at the federal level, but rather as the result of the pre-emptive strike of the provincial governments in establishing their own securities commissions and taking de facto control of the industry."[13]

Given the general consensus that Ontario's June policy announcement served to undermine the federal government's free trade agenda, then, it is worthwhile to examine the objectives of and rationale for the province's decision to open up its securities sector in 1986. This constitutes a courageous undertaking if one is at all moved by an admonition from Donald Coxe, the head of Gordon Capital Corp.'s New York operations. Coxe noted in 1987 that given "this admirable decision sprang from a desire to bash the feds illustrates Bismark's dictum that he who would retain his respect for legislation and sausages shouldn't inquire too closely into the origins of either...".[14]

On the face of it, at least, Ottawa appeared to have compelling evidence to support its theory of a Queen's Park led conspiracy to thwart the free trade negotiations. The Peterson government was, after all, the only provincial administration to officially oppose the federal Conservatives' trade initiative, forcefully stating its intention to resist any attempt by Ottawa to include sectors subject to provincial jurisdiction in the negotiations. With respect to the securities industry, Kwinter told *The Globe and Mail*:[15] "It is an area Ontario has jurisdiction over...We don't see it as something we want to use as a bargaining chip" in the FTA negotiations. Thus, it was suggested by some that Ontario's decision, and its timing, resulted more from a desire to reaffirm its authority in the area of securities regulation than from the consideration of sound, normative policy goals.

When all was said and done, there was little doubt that the Canadian trade negotiators were dissatisfied with the fruits of their efforts. Article 1702:4 of the *Canada-U.S. Free Trade Agreement* states that the provisions on financial services "shall not be construed as representing the mutual satisfaction of the Parties concerning the treatment of their respective financial institutions."[16] It is difficult to deny that Canadian institutions operating in the U.S. appear to be at a disadvantage to their U.S. counterparts operating in Canada. The FTA's principle of "national treatment" exempted U.S. banks operating in Canada from lending and branching restrictions different from those faced by the domestic banks; U.S. citizens won the same rights as Canadians with respect to the ownership and operation of banks and other federally-regulated financial institutions. In addition, Ontario's new rules enabled U.S. banks to expand their Canadian operations to include investment banking, a right they are explicitly denied in their own country by the 1933 *Glass-Steagall Act*.[17]

In exchange, the United States pledged that Canadian banks would benefit to the same degree as U.S. institutions with respect to any future amendments to Glass-Steagall.[18] (The Canadian banks, whose U.S. banking operations dated from long before the 1927 *McFadden Act* restricting inter-state branching, also saw their existing U.S. operations grandfathered.) The Big Six were, nevertheless, livid at the outcome of the negotiations. CBA president Robert MacIntosh denounced the U.S. government's pledge to extend future modifications of U.S. banking law to include Canadian institutions as "a zero concession...a nothing"[19] and a "bird in the bush."[20] MacIntosh explained his displeasure before the House of Commons Standing Committee on External Affairs, asserting that:

> In the case of Canada, with our parliamentary system of responsible government, stated policies mean something...It means government policy. In the United States, who knows what stated policies mean? Does it mean what the senators say or what the president says? There is no such thing in the American system as a clear stated policy?[21]

Pressed by a Conservative member of the committee, MacIntosh concurred that Ontario's decision to open up the securities sector just as the FTA negotiations were beginning handicapped Canadian negotiators: "It almost determined the issue before we ever started."[22]

Yet, if federal policy-makers had reason to suspect the motives of their Ontario counterparts, the latter also began to question the good faith of the Mulroney government. Relations between Ottawa and the Peterson government had already degenerated to the point of public mud-slinging in the wake of the International Banking Centre (IBC) proposal, unveiled in Finance Minister Michael Wilson's February budget. The announcement was seen by Queen's Park as a blatant provocation and attack on Toronto's predominance as the country's financial centre. The fear that foreign institutions would choose Vancouver or Montreal over Toronto as their Canadian base played a significant part in convincing the Peterson government to partially relax foreign ownership restrictions on securities dealers in June.

The Peterson government's suspicion of its federal counterpart reached a fever pitch on November 12, 1986 when the Bank of Nova Scotia was granted a licence to set up a wholly-owned investment dealer in Quebec. The move had come barely three weeks after a clandestine meeting at Quebec's Chateau Montebello between federal Finance Minister Michael Wilson and the CEO's of the Big Six banks. The October 19 rendez-vous had been arranged by the banks, who felt they had to go over Tom Hockin's head in order to impress upon Ottawa the urgency of the securities issue.[23] The message CIBC chairman and CEO Donald Fullerton delivered on behalf of his colleagues boiled down to an ultimatum: Unless Ottawa cleared the way for the banks to get into the securities business, the latter risked being overrun by foreign players and the banks themselves would become marginal participants in global, and potentially even domestic, markets.

The banks found a sympathetic audience in Wilson, who had been hearing the same message from his former colleagues, Dominion Securities chairman James Pitblado and president Anthony Fell.

The Bank of Nova Scotia's move into the Quebec securities market, so close on the heels of the Montebello meeting, prompted speculation that the banks and Ottawa had conspired to force Ontario's hand in the removal of all ownership restrictions on securities dealers in the province. On December 4, 1986, Kwinter announced that the 30 percent limit on outside ownership proposed in June was history; as of the following June, banks and other domestic financial institutions would have free entry into the brokerage business. Foreigners were to acquire the same rights a year later. Despite the attraction of conspiracy theories, however, forces far beyond the control of Ottawa or Queen's Park had presaged the inevitably of depillarization in the securities industry long before Ontario came to the same conclusion in December.

Long before the deregulation ball got rolling, Ontario had consolidated its position as the unequivocal heartland of the Canadian securities industry. By the mid-1980s, the Toronto Stock Exchange (TSE) by far the largest of the five Canadian exchanges, accounted for between 75 percent and 80 percent of the value of all securities transactions.[24] The lion's share of all corporate and government securities issued in Canada was underwritten in the province. The dominant investment dealers, including the four largest, which, in 1985, accounted for 65 percent of all common stock issues,[25] were headquartered in Toronto. Hence, Ontario had traditionally set the pace for the rest of the country in terms of establishing rules and practices for the industry.

As of 1985, the entire capital base of the 100 or so securities firms registered in Canada was about $1 billion.[26] (The large number of firms is misleading, since the vast majority consisted of tiny "boutiques" servicing retail clients, mostly on the regional stock exchanges.) The bulk of industry's capital was concentrated among the largest Toronto brokerages, Dominion Securities, Wood Gundy, McLeod Young Weir, Nesbitt Thomson Deacon, Burns Fry and Richardson Greenshields. While the industry's capital base was strikingly small by international standards, barriers to entry and foreign ownership restrictions allowed the major Canadian securities firms to operate in an environment free from international competition. Not surprisingly, then, the industry performed well in terms of return on equity, far outpacing the average for all Canadian industries. For instance, in 1983, the average rate of return for investment dealers was in excess of 20 percent, while the "all industries" average was around four percent.[27]

As of 1985, the securities industry in Ontario was divided between the registered market, which was tightly regulated and in which foreign ownership restrictions applied, and the exempt market, which was unregulated and in which foreign participation was permitted. There were essentially two rationales for exempting part of the securities market from regulatory control:[28] First, there was really no need to impose registration requirements on firms that dealt in certain classes of securities, such as government bonds, because the riskless nature of these instruments meant the investing public did not need extra protection. This exemption allowed federally-chartered banks to engage in underwriting government debt, for instance, since they did not have to register with a securities commission to do so.

The second rationale for the exempt market related to the nature of the participants in the market. It was deemed that "sophisticated and knowledgeable investors who are quite capable of independent analysis" could manage their affairs without government interference.[29] Included in the latter category were institutional investors such as pension funds and mutual funds. Finally, private placements in excess of $97,000, as well as most international trading, were also included in the exempt market. The significance of the existence of an unregulated market should not go unnoticed here. As the size of this market began to outgrow that of the registered market it became increasingly attractive for foreign securities firms to contemplate making the move into Canada.

With respect to the segment of the market in which registration requirements applied, the Ontario government largely left it to the Ontario Securities Commission (OSC), an arm's-length agency, to formulate, monitor and enforce regulations. But while the OSC defined the conditions for business transactions, such as the rules for disclosure and prospectus requirements, and had, as well, considerable powers to conduct investigations and halt transactions,[30] it delegated substantial powers to the industry to regulate itself through its representative organization, the Investment Dealers' Association (IDA).[31] For instance, the IDA set conditions for entry into the industry, ensured that the proper ethical and business practices are followed by all member firms, administered the Canadian Securities Course, which all brokers must complete in order to work in the industry, as well as the National Contingency Fund, the securities industry equivalent of deposit insurance.[32]

The IDA was a "perfectly representative" organization, since the Ontario *Securities Act* requires that all investment dealers operating in the registered market belong to the association.[33] The "clublike" nature of the investment community,[34] a product of the elite social networks from which the industry's leaders evolved, allowed the IDA to become what political scientist William Coleman calls a "quiet lobby" with privileged access to decision-makers in government.[35] To the extent that the OSC did not depart from its adjudicative role, overseeing the technical implementation of legislation governing the sector, the IDA was essentially free from having to compete with other interests for the ear of policy-makers in government. It used this access to its advantage, most notably to prevent the entry of foreign securities firms into the registered market in Ontario.

The incident which served as a catalyst to the imposition of foreign ownership restrictions was the 1969 acquisition of Royal Securities by the U.S. firm Merrill Lynch. The IDA protested this move, arguing that the strategic role of investment dealers in the economy necessitated domestic control. Its actions led to the implementation of the 10/25 rule, limiting non-resident ownership of investment dealers in the province to 25 percent, with no single non-resident allowed to acquire more than ten percent of a securities firm.[36] By 1974, however, the OSC was becoming increasingly alarmed by the growth of foreign activity in the exempt market and focused on the need to strengthen the capital base of the Canadian-owned firms to improve their competitive position. Its recommendation for a review of the regulatory structure of the industry went unheeded.[37] The issue lay dormant until 1983 when Gordon Capital, Bay Street's aggressive "upstart," proposed to expand its activities in the exempt market by undertaking a joint venture with a Belgian firm. The proposed merger served to renew the debate over foreign ownership at a crucial conjuncture in the industry's history.

The foreign ownership issue resurfaced at the same time that the wisdom of limiting other financial institutions' (banks and trust companies, for example) stake in an investment dealer to 10 percent was being questioned. This regulation reflected the "pillarized" nature of the Canadian financial system, by which the financial sector was divided into four subsectors, or "pillars", (banks, trust companies, insurers and investment dealers), each retaining the exclusive right to exercise a core function. But with the wave of deregulation sweeping financial markets around the world and the move to "universal banking" in many countries, cross-pillar penetration seemed inevitable to many observers, especially since the Canadian securities industry was badly in need of an injection of capital. It was clear that the debate that was to follow would force the industry, its regulators and the government to grapple with questions that went to the heart of the structure of industry itself. As Cally Jordan points out, "(i)n rapid succession, committees were struck, reports were issued, and half-measures were announced."[38]

The Road to Reform

In response to the Gordon Capital (then called Daly Gordon Securities) proposal, which had initially been vetoed by the IDA and the Toronto Stock Exchange, the OSC launched a review of the rules governing entry into and operation of the Canadian securities industry. The Commission received more than forty submissions, and heard from representatives of the industry, foreign securities firms and the users of capital, the Canadian corporate community.

Not surprisingly, the IDA, pressed for "stringent controls on both ownership and dealer registration to restrict the growth of the (exempt) market."[39]

At least one prominent member of the industry -- McLeod Young Weir chairman Austin Taylor -- broke ranks with his colleagues. Taylor called the IDA's position "disappointing, self-serving to the securities industry, anti-competitive, and definitely not in the interest of either the development of the Canadian capital market or consumers. It is a classic case of ostrichism."[40] The industry set out its position in a report[41] released in September, 1984 by the Joint Securities Industry Committee (JSIC), which was comprised of representatives from the IDA and the Toronto, Montreal, Vancouver and Alberta Stock Exchanges. The 80-page report argued that the answer to the uncertainty confronting the industry was *more* regulation, and not an easing of restrictions governing foreign entry into the sector.

The essential crux of the report was twofold. First, the JSIC argued that the securities industry was sufficiently capitalized and, therefore, ownership restrictions had not deprived the industry of needed capital. Second, the Committee recommended that the exempt market be brought under the purview of regulatory authorities, and that firms active in this market be required to register with the OSC. Doing so, it is worth noting, would have required such firms to comply with the foreign ownership limits applied in the registered market at the time. As the C.D. Howe put it, the JSIC was, in essence, pressing

> for a dramatic retrenchment of the status quo...From the vantage point of economic analysis, (the report) certainly served to rivet attention not only on the perennial issue of protection versus competition, but also on whether the ultimate role of regulation is to serve the interest of the public or of those being regulated.

The Financial Executive Institute of Canada (FEIC), representing the users of capital, categorically rejected the JSIC proposals when it presented its submission to the OSC hearings in late November, 1984. The FEIC was concerned that Canadian companies, particularly small ones, were paying too much for capital because the domestic securities industry was itself undercapitalized and too highly concentrated.[42] It recommended opening the industry up to other domestic financial institutions and foreigners, either through the purchase of up to 49 percent of an existing investment dealer or the establishment of a wholly-owned securities subsidiary.

In February, 1985, the OSC, then led by reformist chairman Peter Dey, delivered its final report[43] to Conservative Consumer and Commercial Relations Minister Robert Elgie. The report proposed what amounted to massive change for the industry,[44] calling for a brave new securities world in which:

> * Non-resident and domestic financial institutions would be permitted to acquire up to 30 percent of an existing investment dealer, with a maximum of 49 percent ownership by any combination of domestic industry "outsiders";
>
> * A new class of wholly-owned foreign dealers would be created. These firms would be treated like domestic investment dealers, but would be limited to a total of 30 percent of industry capital, with the capital of any individual firm limited to 1.5 percent;
>
> * The exempt market would be brought under the OSC's regulatory umbrella and would be open only to domestic and foreign registered dealers.

Not unexpectedly, the domestic dealers roundly rejected the OSC's recommendations. Dominion Securities' James Pitblado maintained that adjusting to the changes would be "a little bit like slow death,"[45] reducing the Canadian industry to "a branch plant operation."[46]

Meanwhile, four hundred kilometres away, Barbara McDougall was preparing to unveil her Green Paper on financial sector reform. Among its proposals was the intention to allow federally-regulated trust and insurance companies to conduct business in any one of the pillars through a wholly-owned financial holding company (FHC). FHC's were to be permitted to acquire equity in an investment dealer to the extent allowed by the provinces. The Green Paper signalled that Ottawa was committed to depillarization, a fact that Ontario, now under a minority Liberal government with its own reformist agenda, could not ignore.

By late in 1985, however, the Ontario government's own task force on financial institutions was advocating a reaffirmation of the "four pillars" concept. In an interim report issued in December, the task force, led by University of Toronto political scientist Stephan Dupre, concluded that the OSC had "overstepped its mandate...by recommending that foreign brokers be given more scope in Ontario."[47] The Dupre report suggested postponing any decision concerning foreign ownership in the securities industry until the outcome of the Canada-U.S. free trade negotiations was known. The report was widely seen as a victory for domestic industry. The chairman of a foreign investment dealer, Howard Hawke of Bache Securities, commented: "Obviously, the joint industry committee got its way. It's a status quo report."[48]

Just as the task force was making its recommendations known, officials in Washington and Ottawa were completing preparations to launch the bilateral trade negotiations. However, no agreement had been reached to include financial services in the negotiations. As mentioned earlier, the delay centred around an internal despite on the U.S. side between the Office of the

Trade Representative (USTR) and the Treasury Department. The latter, under Secretary James Baker, was unwilling to surrender its authority to negotiate banking issues with foreign governments, and thus, pressed for the exclusion of financial services from the USTR-led trade talks.

The disagreement had all the makings of a "bureaucratic turf war" that only served to create discomfort among policy-makers in Ontario. Without assurance that the negotiations on financial services would proceed at a reasonable pace, if at all, the task force's recommendation to postpone any decision on the ownership issue looked increasingly untenable. In doing so, the Peterson government would have appeared indecisive, leaving the future of one of the province's most vital industries in the hands of its federal rival. At the same time, the uncertainty hovering over investment community placed added pressure on the government to act. The new, and equally reformist, OSC chairman, Stanley Beck, urged the government to come to a decision quickly as "delay would be injurious to all of the interested parties."[49]

Having heard the pleas and recommendations of all interested parties, the Peterson government was faced with the task of formulating a policy. In doing so, it was forced to reconcile its own "parochial" interests with the realities then confronting the securities industry in a rapidly emerging global market. While the government may have wished to accomplish several objectives, a C.D. Howe Institute study identified three that held special priority.[50] First, the government wanted to ensure, as a minimum, that Toronto retained its dominant presence in the domestic market, as a springboard to becoming the leading financial centre in the world after New York, London and Tokyo. Second, it wished to create an environment in which Canadian-owned securities firms could aspire to world-class status. The key to attaining this goal was, in short, facilitating the investment dealers' access to outside capital. The third objective related to the "ultimate rationale" for the securities industry itself -- capital formation. In order for the province's manufacturers and other industries to remain internationally competitive, corporations required access to capital on the best possible terms, something which only a highly competitive and sophisticated securities industry could provide. But an examination of the Ontario securities industry and the challenges it faced in the mid-1980s made it clear to the government that its goals could not be realized by opting for the status quo.

Given the Peterson government's base in rural and suburban Ontario, and not among the financial elite of Bay Street, it was naturally less beholden to the powerful business interests that backstopped the dethroned Tory dynasty. The Liberals' minority position, depending as they did on the support of Bob Rae's New Democrats to govern, further reinforced their reformist inclinations. The latter were evident in such initiatives as pay equity and the implementation of employer health premiums. Those programs confirmed the government's willingness to take on vested interests. It was, thus, not surprising to see it turn its sights onto the securities industry.

Given the role market intermediaries play in channelling capital to the real sector of the economy, governments, *ceteris paribus* wish to ensure that healthy competition prevails among investment dealers so that corporations have access to capital at the best possible terms. Yet, in the case of the Ontario securities industry in 1985, the assumption of a competitive industry looked dubious. The evidence seemed to point to a situation where regulation, (ownership restrictions), had rendered the market virtually uncontestable. Consider, for instance, the four firm concentration ratio, a classic, though admittedly imperfect, measure of industry competitiveness. Where the four largest firms account for more than 50 percent of the market, an industry is said to be oligopolistic.[51] In 1984, the four firm concentration ratios in Canadian markets for the underwriting of new issues of common stock and of bonds, were 65 percent and

67 percent, respectively.[52] These ratios surpassed those for all other markets in the Canadian financial industry. The most profitable sector of the securities market, corporate underwriting, was dominated by a handful of firms, which had gone unchallenged for years. The elimination of fixed commissions in 1983, and the aggressive posturing of Gordon Capital, had served to inject a degree of competitiveness, but the fact remained that ownership restrictions had "created an entry barrier to the Canadian securities industry...No viable means (existed) whereby the new and small (could) amass the capital needed to challenge the old and established."[53]

Of course, anticipating such criticisms, the industry biggest players came to the 1985 OSC hearings with ammunition of their own. The JSIC asserted, for instance, that the five largest firms generated only 36 percent of industry revenues in 1983,[54] proclaiming that "(t)his low concentration in the securities industry confirms its competitive nature." At least one staunch "trust-buster," *Toronto Star* reporter Diane Francis, wasn't buying the industry's line. In her 1986 diatribe against corporate concentration in Canada, *Controlling Interest*,[55] Francis denounced the brokers' cartel.

> On Bay Street, the so-called bastion of free enterprise, the brokers are highly concentrated and fiercely anti-competitive. In 1983, they virtually drove out of the province Charles Schwab Inc., the largest discount broker in the U.S., by placing foreign ownership obstacles in its path. The result is few brokers to choose from, little commission competitiveness, and too much concentration: by 1985 five firms controlled half the capital of the three dozen brokers on the TSE...The ten largest had 72.8 percent of the industry's capital.[56]

Yet, while it was generally acknowledged that the economy would have benefitted from an injection of competition and dynamism into the securities industry, more pressing in policy-makers' eyes was the need for an injection of capital. What focused attention on the industry's meagre capital base, by international standards, were the exogenous threats and challenges it was confronting.

The Growth of the Exempt Market. The exempt market, to which foreign firms had unrestricted access, began to account for an increasingly large chunk of the overall market as institutional investors, such as pension funds, came to dominate the list of market participants. The expanding sphere of exempt activity and the absence of onerous restrictions, such as prospectus requirements, allowed firms active in the exempt market to achieve economies of scale unattainable in the regulated market. In 1985, most of the $1 trillion of bond and money market trading done in Canada fell under the designation of the exempt market.[57] As the exempt market was growing at a much faster pace than the regulated market, the likelihood began to rise that domestic firms would be overrun by better capitalized foreign dealers was real. This threat was exacerbated when, in 1986, New York giant Goldman Sachs & Co. -- with a capital base larger than that of the *entire* Canadian industry -- was rumoured to be opening a Toronto operation.[58] The JSIC wanted ownership restrictions extended to the exempt market. In the unlikely event of this happening, however, the Canadian firms seemed reconciled to becoming subordinate players in that market in exchange for the maintenance of ownership restrictions in their protected fiefdom, the regulated market.

Globalization and Industry Capitalization. By 1986, it was clear that financial markets had become globalized. Small domestic players with insufficient capital were unprepared to service clients who were turning increasingly to foreign markets to raise funds. Between 1963 and 1970, 72.6 percent of domestic issuers' bonds were placed in Canada. For the 1980-87 period, the comparative figure had fallen to 53 percent.[59] Canadian borrowers, including Ottawa and the provinces, were almost exclusively choosing foreign firms to manage their international issues. Canadian institutions handled only 32 percent of all Eurobond issues denominated in Canadian dollars between 1980 and 1988.[60] The fact that Ottawa relied much more on foreign than domestic dealers, which, was described in a C.D. Howe Institute study as "a telling commentary on the success of the Canadian and Ontario regulatory policies in the securities area."[61] The pitiable capitalization of the Canadian industry was even noted by the OECD, which pointed out that "(e)ven the largest of the Canadian firms are capitalized at less than a twentieth of the size of the larger Japanese and American securities firms and the vast majority of Canadian securities firms are significantly smaller than the largest Canadian firms."[62]

The "Bought Deal". In the early 1980's, Gordon Capital pioneered what came to be known as the "bought deal", whereby an underwriter acts as "principal" in the issuance of new corporate securities. This process requires an investment dealer to purchase outright all or part of an issue, thus transferring the market risk faced during the distribution of the securities from the issuer to the intermediary. The arrangement made for a more efficient market because well-capitalized intermediaries can diversify distribution risk while issuers cannot.[63] However, once again, the domestic industry's small capital base raised concern over Canadian firms' ability to compete with highly capitalized foreign dealers.

Depillarization. The blurring of the distinctions between commercial and investment banking was proceeding apace in the early 1980s. The emergence of innovative financial instruments, such as commercial paper, enabled commercial banks to make inroads into the traditional domain of the securities industry. First, the growing trend toward "securitization", (the repackaging of bank loans as asset-backed marketable securities), allowed the banks to impinge on the hitherto exclusive terrain of the investment dealers. Second, the birth of Canadian merchant banks, controlled by financial conglomerates such as Trilon Financial, created an important new source of funds for domestic firms, easing their reliance on securities markets.

International Banking Centres and Deregulation in Quebec. It wasn't enough that Ottawa appeared to have an anti-Ontario bias in designating Montreal and Vancouver International Banking Centres (IBC's) in 1986; the Quebec government also appeared hellbent on deregulation. Foreign ownership restrictions on investment dealers were removed in 1973, and in 1983 the government abolished regulations prohibiting the ownership of securities dealers by other financial institutions. As Richard Schultz and Allan Alexandroff noted:

> At a minimum, Quebec's unilateral actions force the pace of change -- particularly in Ontario...(P)reparing for the integration (of financial services) in Ontario and Quebec in isolation, an possibly in haste, may prove detrimental to Canada's capital markets.[64]

Reciprocity. For the handful of larger Canadian securities firms that had established or wished to establish a foreign presence, it became clear that they would face obstacles in doing so unless foreign firms were guaranteed reciprocal access to the Canadian securities industry. Both Japan and Great Britain were in the process of applying, at least on a de facto basis, reciprocity conditions on the entry of foreign securities firms. To the extent that Canadian investment dealers needed access to foreign markets, both to service their domestic clients and achieve economies of scale, the issue of reciprocity was likely to grow in importance over time.

While the JSIC argued that "the domestic financial markets are so central to the effective operation of our economy that their foreign control would be unacceptable,"[65] the evidence appeared incontrovertible that opening the sector to outsiders was the only way to avoid its subordination. Canada-U.S. free trade seemed to figure little in this scenario; injecting capital into the industry seemed to have been the most pressing concern. Allowing foreign investment was necessary as much for this reason as to ameliorate the competitive nature of the industry. The Big Six banks, especially, were seen as the best source of "Canadian" capital.

Finally, on June 11, 1986, Monte Kwinter announced the new rules, which, not coincidentally, closely resembled those proposed by the OSC in its 1985 report. Other Canadian financial institutions, including the chartered banks, and non-resident investors would be allowed to own up to 30 percent of an existing investment dealer, subject to a 49 percent ceiling on combined "outsider" ownership. The government also adopted the OSC proposal that a new category of wholly-owned foreign dealers be created, limited to a total of 30 percent of industry capital. Finally, the government proposed to regulate firms' activities in the exempt market, though not to the extent recommended by the OSC report. In sum, the new policy was expected to inject the domestic securities sector with much-needed capital and stimulate competition, while allowing control to remain in the hands of industry "insiders" by restricting outside ownership to a limit of 49 percent.

In the weeks that followed the announcement, however, it became clear that the implementation of the new policy would prove difficult. Events, more than federal policy-makers, conspired to force the Peterson government to revise its policy in December. It announced then its intention to remove *all* ownership restrictions and abandon the proposed cap on foreign firms' market share. Ironically, what brought it to its December 4 policy statement was the industry itself, which for months had steadfastly refused to consider the easing of ownership rules. In the wake of the June announcement, the largest securities firms became concerned that the 30 percent limit on foreign ownership would inhibit their ability to set up operations abroad, to the extent that foreign authorities enforced reciprocity rules. As well, the 30 percent limit was seen as being too restrictive to attract sufficient outside capital to the industry. It was believed that the chartered banks would be unwilling to take a minority position in a dealer. In the end, though, what led the industry's "kingpins" to push for even more liberal ownership rules was their personal desire to sell out at the best price possible. Partners in some of the biggest firms, including Dominion Securities' Tony Fell, Nesbitt Thomson's Brian Steck and Wood Gundy's Ted Medland, apparently came to that conclusion at a Fall, 1986 meeting. As one anonymous participant at the meeting told *The Globe and Mail*: "They felt that part ownership was depreciating the value of their assets if they wanted to sell out. It was personal greed."[66] Suddenly, the vested interests previously most opposed to government's plans were now pushing Kwinter to go further. One lobbyist recalled that:

> The securities industry changed its mind. The reason the securities thing moved when it did (in December, 1986) was because the industry had come to believe that it was necessary. They were getting run out of the business. They were losing underwriting business. The root of the change came down to the fact that they realized...they may have 100 percent of the Canadian (regulated) market, but the Canadian market is shrinking rapidly...It really was a very desperate situation. The market was moving so quickly that the fear was that in another year it could have really slipped away.[67]

The October launch of Britain's "Big Bang," allowing free entry into the country's securities markets, only drove home the inevitability of deregulation.

The June policy was also doomed by the logistical problems created in slicing the pie among foreign firms' pie. (Recall that the June proposals included the creation of a new category of wholly-owned foreign dealers, limited to 30 percent of industry capital, with individual foreign dealers restricted to no more than 1.5 percent of the market.) The OSC would have, hence, been confronted with the politically-sensitive task of choosing, among foreign applicants, the twenty odd firms to fill this category. The New York-based Securities Industry Association called the proposal unworkable, arguing that because of the capital restrictions "it is doubtful whether the present proposals will bring in outside capital or improve international linkages."[68]

The fate of the June proposal was, however, sealed by the October 19 Montebello meeting between Michael Wilson and the banks, and the Bank of Nova Scotia's subsequent foray into the securities business via a Quebec-based dealer. The proposed establishment of wholly-owned Scotia Securities was seen as enjoying Ottawa's tacit endorsement. The federal government had apparently been putting out the word that while the *Bank Act* explicitly forbade the banks from engaging in corporate underwriting, a separate clause permitted them "to own a financial subsidiary for two years at the discretion of the (federal finance) minister."[69] For Ontario, time was of the essence. As CBA president Robert MacIntosh told *The Globe and Mail* at the time: "If they (Ontario) do nothing, you won't need an international banking centre to have a transfer (of business) to Montreal."[70]

For Tom Hockin, then, at least one part of the policy paper he was preparing in late 1986 was written by Michael Wilson and his deputy, Stanley Hartt. Once Ontario went public with its new policy on December 4, the *Bank Act* had to be amended to allow the banks to buy into the securities industry -- which they did with blind enthusiasm, paying multiples over book value. Among the Big Six, only the Toronto Dominion Bank chose to build its securities subsidiary from scratch. The Royal Bank, meanwhile, took over Dominion Securities, CIBC bought (or, rather, rescued) Wood Gundy, ScotiaBank acquired McLeod Young, the Bank of Montreal took over Nesbitt Thomson and the National Bank purchased Levesque Beaubien. In one fell swoop, the capital base of the domestic securities industry more than doubled. For a time, too, foreign brokers set up shop on Bay Street. But unable to crack what, in the period following the October, 1987 stock market crash, became a moribund market, many soon scaled down their operations or closed their offices.

NOTES

1. Cited in "Kwinter, McDougall in row," *The Globe and Mail*, June 12, 1986.

2. Cited in Bruce Little, "McDougall, Kwinter differ on co-operation," *The Globe and Mail*, June 13, 1986.

3. Allan Robinson, "Ontario plans to open up securities industry," *The Globe and Mail*, June 12, 1986.

4. With the announcement, Ontario became the first jurisdiction in North America to, in part at least, break down the barriers separating commercial banks and investment banks.

5. See Christopher Waddell, "Financial sector not open to negotiation, U.S. says," *The Globe and Mail*, June 19, 1986.

6. Gilbert Winham, *Trading with Canada* (New York: Priority Press Publications, 1988), 34.

7. See Jennifer Lewington and Christopher Waddell, "Banking regulations stall trade negotiations," *The Globe and Mail*, August 28, 1987.

8. Confidential interview, November, 1992.

9. In early 1986, the federal government introduced legislation to confer special tax benefits on banks that conducted certain international deposit and lending transactions in Vancouver or Montreal. See Christopher Waddell, "Ottawa considers designating Montreal a world bank centre," *The Globe and Mail*, February 14, 1986. While the move was largely an attempt to repatriate activity that was currently being done offshore, and at the same time spread federal largesse to the regions, Ontario was incensed. It argued that special status for Montreal and Vancouver would damage Toronto's standing as the country's premier financial centre. Seven years later, such fears appear to have been overblown.

10. Cited in Robert MacIntosh, *Different Drummers: Banking and Politics in Canada* (Toronto: Macmillan Canada, 1991), 269.

11. Little.

12. Economic Council of Canada, *A Framework for Financial Regulation* (Ottawa: Ministry of Supply and Services, 1987), 13.

13. Cally Jordan, "Canadian Financial Services -- The New Broom," *The Review of Financial Services Regulation* 3 (October, 21, 1987).

14. Donald Coxe, "Bringing on the world," *Canadian Business* (June, 1987).

15. Cited in Robinson.

16. Department of External Affairs, *Canada-U.S. Free Trade Agreement* (Ottawa: Ministry of Supply and Services, 1988), 252.

17. This is discussed in greater detail in R. Lipsey and R. York, *Evaluating the Free Trade Agreement* (Toronto: C.D. Howe Institute, 1988), 90-91.

18. Canadian negotiators did convince the U.S. to bend *Glass-Steagall* slightly to allow Canadian banks to underwrite and deal in, either directly or indirectly through their securities subsidiaries, the securities of the Canadian federal or provincial governments, as well as those of Crown corporations. This was a minimum concession needed to appease the Big Six. The New York offices of the Canadian banks had been in this business for decades and were not going to stand idly by while their existing privileges were negotiated away. Lipsey and York (92) note that "(s)ince the bulk of the underwriting for Canadian Crown corporations is done in New York, this is a significant gain to Canadian financial institutions."

19. Virginia Galt, "Foreign-ownership rule dropped for banks," *The Globe and Mail*, October 6, 1987.

20. MacIntosh, 281.

21. House of Commons Standing Committee on External Affairs and International Trade, *Proceedings* (Ottawa: Ministry of Supply and Services, November 4, 1988), 34-49.

22. Ibid., 34-50. The Canadian government's failure to exact greater concessions appeared, early on after the FTA was signed, to be a serious backward step for the U.S. operations of Canadian institutions. In 1987, when four of the Big Six purchased securities dealers, the latter lost their right to underwrite corporate stocks and bonds or trade for their own account in the U.S. In effect, by becoming bank subsidiaries, RBC Dominion Securities Ltd. (Royal Bank), Wood Gundy Inc. (CIBC), Nesbitt Thomson Deacon Inc. (Bank of Montreal) and Scotia McLeod Inc. (Bank of Nova Scotia) were forced to close a major part of their New York operations. (They retained the right to act as agents, processing stock orders.) The ground began to shift in September, 1990 when the Federal Reserve Board granted limited underwriting powers to a major money centre bank, J.P. Morgan & Co. Under what is known as a "Section 20" exemption, the bank is allowed to engage in debt and equity underwriting provided that its revenues from such transactions do not exceed 10 per cent of its gross securities revenues. The move was interpreted as a "chipping away -- or de facto repeal -- of *Glass Steagall.*" See Konrad Yakabuski, "Canadian dealers eyeing U.S. for stock underwriting powers," *The Toronto Star*, September 25, 1990. Since 1990, several Canadian banks and bank-owned brokerages have been granted Section 20 exemptions, including the Royal Bank and CIBC.

23. Robert MacIntosh (275) expressed the banks' frustration with Hockin:

> By September, there were few signs that the message was getting through;...(O)ur experience with Tom Hockin was that he had no great conviction about defending federal institutions from provincial policies. We felt we had to reach Michael Wilson to emphasize the urgency of the situation.

24. Susan Goldenberg, *Trading: Inside the World's Leading Stock Exchanges* (San Diego: Harcourt Brace Jovanovich, 1986), 117.

25. Economic Council of Canada, 31.

26. T. Courchene, J. Todd, and L. Schwartz, *Ontario's Proposals for the Securities Industry* (Toronto: C.D. Howe Institute, 1986), 7.

27. See Ronald Anderson, "Securities industry due for big change," *The Globe and Mail*, November 21, 1986.

28. These are discussed in greater detail in Courchene, Todd and Schwartz, 4.

29. Ibid.

30. These powers are outlined in R. Schultz and A. Alexandroff, *Economic Regulation and the Federal System* (Toronto: University of Toronto Press, 1985), 125-129.

31. For more on this, see William Coleman, *Business and Politics* (Montreal: McGill-Queen's Press, 1988), 188-189.

32. The draining of the fund by the failure of Osler Inc. in 1988 precipitated calls for reform from the industry's largest member. The new fund, the Canadian Investor Protection Fund, is run independently from the IDA.

33. Coleman, 188.

34. See Goldenberg, 120.

35. Coleman, 190.

36. D. Strongin, "Big Bang -- Canadian Style," *Capital Markets Review* 3 (April 6, 1987).

37. Ibid.

38. Jordan.

39. W.T.Stanbury, *Business-Government Relations in Canada* (Agincourt, Ontario: Methuen Publications, 1986), 335-336.

40. Ibid., 336.

41. Joint Securities Industry Committee, *Report on the Regulation and Ownership of Market Intermediaries in Canada* (Toronto: Joint Securities Industry Committee, September 1984). (Henceforth, JSIC.)

42. Barry Critchley, "More key issues under OSC focus," *The Financial Post*, December 1, 1984.

43. Ontario Securities Commission, *A Regulatory Framework for Entry Into and Ownership of the Ontario Securities Industry* (Toronto: Ontario Securities Commission, 1985). (Henceforth, OSC.)

44. See Allan Robinson, "OSC proposes easier ownership rules," *The Globe and Mail*, February 19, 1986.

45. Allan Robinson, "Reaction is muted to OSC plan," *The Globe and Mail*, February 20, 1985.

46. Dennis Slocum, "Brokers oppose foreign control," *The Globe and Mail*, June 5, 1986.

47. Dennis Slocum and Allan Robinson, "Task force wary about opening brokerage borders," *The Globe and Mail*, December 18, 1985.

48. Ibid.

49. Martin Mittelstaedt, "OSC urges loosening rules for entry into the market," *The Globe and Mail*, February 21, 1986.

50. Courchene, Todd and Scwartz, 14.

51. E. Neave, "Canada's Approach to Financial Regulation," *Canadian Public Policy* XV (1989), 1-2.

52. Ibid., 3.

53. Courchene, Todd and Schwartz, 28.

54. JSIC, II-2.

55. Diane Francis, *Controlling Interest: Who Owns Canada?* (Toronto: McClelland-Banting Inc., 1986).

56. Ibid., 349.

57. Courchene, Todd and Schwartz, 6.

58. Ibid., 15. The rumour proved to be true. Goldman announced in January, 1987 that it would set up shop on Bay Street, although its decision was likely influenced by the Peterson government's December, 1986 move to lift all restrictions on foreign firms. See Fred Lebolt, "Big U.S. investment firm to open offices in Toronto," *The Toronto Star*, January 15, 1987.

59. Economic Council of Canada, *A New Frontier: Globalization and Canada's Financial Markets* (Ottawa: Ministry of Supply and Services, 1989), 18-19.

60. Ibid.

61. Courchene, Todd, and Schwartz, 9.

62. Organization for Economic Cooperation and Development, *International Trade in Services: Securities* (Paris: OECD, 1987), 67.

63. Courchene, Todd and Schwartz, 16.

64. See Schultz and Alexandroff, 137.

65. JSIC, 16.

66. "Power plays opened securities industry," *The Globe and Mail*, December 31, 1986.

67. Confidential interview, November, 1992.

68. Allan Robinson, "Brokers fail to find out how OSC will slice the pie," *The Globe and Mail*, October 21, 1986.

69. Diane Francis, "Banks urged Wilson to let them operate brokerages, sources say," *The Toronto Star*, November 29, 1986.

70. Cited in MacIntosh, 277.

CHAPTER 7

STRIKE TWO: THE (SHORT) LIFE AND DEATH OF THE BLUE PAPER

The tabling of the Estey report, (as well as the Coopers & Lybrand study on the Inspector-General's office),[1] and the pivotal Montebello meeting settled two of the most contentious issues complicating Tom Hockin's attempts to craft a policy to replace the Green Paper. The Estey and Chippindale reports allowed the Minister to proceed with an overhaul of the regulatory apparatus along lines almost identical to those contemplated months earlier by McDougall and Cohen. Montebello, on the other hand, made untenable McDougall's position that the banks would have to wait until the next round of deregulation before sharing in the bounty of depillarization; once the securities business was opened to the banks, Ottawa could not very well deny them insurance and trust powers without, in the words of one lobbyist, "looking arbitrary."[2] While that in itself might not have been enough to prevent the banks' exclusion, (government decisions, after all, often look arbitrary), the change in ministers and deputies further shifted the landscape. Hockin, the internationalist, and Fred Gorbet, the Associate Deputy Minister of Finance closest to the financial reform process, were partial to including the banks.

Still, there remained one problem-fraught issue that had to be dealt with if Hockin was to meet his self-imposed, Christmas, 1986 deadline for the unveiling of the government's financial reform package: the rules governing the ownership of financial institutions. Compounding the problem was the sense of urgency prevailing at the time. Hockin and the government had already been criticized for lacking a sensible, "made-in-Canada" ownership policy when two troubled banks, the Bank of British Columbia and the Continental Bank, had to be sold to foreign institutions during the fall of 1986 because inflexible laws prevented domestic buyers, such as the largest trusts, from making an offer.[3] The House of Commons Finance Committee had also heaped scorn on the Mulroney government for approving the merger of Canada Trust and Canada Permanent, and the later takeover of Canada Trust by Imasco, without having a consistent ownership policy in place.

The banks' inclusion in the depillarization policy, however, rendered the formulation of an ownership policy even more problematic for Hockin. There was never any serious contemplation given to the possibility of relaxing the 10 percent ownership rule on the Schedule A banks. Yet, if the latter were to possess business powers almost indistinguishable from those of other financial intermediaries, the absence of domestic ownership restrictions on trust companies and insurers reintroduced a new element of arbitrariness into the government's policy. To mitigate against that prospect, Gorbet, according to lobbyists close to the process, advised Hockin to take a tough stance against closely-held ownership and commercial-financial links. Canada Trust president Merv Lahn, with whom Hockin shared a close relationship stemming from their London, Ontario roots, also pressed the Minister to mandate wide ownership rules. Finally, members of the Finance Committee, particularly Paul McCrossan and chairman Don Blenkarn, were unrelenting in appealing to Hockin to adopt the 30 percent ceiling on commercial ownership of financial institutions that the committee had proposed the previous April.

Hockin and Finance Minister Michael Wilson subscribed to the concerns of Lahn, Gorbet and McCrossan and agreed to present them to the cabinet. Although the issue was addressed by several cabinet committees in late 1986, the pivotal discussions of the ownership rules appear to have taken place during early December. Whether Hockin and Wilson pushed for the 30 percent limit advocated by the Finance Committee, as some observers maintained,[4] is unclear. But the consensus among lobbyists and the media was that they did propose stringent limits of some sort on the ownership of non-bank financial institutions.[5] Their pleas were opposed by McDougall and several Quebec ministers, including Michel Cote and Robert de Cotret, who were concerned that such restrictions would impede the growth of burgeoning Montreal financial conglomerates such as the Laurentian Group and Paul Desmarais's Power Financial Corp.

The cabinet split forced Hockin, by nature a conciliator, to build a consensus among his colleagues. He fell back on a recommendation made by Thomas Courchene, then a University of Western Ontario economist. Courchene, who had been brought in to advise Hockin during the fall of 1986, proposed that at least 35 percent of a non-bank institution's shares be publicly traded. The idea of mandating a large public float was not new; the recommendation first cropped up in the Senate Banking Committee's May, 1986 report on the Green Paper,[6] which was drafted by Courchene himself. The logic behind the 35 percent rule was that it would allow for a measure of public scrutiny with respect to the affairs of closely-held financial conglomerates. Disclosure requirements imposed on publicly-traded corporations would mitigate against "informational assymetries"[7] and prevent owners from engaging in self-dealing activities contrary to the interests of minority shareholders. If the latter owned 35 percent of the company, it was reasoned, they would constitute a more redoubtable check on the practices of the controlling shareholders. The adoption of the 35 percent rule appears to have been sufficient to placate the powerful Quebec contingent in cabinet and the Prime Minister, who was rumoured to have been heavily lobbied by Brascan's Trevor Eyton, a key Tory fundraiser, and operatives from Desmarais's Power empire.[8] By accommodating existing financial conglomerates, subject to the 35 percent rule, Hockin was able to preserve the crux of his ownership policy. On December 18, 1986, the Minister rose in the House of Commons to unveil a financial reform package that mirrored his own (unstated) preference for wide ownership.

Needless to say, Hockin's "Blue Paper"[9] was vastly different in tone and substance from its predecessor. First, unlike the Green Paper, the Blue Paper contained a provision limiting ownership in commercially-linked, trust, loan and insurance companies to 65 percent, requiring that at least 35 percent of the stock be publicly traded and widely-held. The new rules would have allowed industrial conglomerates such as Brascan, Imasco, and Power Corp., to retain their controlling interests in the country's largest trust companies.[10] On the surface, therefore, it appeared that the trust companies had won the lobbying war, since the proposals were much less restrictive than the 30 percent ceiling on non-financial ownership of non-bank financial institutions originally thought to be favoured by Hockin. The Minister himself encouraged such interpretations by portraying the perpetuation of dual ownership regimes for banks and other financial institutions as a "pragmatic" solution, balancing "competing interests responsibly."[11]

It was in the language of the Blue Paper, however, that Hockin's true intentions were revealed. The document asserted that

> (i)n the government's view, it is desirable to constrain linkages between the financial and commercial sectors of the economy and -- where these linkages now exist or where institutions without such linkages grow beyond a certain size -- to encourage a significant minority holding....
>
> In respect of trust, loan and insurance companies, which at present are not subject to domestic ownership controls, the proposals *arrest* the industry trend towards more pervasive financial-commercial links. They also allow for the development of significant and broad minority shareholding to provide increased support to the functioning of a more effective system of corporate governance.[12]

In addition to the 65 percent limit, no future commercial-financial linkages were to be allowed for trust, loan and insurance companies whose capital base exceeded $50 million, (roughly any institution with assets of more than $1 billion). In effect, commercial conglomerates were to be denied future access into the financial sector; the banks were to be spared competition from new entrants with commercial links. Commercial enterprises with stakes in non-bank institutions were to be frozen at current ownership levels and prohibited from increasing their investment. For institutions without commercial links, but with a capital base of more than $750 million (or assets of about $15 billion), no future shareholder would be allowed to own more than 10 percent and share transfers above 10 percent in any institutions were to be subject to approval by the Minister of Finance. Together, the ownership provisions would have robbed Brascan, Power, Imasco and dozens of other owners of their "control premium"[13] if they sold their stakes, since large institutions, and *any* with commercial links, could only be sold on a wide basis.

The Blue Paper's provisions on non-arm's length transactions did not go as far as the Green Paper's outright ban on such transactions, but did constitute a considerable tightening up of existing regulations. The new rules, which were to apply to all types of institutions, adopted a three-tier approach: a ban on most types of transactions, internal controls for permitted classes of transactions, and pre-clearance with regulators for unusual transactions. Hence, the thrust of the Blue Paper was that self-dealing problems were to be controlled in part by the imposition of bank-like ownership rules on all financial institutions, and in part by more restrictive rules on non-arm's length transactions.

The Blue Paper abandoned the FHC idea contained in the Green Paper, instead allowing financial institutions to enter other pillars either directly or by establishing a subsidiary whose services coulds be offered through an institution's existing branch network. There were two notable exceptions to this rule: banks were to be allowed to directly acquire an existing investment dealer instead of having to establish one, and the other pillars were to be prohibited from selling insurance products through their branches. The banks, needless to say, opposed the latter proposal.[14] Their exclusion, however, was a political calculation on the part of the government. Despite enormous pressure applied on officials by the CBA, as well as its forceful argumentation that the banks could bring considerable cost savings to consumers, the government sided with the insurance lobby. The Tory caucus, whose members were pressured by insurance agents in their ridings, took up the insurance industry's cause. National Trustco owner Hal Jackman, whose empire counted both a property and casualty and life insurance company among its holdings, told *The Toronto Star's* Diane Francis:

> The fact that insurance is missing (from the networking powers granted to the banks) is totally inconsistent, but it's the biggest lobby in Canada -- not the (insurance) companies, but the agents. Look at the people who man the polls at election time. It's insurance agents.[15]

The media's immediate assessment of the Blue Paper was that, because the Bronfmans, Desmarais and Imasco would have been able to retain their controlling stakes, the trust companies had won the lobbying war. *The Toronto Star* declared, for instance, that Hockin "went out of his way to protect the ownership structures that currently exist. And by attempting to appease vested interests, Hockin may well have put Canada's future financial health in jeopardy."[16] *The Financial Post*, meanwhile, asserted that "you can almost hear sighs of relief in the (trust company) boardrooms."[17] The truth was, however that trust company owners weren't sighing; they were seething.

The Blue Paper left trust owners scrambling to discern how the government intended to apply the principles outlined in the document. Would it leave existing trust owners alone or was the implicit goal to ratchet their stakes down to 10 percent over time? As lobbyists began to reflect on the Blue Paper , they inevitably settled on the latter interpretation. As it was written, the Blue Paper appeared to state that not only would existing trust owners be prevented from selling their control blocks in the future,[18] but they would not be allowed to participate in future share issues by their companies in order to maintain their percentage of ownership. Over time, their stakes would be diluted. Furthermore, because the Blue Paper banned commercial enterprises from investing in the financial sector in the future, current trust owners such as the Bronfmans would have been unable to add to their financial empire since their Royal Trustco Ltd. could not have purchased competitors.

In sum, Ottawa did not explicitly say that it wanted to see wide ownership over time. In several clauses, however, the Blue Paper looked like it would have inevitably led to that. The trust industry thus became highly suspicious of Hockin's intentions, concerned that the package contained other "traps" that they had not yet uncovered. As one top-level bureaucrat noted:

> The (trust) industry went berserk. Suddenly, everyone was going back to the Blue Paper asking how this was going to hit them, what are the possible ways this is going to be implemented. Are they going to rules and regulations that are tougher on companies that are closely-held? There was a real paranoia out there among some of the players.[19]

Trust executives' distrust of Hockin escalated after the Minister introduced Bill C-56 in May, 1987. The bill was primarily aimed at clearing the way for banks to buy securities dealers and create the Office of the Superintendent of Financial Institutions to regulate the industry -- two issues on which all parties were in agreement. The proposed legislation, however, also contained one provision that confirmed for trust industry executives that Ottawa was set on wide ownership. As it was drafted, the bill appeared to give the Minister of Finance the authority to veto share transfers of more than 10 percent in a company that, within its corporate network, owned a federally-regulated financial institution. "So a change in ownership (of more than 10 percent) of a group like Brascan, it was purported, would have needed ministerial approval because they own a trust company," one policy-maker said. "It was that kind of stuff that cemented in people's minds that these guys have a policy position that they want a 10 percent ceiling."[20] This sentiment was confirmed by a trust lobbyist who commented: "They were trying to sneak it through in the OSFI legislation so they wouldn't have to put it in the financial services legislation, where it would be noticed. That was the death of the Hockin package right there."[21]

The trust industry was not the only group displeased with the Blue Paper. The government of Quebec, most notably, reacted harshly to the proposals, fearing the ban on future financial-commercial links would stunt the growth of its burgeoning financial conglomerates like the Laurentian Group. At the very time that Ottawa was proposing more severe restrictions on the intermingling of finance and commerce within a single corporate group, Quebec was undertaking policies designed to encourage it. The federal government clearly underestimated the significance of Quebec's opposition, preoccupied as it was with quelling the revolt brewing among members of the trust industry.

The sense of betrayal felt by trust executives led them to step up their lobbying efforts. Several of the industry's most senior executives personally entered the fray, lobbying the offices of Wilson and Mulroney directly. In addition to Trevor Eyton, who enjoyed close connections at the top as the Progressive Conservatives' leading fundraiser in the Toronto financial district, another important executive to get involved was Jim Burns, the chairman and chief executive of Power Financial Corp. Burns' connections in Ottawa are evidence of the circuitous networks through which influence is exerted in the capital.

Burns was a native of Winnipeg and a life-long Tory. His son Jamie was well-known in Ottawa circles as Don Mazankowski's chief-of-staff, and later, as a lobbyist with his own firm. Fellow lobbyist Jon Johnson, a one-time aide to Mulroney, was a friend of Jamie and the Burns family since childhood. Johnson's Government Policy Consultants was also a lobbyist for many players in the trust industry, including Imasco. Johnson's family wielded considerable influence in Tory circles. His sister Janis was appointed to the Senate by Mulroney, while his father was made Lieutenant-Governor of Manitoba.

Burns, Eyton and others made their displeasure known to the Prime Minister, who until then had shown little personal interest in the issue. As one observer close to the events described it:

> Mulroney suddenly became interested in the file, as they say. His interest was purely political. It was 1987 and he was going into an election with a Minister of State for Finance who couldn't control the policy he was taking through the Commons. He had major financial institutions and major political allies jumping up and down seeing red. He had a major political problem on his hands.[22]

The first indication that the tide was shifting in the trusts' favour came when the ministerial approval clause of C-56 was removed, allowing the overhaul of the supervisory apparatus to proceed as well as meeting Ontario's June deadline for the opening of its securities industry to outsiders.

The second significant development to change the course of financial reform was the selection, by Stanley Hartt in late summer of 1987, of Nick LePan as the assistant deputy minister in charge of the financial sector policy branch. With Gorbet devoting his time almost exclusively to executing the Tories' overhaul of the tax system, LePan, a pragmatist by nature, became the most influential member of the bureaucracy involved in financial reform. Ironically, LePan had spent all of his previous 13 years in the bureaucracy working on tax policy and came to his new post with little knowledge of the financial sector. But he proved a quick study and soon won over all sides of the industry with his display of competence and accessibility. As one bank lobbyist noted:

> LePan was important because he introduced an element of analytical rigour; his style went over well. It was a combination of his ability to really grasp the issues, to deal with the details, and then to communicate them to anybody. His whole set of attributes were fairly beneficial to the process.[23]

LePan's first goal was to produce draft legislation of the Blue Paper's proposals in order to advance the debate to the next stage. As it was, trust and bank executives were arguing over interpretations of the Blue Paper's proposals. Draft legislation was needed to "put some meat" on what was until then only a vague policy statement, "even if we knew (the draft legislation) wasn't going to stick," in the words of one senior bureaucrat.[24]

When the draft bill was tabled in December, 1987, it was clear that the government was slowly moving away from the restrictive ownership policy articulated in the Blue Paper. Although the bill incorporated the proposal to ban new commercially-linked entrants into the financial sector, the draft provided for existing players such as Brascan and Power to expand their financial holdings in the future.[25] The trust industry had won one battle in its war to derail the Blue Paper.

Neither the trust industry nor Quebec were placated, however, by the concessions Ottawa made on existing commercially-linked financial conglomerates. Trust executives continued to lobby strenuously while Quebec brought the four Western provinces on board in the fight against the Blue Paper. The provinces, eager to promote the growth of indigenous financial institutions, were aware that the only local sources of capital for the creation of such institutions were commercial enterprises. While the imposition of tight ownership rules by Ottawa would not have prevented the provinces from adopting looser regulations for provincially-charted institutions, the latter would have been deprived of diversifying through the acquisition of a federally-chartered company if the Blue Paper's proposals were put into law. Ottawa, meanwhile, risked seeing federally-charted institutions switch to provincial charters in the future to escape its strict rules.[26]

To resolve the federal-provincial dispute, Ottawa enlisted Michel Caron, an associate deputy minister in the Finance Department. The choice of Caron was in itself telling. Before coming to Ottawa in 1987, he had spent most of his career in the Quebec public sector, at Hydro-Quebec and most notably as the province's Deputy Minister of Finance between 1977 and 1982. The minister at the time was, of course, none other than Jacques Parizeau, the architect of financial deregulation in that province. Caron's decentralist philosophy made him an adversary of the banks and an ally of the provinces and the trust industry.[27]

By mid-1988 Hockin had acknowledged defeat. He announced that the draft legislation introduced the previous December would be withdrawn, but in the same breath promised a new draft bill by early fall.[28] With a federal election expected within a few months, however, it was clear that no legislation could be hobbled together and passed before the writ was dropped. For a government in election mode, financial reform ranked low on the policy agenda. It was to be several months into the government's second term before Ottawa re-embraced the issue. Passage of the Canada-U.S. Free Trade Agreement, tax reform and the introduction of the goods and services tax, and the Meech Lake constitutional accord were just three of the high-priority, and highly-political, matters that diverted the government's attention from financial sector reform.

Ironically, it was the government, which would have been content to see the issue go away, that brought financial reform back to the fore. Its decision to grant a Schedule II banking licence to the American Express Co. in late 1988 triggered an extensive lobbying campaign by the CBA. The latter was successful in getting Ottawa to delay Amex's entry onto the Canadian banking scene and in winning the promise of new powers for the banks.[29] But more importantly, the decision to grant a banking licence to Amex raised doubts about Ottawa's commitment to preventing financial-commercial links. At the very least, it was clearly inconsistent with the policy outlined in the Blue Paper. As Thomas Courchene noted at the time: "Amex would be permitted to continue, via subsidiaries, commercial operations in Canada, ... which are *not* permitted to Canadian commercial banks."[30] Not surprisingly, confusion abounded as to where the federal government really stood on the ownership issue.

The truth was it no longer had a position. Its sole goal, under the new Minister of State for Finance Gilles Loiselle, was to build enough of a consensus among the trusts and banks to get the legislation through. The normative objective of adopting the optimal policy, from a socio-economic perspective, was now clearly secondary. The government's unwillingness to truncate the issue once and for all only frustrated industry players. But Ottawa was in a no-win situation. As Jacquie McNish wrote in *The Globe and Mail* in late 1989: "the federal government is apparently reluctant to choose sides because it would pit them against a powerful interest group."[31]

Loiselle was a particularly apt choice to build the consensus needed to get the reforms through. Prior to running for the Conservatives in Langelier in 1988, Loiselle had spent most of his career in journalism and education and, latterly, in the Quebec diplomatic corps. He left Ottawa's French language *Le Droit* newspaper in 1953 to move into radio, then left that three years later to become the principal of a *lycee* in Ethiopia. He returned to journalism as the Paris correspondent for Radio-Canada in 1962. In 1967, he entered the public sector as the head of the Quebec government's communications branch. He moved on in 1976 to become the director of the National Assembly's intergovernmental affairs division and a year later became Quebec's Delegate-General in Britain until 1982. He then returned to Quebec to become the province's Assistant Deputy Minister of Canadian Affairs. In 1985, he became Quebec's Delegate-General in Rome and was later put in charge of charting Quebec's role in the then nascent *Francophonie*, the French language equivalent of the British Commonwealth.

In addition to his skills as a diplomat, Loiselle was able to approach financial sector reform with a degree of detachment that none of his predecessors brought to the job. One senior bureaucrat described Loiselle's approach as follows:

> He came to the portfolio with no hang-ups, no baggage whatsoever. Our first meetings were like sitting him down for a class; we ran seminars for a few weeks -- here's the issues, here's the numbers, here's the history. He was very open, an avid learner and basically because he didn't have any prior views one way or the other on the ownership issue, it was easy for him to say that the best policy is no policy. He was able to say, when no one else could bring themselves to say it, "What's so wrong with the status quo?" That was a sea change.[32]

While the trust industry found an ally in Loiselle, however, the banks were steadfast in their refusal to bend on the ownership issue without concessions from Ottawa on other issues important to them, such as insurance retailing through their branches and the right to enter the field of automobile leasing. Ottawa was unwilling to budge on those issues. Thus, Loiselle was faced with the possibility of becoming another casualty in the junior finance portfolio, in the manner of his predecessors.

Loiselle and LePan, who according to observers formed a model working relationship in government, eventually presented the entire industry with an all or nothing ultimatum. Either all sides form a common front in accepting the government's position on the ownership issue, insurance and auto-leasing or risk losing all of the other potential benefits that were to be had by liberalizing regulations in the sector. "We never gave an inch on our position that this was a package deal," one top bureaucrat said.[33] "We told everybody that they had to come to recognize that they all had to put a little water in their wine. But we knew no one would have to put nearly as much water in their wine as the banks."

The message Ottawa sent out to the industry was categoric; unless all sides could unite in agreement that a legislative package of reforms not completely to their liking was better than no package at all, the government had no intention of advancing the legislation. The government "could not afford to have any major dissent from the industry because that would basically scuttle its efforts to get (the reforms) through," a bank lobbyist commented.[34] "Ottawa needed a signal that the industry was actually behind the package as a whole. Sure warring at the sides, but behind the package as a whole."

Such a signal came finally in March, 1990 when CBA president Helen Sinclair and her counterparts in the trust and life insurance industries, John Evans and Mark Daniels, respectively, drafted a joint letter to Michael Wilson and Gilles Loiselle urging the government to introduce the legislation.[35] "That was the message saying one way or the other we would resolve our differences and support the package," one lobbyist noted.[36]

From that point, the process moved along with astonishing rapidity, considering the languorous pace of progress during the previous five years. By September, the government was ready to introduce the package, an impressive feat considering the reforms involved introducing hundreds of amendments to existing legislation. On September 27, 1990, Loiselle tabled the first of five bills that were to be introduced to implement the reforms, the new *Trust and Loan*

Companies Act.[37] In the accompanying documents provided to reporters, the government's approach was clear. "Arguments have been made in favour of both widely-held ownership and closely-held ownership, and it is apparent that no ownership model is correct to the exclusion of others," the documents said.[38] "The proposed legislation thus puts forward a pragmatic approach...".

The documents were similarly unequivocal in pointing out to the extent to which the government had backed down from the proposals it put forward in the Blue Paper. The legislation "will permit federal trust, loan and stock insurance companies to continue to be closely-held, *and, if sold, to be sold on a closely-held basis*."[39] In short, the sole modification of note to existing ownership rules was a stipulation that within five years, trust, loan and stock insurance companies with more than $750 million in capital would have to ensure that at least 35 percent of their shares were widely-held and publicly traded. Controlling shareholders were given the option of either listing their regulated financial institution directly, or meeting the 35-per-cent rule through a financial holding company. In practice, only one major trust company was affected by the change: Canada Trust and Mortgage Co., which was 98 percent-owned by Imasco.

The reforms, which moved rather smoothly through the House of Commons and came into force July 1, 1992, encapsulated most of the liberalization envisioned when Wilson outlined his intentions some eight years earlier. Institutions were essentially free to operate across the financial spectrum, either directly or through subsidiaries, while stricter controls were placed on self-dealing and corporate governance. There was no question, however, of regulators being given the authority to supervise financial holding companies, the infamous "trustcos." Plus ça change, plus c'est la même chose.

NOTES

1. The Estey Report was discussed in Chapter 5. The Coopers & Lybrand Study was tabled in April, 1986. See Coopers & Lybrand, *A Study to Assess the Current Mandate and Operations of The Office of the Inspector General of Banks*, Submitted to The Honourable Barbara McDougall, Minister of State (Finance) by Coopers & Lybrand, April, 1986.

2. Confidential interview, November, 1992.

3. See "Finance Committee hits Ottawa for lacking policy on ownership," *The Globe and Mail*, December 11, 1986. The Bank of BC was taken over by the Hongkong Bank of Canada, with the Canada Deposit Insurance Corp. putting up $200 million to facilitate the transaction. The Continental was taken over by Lloyds Bank Canada, in a deal in which the latter purchased 90 per cent of its assets. Lloyds's Canadian subsidiary was subsequently taken over by Hongkong Bank Canada.

4. See Diane Francis, "Wilson said eyeing financial empire limits," *The Toronto Star*, December 9, 1986.

5. This information was related in confidential interviews conducted in late 1992 and several newspaper reports during early December, 1986. See also Christopher Waddell, "Cabinet split delays financial proposal, *The Globe and Mail*, December 13, 1986.

6. Senate of Canada Standing Committee on Banking, Trade and Commerce, *Towards a More Competitive Financial Environment*, Sixteenth Report, First Session, Thirty-third Parliament, May 1, 1986. The 35 per cent rule was first proposed in the Senate Report, 7.

7. These are discussed in Chapter 2. They arise when one party to a transaction, in this case minority shareholders, does not have a full appreciation of his/her marginal benefit from the transaction. In short, minority shareholders are at a disadvantage because they don't have access to all the information available to a company's managers or majority shareholders.

8. See, for instance, Francis, "Wilson...", and Waddell, "Cabinet split...". With respect to Prime Minister Brian Mulroney, one lobbyist active during this period disputed the role attributed to him by the media. The lobbyist, in a December, 1992 confidential interview, said Mulroney did not take a strong interest in the ownership issue until late 1987, after Brascan and Power began their "heavy lobbying" and a year after Hockin tabled his ownership proposals.

In addition to raising money for the Conservatives, the owners of financial conglomerates were themselves significant contributors to the party. In 1988, for instance, Brascan-controlled Royal Trustco Ltd. donated $77,405 to the federal PC party, compared to $26,000 to the Liberals. In the same year, Belzberg's First City Financial Corp. gave $55,714 to the Conservatives, twice as much as it gave to the Liberals. Central Capital Corp. then controlled by Leonard Ellen and Reuben Cohen, contributed $25,800 to the PC party in 1988, and gave $10,000 to the Liberals. Standard Trustco Ltd., then still part of Stephen Roman's empire, donated $15,363 to the Conservatives in 1988, three times as much as it gave to the Liberals. These figures are taken from W.T. Stanbury, *"Data on Contributions to Federal Political Parties in Canada, 1974-1989"* (Vancouver: University of British Columbia, August, 1990).

9. Department of Finance, *New Directions for the Financial Sector* (Ottawa: Ministry of Supply and Services, December 18, 1986). (Henceforth, the "Blue Paper").

10. Imasco, which owned 100 per cent of Canada Trust, would have had to dilute its stake in the trust company to 65 per cent within five years. Power Corp. which controlled non-bank institutions through Power Financial, would have had to reduce its stake in the financial holding company, which in turn controlled Montreal Trustco, Great-West Life Assurance Co. and Investors Group Syndicate. Brascan, which had effective control of Royal Trustco through Trilon Financial, would not have been directly affected by the proposal since Trilon owned only about 50 per cent of Royal Trustco's shares.

11. Department of Finance, iii-iv.

12. Department of Finance, 17, 8. (Our emphasis).

13. The control premium refers to amount over and above a company's prevailing share price that a buyer would be willing to pay to assume a controlling interest in the company.

14. See Canadian Bankers' Association, *Response to the Federal Policy Statement: New Directions for the Financial Sector* (Toronto: Canadian Bankers' Association, 1987).

15. Diane Francis, "Financial paper forged by lobbyists for big empires," *The Toronto Star*, December 24, 1986.

16. "Financial free-for-all," *The Toronto Star*, December 19, 1986.

17. Matthew Horsman, "You can almost hear sighs of relief in the boardrooms," *The Financial Post*, December 22, 1986.

18. The Blue Paper stated that no one in the future could purchase more than 10 per cent of trust company with more than $750 million in capital. Therefore, it would have been impossible for present owners to unload their stakes, except on a widely-held basis.

19. Confidential interview, November, 1992.

20. Confidential interview, November, 1992.

21. Confidential interview, December, 1992.

22. Confidential interview, December, 1992.

23. Confidential interview, November, 1992.

24. Confidential interview, November, 1992.

25. See Jonathan Ferguson, "Ottawa to give trust firms broader powers," *The Toronto Star*, December 22, 1987.

26. See "Five provinces' row with Ottawa delays new rules for trust firms," *The Toronto Star*, June 15, 1988.

27. Several lobbyists interviewed gave this impression.

28. See "Ottawa rewriting rules covering trust companies," *The Toronto Star*, August 24, 1988.

29. See A. Freeman, "U.S.-owned firms not eligible for banking licences, Minister says," *The Globe and Mail*, March 23, 1990.

30. Thomas Courchene, "Crumbling Pillars: Creative Destruction or Cavalier Demolition" (Lethbridge, Alta: Conference on Deregulation and Reregulation, 1989), 37.

31. Jacquie McNish, "Financial reforms delayed by Ottawa again," *The Globe and Mail*, December 5, 1989.

32. Confidential interview, November, 1992.

33. Confidential interview, November, 1992.

34. Confidential interview, November, 1992.

35. See Jacquie McNish, "Financial groups unite in reform plea," *The Globe and Mail*, March 15, 1990.

36. Confidential interview, November, 1992.

37. Bill C-83, *Trust and Loan Companies Act, 1990*, tabled September 27, 1990.

38. Department of Finance, *Reform of Federal Financial Institutions: Overview of Legislative Proposals* (Fall 1990), 7-8.

39. Ibid., 9. Emphasis added.

CHAPTER 8

PLUS ÇA CHANGE: DISCUSSION AND CONCLUSION

> In the rich countries, the specific emphasis of regulation has always varied from time to time and place to place. Public policy concerns about issues such as concentration of financial power, conflicts of interest, unfair competition, and the protection of investors or depositors ebb and flow with fashion and disasters... Governments may - and frequently do - choose to favour or handicap one group over another... But these should always be recognized for the political choices they are.[1]

The discussion of the normative rationales for financial regulation in Chapter 2 outlined policy options available to governments based primarily on the principles of economic efficiency and fairness. But policy choices are not made in a vacuum solely on the basis of normative principles. They are, more often than not, the result of the protracted and complicated workings of the political process. To understand the context in which political choices on financial regulation are made, then, it is necessary to have an appreciation of the relative influence of the various actors involved in the process. The access enjoyed by organized interest groups to decision-makers, the personalities of their representatives, the financial and other resources at their disposal to lobby politicians and bureaucrats are all factors to keep in mind in attempting to account for policy outcomes. Close attention must equally be paid to political representatives, their ideological dispositions and their position in the governmental hierarchy.

Our chronological account of financial sector reform in Canada between 1982 and 1992 demonstrated that an eclectic and ever-changing cast of actors was involved in the policy process. On the industry side, however, the intermediary bodies through which the debate was waged remained relatively constant. The predominant organization in the banking sector was the Canadian Bankers' Association (CBA), which had enjoyed legal status since 1900.[2] It is a perfectly representative organization as all Schedule I and Schedule II chartered banks are required by law to belong. The CBA's legal status gave it substantial legitimacy in the eyes of government regulators, and traditionally, the CBA worked closely with the Bank of Canada and the Department of Finance, aiding in the implementation of monetary policy. One author referred to a relationship characterized by a "drawing room atmosphere... (where) a couple of CBA mandarins and the federal Minister of Finance created banking policy over an after dinner Remy."[3] The CBA's traditional, privileged access to government explained, then, its success in fulfilling its primary functions: "to advocate continued minimal intervention and to counter claims of other financial intermediaries for a share of the banking pie."[4]

Coleman describes the CBA as "one of the more formidable associations representing Canadian business."[5] With a staff in excess of 100, it is clearly one of the largest business associations in the country. Although the CBA does not disclose its annual budget, its large staff and extensive advertising and lobbying activities indicate that its resources are substantial. The CBA's internal structure is highly developed, geared to policy advocacy. The Public Affairs Division monitors "public perceptions about banking and bank-related issues" and designs "public relations campaigns directed at "correcting" erroneous or harmful views."[6] The Legislation and Government Division monitors federal and provincial legislative initiatives, advises members on their effects, and prepares briefs for presentation to government regulators, politicians and legislative committees.

Since 1980, the President of the CBA has occupied the position on a full-time and permanent basis, "in recognition that the industry's involvement in federal and provincial government relations activities had become too time-consuming to be handled on a part-time basis by a banker with heavy responsibilities in his own bank."[7] Robert M. MacIntosh, a former executive vice-president at the Bank of Nova Scotia, occupied the position of president until 1989, and was, hence, the industry's chief representative during most of the debate on financial reform. MacIntosh without doubt was keenly sensitive to the workings of the political process and the need to mobilize public opinion in the banks' favour, "because that's what makes the politicians move."[8]

MacIntosh's skills in winning over the public, however, were often questioned both by industry insiders and outsiders. His abrasive nature, and handling of sensitive issues, such as bank service charges, were the subject of much criticism. One author noted that:

> (a)s one critic put it, "MacIntosh is the only bull who carries around his own china shop." Communications skills are not exactly his strong suit. Says (House of Commons Finance Committee Chairman Don) Blenkarn, "When he's not calling me a socialist schizophrenic, he's busy alienating the press. What kind of way is that to get people on your side?[9]

MacIntosh's protege, Helen Sinclair, took over as CBA president in mid-1989. Sinclair was widely seen as possessing superior communications skills, as well as a more conciliatory disposition, that would help remake the banks' poor public image. At 38, she had already served as the CBA's director of public affairs between 1980 and 1985, and as a senior vice-president at the Bank of Nova Scotia before assuming the CBA presidency.

Despite the CBA's apparent success as a lobby group, the appointment of a permanent president in 1980 was a response to the more sophisticated and complicated nature of interest group politics that had evolved in Canada. No longer was it possible for the banks to exploit their privileged access to regulators and politicians to draft policies affecting the financial sector in secrecy. Coleman notes that the *Bank Act* revision of 1980 illustrated the extent to which the policy process in the financial sector had come "to involve a wide range of special interests, making it more difficult for the banks to defend their interests," as well as the fact that the banks had had "difficulty responding to a series of... challenges mounted by leaner, more aggressive financial intermediaries."[10]

The leaner, more aggressive financial intermediaries to which Coleman refers are primarily the country's largest trust companies, the majority of which had come under the financial empires controlled by some of Canada's largest industrial conglomerates. The trust companies were the banks' principal adversaries on the issue of financial reform. Their aggressive business practices (considered banking activities in all but name), and the pressure they exerted on policy-makers for more powers in the early 1980's, were largely responsible for forcing financial sector reform onto the policy agenda. On the issue of ownership regulations, the dichotomy between the banks and the trust companies was absolute.

The organization representing the trust companies' interests during the decade-long process of financial reform was the Trust Companies Association of Canada (TCAC), or more commonly known as the TCA. Unlike the chartered banks, trust companies in Canada can be chartered federally or provincially. Thus, the TCA has provincial wings which interact with provincial regulators. The TCA defines its role as one of

> (identifying) the trust industry's interests and aspirations and (articulating) these to all appropriate levels of government, the media and the public. The Association anticipates government policy direction, attempts to assist in shaping this direction, and advises governments of the impact of their proposed actions on the trust industry and consumers of financial services.[11]

The TCA's role as industry spokesman and lobbyist increased substantially during the 1980's as the considerable growth of its member companies made the trusts more important players in the financial sector. Its profile and effectiveness as a lobby group were also enhanced by the political acumen its president, John L. Evans.

Evans, who took over as president shortly after the tabling of the Blue Paper, brought to the job experience in government and as a lobbyist, as well as academic credentials as a professor of finance and economics. Evans gained his shrewd understanding of the political process during a career in which he had alternately served as a senior bureaucrat in the 1970's (at Consumer and Corporate Affairs), a Liberal MP between 1979 and 1984, and as a consultant on public policy from 1984 to 1987. During his term as the Member of Parliament for Ottawa-Centre, he served as the Parliamentary Assistant to the Minister of Finance, a position which undoubtedly gave him a solid understanding of the department and its bureaucrats.

Compared to the CBA, the TCA is a much smaller organization, though with a highly-developed internal structure geared towards policy advocacy, with about 19 full-time employees and a budget, in 1989, of slightly more than $1 million. That the trust companies proved a larger than expected rival for the banks on the lobbying front is attributed, in part, to Evans' effectiveness, and most notably to the fact that several members of the "Canadian business establishment" had significant holdings in the trust industry through financial conglomerates. The high profile of these individuals as leaders of the business community, as well as their access (and in some cases political and social ties) to the highest instances of government, indicate their inherent ability to influence policy outcomes.

Two other groups that merit mentioning as actors in the policy process are the Canadian Life and Health Insurance Association (CLHIA) and the Investment Dealers Association (IDA), both of which had high stakes in the outcome of financial reform. Their input on the ownership issue was, however, peripheral, since the Ontario government's decision to open up the securities sector to other financial institutions resolved the ownership matter as it affected investment dealers and the CLHIA concentrated its efforts on preventing the incursion of banks into the insurance sector.

Among the organizations with an indirect interest in financial reform was the Consumers' Association of Canada (CAC). However, as is the case on most policy issues, the CAC, in as much as it represents diffuse interests with a vaguely defined constituency, appeared unable to wield much influence. The CAC was most effective on issues on which it was able to mobilize public opinion, such as bank service charges. However, the matter of ownership regulations for financial institutions was not a particularly salient or contentious issue among the public. Despite this fact, the CAC was an active participant in the process, appearing regularly before parliamentary committees pressing regulators to emphasize consumer protection through widely-held ownership rules.[12]

The principal political actors possessing the ability to directly influence the outcome of the ownership issue were the Prime Minister, Michael Wilson, Barbara McDougall, Thomas Hockin, Gilles Loiselle, and Don Blenkarn. McDougall and Hockin, in their respective capacities as Minister of State for Finance, (the former between 1984 and 1986, the latter from 1986 to 1989), had the direct responsibility for drafting and implementing the reforms for the financial sector. Hence, each was the target of intense lobbying. Whereas McDougall, a financial analyst, appeared sympathetic to the trust companies (on the basis of the Green Paper), Hockin, an academic and "internationalist" in disposition, recognized the need to strengthen the banks' competitive position. Loiselle, maintained the appearance of neutrality on the issue.

Merely listing the primary actors and their relative strengths and weaknesses is of little use to students of public policy without further examining the structures within which such actors work and the events that move the process along. The advancement of policies through the instances of government is, after all, a dynamic process.

Furthermore, in advanced capitalist democracies, such as Canada, interest groups are invariably geared toward policy advocacy. Organized interests seek to realize the goals (pecuniary or otherwise) of their members by influencing public policy. Interacting with government is central to attaining their objectives, as few groups are unaffected by what government does (or doesn't do).

Coleman describes policy advocacy as

> the attempt to influence what will or will not be a matter of public policy, the content of policies as they are being made, and they way in which they are being implemented once agreed to by the government and by the legislature. The key word in this definition is influence: the group is outside the policy process; it belongs to civil society and is calling upon the state, specifically those who make public policy. The guiding principle of action is competition, the capture of distributional benefits, normally at the expense of other social groups, organized or unorganized.[13]

More specifically, Stanbury[14] offers four principal objectives of interest groups seeking to influence public policy:

> 1. To obtain new legislation (statutes or subordinate legislation) favourable to the interests of the group...
>
> 2. To obtain favourable interpretations of existing legislation or policy by line departments, regulatory agencies or the cabinet...
>
> 3. To prevent undesirable changes in legislation or in interpretation of existing legislation or policy in (1) or (2).
>
> 4. To obtain longer-term changes in access to or participation in the public policy-making process...

Employing these distinctions, then, one can identify the objectives of the TCA and the CBA, respectively, on the issue of financial sector reform. The TCA sought new legislation expanding its power to conduct bank-like activities, notably commercial lending. In addition, it pushed for the maintenance of existing ownership rules for trust companies. The final, and perhaps most significant, goal of the TCA was the desire to win the recognition of policy-makers and, hence, the right to participate in the formulation of legislation affecting the sector, a right the banks had enjoyed for decades.

As for the CBA, it also sought new powers for the banks. In addition, it argued, in response to the Green Paper, for the imposition of widely-held ownership rules on trust companies. While it regarded the participation of trust company representatives in the formulation of policy affecting the sector as a *fait accompli*, it pressed the government to maintain a state agency that would oversee the banking sector alone, instead of one governing the activities of all financial institutions.[15] This may be seen as an attempt to preserve somewhat its privileged access to policy-makers.

A group's success in achieving its objectives depends on several factors, not the least of which are the scope of their lobbying efforts, the personalities involved in the process, and a host of exogenous variables beyond the groups' control (e.g. a government too preoccupied with other issues). But the outcome of the policy process can depend just as much on the organizational strength of the interest groups involved, as well as the structure of the government agencies with which they interact.

Examining the impact of the latter two factors is the study of state-society relations, a concept familiar to students of politics. For several years, the pluralist school appeared to have provided the definitive model of state-society relations. However, the ideological hegemony of pluralism has withered in recent years, as researchers have attempted to shed new light on the way the state interacts with civil society, realizes it "preferences", or maintains social order.

Hence, we have seen the emergence of several new models of state-society relations, such as the corporatist and state-autonomist paradigms, as well as a somewhat less "innocuous" version of pluralism in which the playing field is anything but level.

Most such studies have looked at state-society relations at the national level. However, the proliferation since the 1960s of government agencies with a circumscribed and often sectoral mandate, and the multiplication over the same period of the number of sector-specific trade and business associations, has led many to conclude that sectoral analysis of state society relations might yield more meaningful explanations for the outcome of public policy.

Coleman maintains that the organization of societal interests and the structure of the state are determining factors in the emergence of different "policy networks" in different sectors of the economy or society.[16] The type of policy network that emerges in a given sector depends on the "policy-capacity" of the sectoral associational system and the structure of the state agency or agencies overseeing the sector.

The extent to which a sectoral associational system is policy-capable is based on four criteria: its density or representative nature; the number of the associations in the sector and the degree of competition between them; the authority the industry association has to act as industry/sector spokesperson when interacting with the state and its ability to impose decisions on its members; the degree of horizontal differentiation between sectors.[17] The ideal-typical policy-capable associational system, then, would consist of one sectoral association representing the vast majority, say 75 percent or more, of its potential constituency, with full authority to negotiate on behalf of its membership with the state, and without any overlapping membership from different sectors.

Peak (i.e.national) associations of business or labour face positive incentives to direct their efforts toward pursuing the "national interest", in which, because of their encompassing nature, they have a very large stake. By contrast, a sectoral association with a high degree of policy-capacity has a tendency to become what Olson calls a "distributional coalition" with an incentive to "seek redistributions to itself without devoting any significant effort to minimize the excess burden of these redistributions, because its members will only bear a minute share in the reduction in the national income that results."[18]

In short, policy-capable sectoral associations can become formidable lobbies, pressuring government for legislative actions, such as tariff protection, new powers for financial institutions, or regulations that would hinder their competitors -- measures that increase their income at the expense of other groups or society as a whole.

The type of policy network that emerges in a given sector also depends on the organizational structure of government. Where a state agency has a mandate to oversee a given sector it can often be vulnerable to capture by policy-capable associations. Suleiman maintains that

> agencies are created to protect sectors and groups. And this protective role leads to a clientelistic relationship between the state and private groups that ends up circumscribing the state's power to define and implement policies that do not protect the interests, goals and privileges of the group.[19]

Consequently, a state agency can come to defend its clientele against other state agencies, further inhibiting its ability to articulate objectives which differ from those of its clientele group. Agencies with a trans-sectoral mandate, such as a horizontal coordinating agency like the Department of Finance, are not subject to capture by narrowly-focused interest groups on this scale.

Drawing on the above discussion, Coleman[20] distinguishes four different types of policy networks at the sectoral level: corporatism, state autonomy, clientelism, and pressure pluralism. Corporatism occurs where the state delegates the authority to private interests to participate in the formulation and implementation of public policy. Where the cohesion of the state agency is high and the policy-capacity of the associational system low, the state may be in a position to realize its objectives in the face of societal resistance. This situation would be analogous to one of state-autonomy.

Clientelism occurs where a sector-specific state agency with a narrow mandate is "captured" by a strong sectoral association. Pressure pluralist networks

> arise when state agencies are relatively strong, with some sense of a general interest, relatively self-sufficient in information and in securing compliance with policy directives from industry... Celebrated in the classics on pluralism, this type of network is what analysts and observers call a "lobby" or "pressure group politics." ...(An interest group) competes for the ear of those in power with other class or group advocates in an apparently open political marketplace. Nevertheless this market is not as free and competitive as it might seem.[21]

Coleman's typology is, of course, for heuristic purposes only. But it is nevertheless useful in attempting to account for the outcome of policy issues in certain sectors. Our discussion of developments following the tabling of the Green Paper, however, indicated that the factors affecting policy outcomes are many and varied and go beyond the simply the organizational structures of interest groups and the state. Despite this caveat, the latter remain among the most important factors and hence an application of Coleman's typology to the Canadian financial sector is worthwhile.

We noted earlier that, in the past, there was complete differentiation among the four pillars of the financial system with little interaction among them. Hence, there were essentially four independent sub-sectors. The interests of each pillar were represented by a dominant industry association: the CBA represented the chartered banks, the TCA the trust companies, the CLHIA was the dominant organization in the insurance sector, while the IDAC represented investment dealers. All these organizations were highly "policy-capable", and there was little or no direct competition between them.

In addition, the structure of government regulatory agencies mirrored the differentiation among the pillars. For instance, the activities of the chartered banks were overseen primarily by the Bank of Canada (and to a lesser degree by the Office of the Inspector-General of Banks), while the trust companies were regulated by the trust division of the Office of the Superintendent of Insurance. Accordingly, each pillar association sought to cultivate close relations with its companion state agency in the hope that the latter would defend its interests in government. Pillar-agency interaction was discrete, conducted out of the public eye. Thus, the dominant policy network in each sub-sector of the financial system was analogous to a form of clientelism. This type of policy network was without doubt most highly developed in the banking sector, and given the unchallenged dominance of the central bank in the government hierarchy, the CBA can be said to have traditionally had the most success in influencing policy affecting the financial sector.

The developments leading to the blurring of the distinctions between the pillars of the financial system discussed earlier, as well as the aggressive nature and spectacular growth of the trust companies, served to disrupt the existing clientele networks. With institutions in each pillar attempting at the same time to penetrate other pillars and fight off incursions by others into its domain, the TCA and CBA were plunged into a competitive associational system, with each fighting for the ear of government. Each group's clientelistic relationship with its companion state agency was undermined by the consolidation of responsibility for financial institutions issues in the Department of Finance after the 1967 *Bank Act*. With responsibility for financial sector reform placed in the hands of the Department of Finance, a horizontal coordinating agency, the potential for capture by narrowly-focused interests was essentially eliminated. The resulting policy network has been, then, analogous to a situation of pressure pluralism, where the outcome of policy is left to the workings of the "political marketplace."

In such an environment, the content of policies is left less to the application of normative principles by apolitical bureaucrats, than to the ability of organized interests to put their stamp on legislation by influencing policy-makers. Hence, the Green Paper was very much a testimony to the trust companies' lobbying efforts of the early 1980's and the newly acquired sophistication of the TCA as a lobby group of consequence. The derailment of the proposals laid out in the Green Paper was partly a result of strenuous lobbying on the banks' part, but mostly by factors beyond its control: the collapse of two banks, the backlash among members of the Commons Finance Committee on ownership rules, provincial opposition to the proposals, Ontario's unilateral move to open up the securities sector.

The Blue Paper must be seen, then, as a response by policy-makers to placate all of these powerful interests, while at the same time achieving the goals of the Minister of State for Finance and his top bureaucrat for tougher ownership rules. By grandfathering existing trust companies controlled by non-financial conglomerates (up to a 65 percent ceiling), the government aimed to win support for its proposals from the most powerful and influential individuals in the trust industry. On the other hand, by prohibiting all future financial-commercial links and imposing bank-like ownership rules on future entrants into the trust industry, policy-makers hoped to mitigate the CBA's opposition to its proposals.

But the Blue Paper's proposals failed to satisfy either of these groups, and the intense lobbying campaigns of both the TCA and CBA resumed immediately following its publication. Faced with the demands of these two extremely sophisticated groups, the government was loath to commit itself to any policy that would "pit (it) against a powerful interest group."[22] The subsequent stalemate was essentially the product of the government's reluctance to act. Its strategy became one of delivering an all or nothing ultimatum to members of the industry to come to a compromise among themselves or risk seeing the legislative proposals shelved indefinitely. Policy-making of this sort may indeed have unsettling implications for both the public interest and democracy. A discussion of such a complex matter is, admittedly, beyond the scope of this thesis.

CONCLUSION

At time of writing, a year has passed since the five bills the federal government introduced to implement its financial reform package went into force. Ironically, with few exceptions, the only institutions to take advantage of the lifting of cross-pillar ownership restrictions have been the banks. Well before the legislation was proclaimed, many of them had applied to set up trust subsidiaries. Already, with the takeover of Royal Trust and Central Guaranty Trust by banks, the latter are now the largest providers of fiduciary services. The trust industry, meanwhile, is in tatters. This is hardly the outcome trust owners expected when they fought so hard to resist the shackles of ownership restrictions. They were victorious on that front, but it is difficult to judge their triumph as anything other than a Pyrrhic victory. Few of those who lobbied for liberal ownership rules are around to savour them. The first to abandon the industry was Paul Desmarais, who, in 1989, sold Power Corp.'s controlling interest in

Montreal Trust to widely-held BCE Inc. The latter is already considering selling its acquisition to one of the major banks. The Edper-Bronfman empire has been forced to cede its stake in the trust industry, via Royal Trustco, to the country's biggest bank. Central Guaranty Trust has been relegated to the annals of history, as have First City Trust, Standard Trust, Guardian Trust, General Trust and a host of others. Finally, the Laurentian Group, which pushed the Quebec government into challenging Ottawa's ownership proposals in the Green and Blue papers, has surrendered to a merger with Mouvement Desjardins.[23]

The demise of these entities give credence to the many criticisms of closely-held ownership that were levelled throughout the debate on financial sector reform. At the very least, it suggests the overwhelming focus of policy-makers' attention on diffusing the ownership issue was inappropriate. Politics took precedence over policy. The federal government acknowledged as much when, in December 1991 -- just as its financial reform package was receiving Senate approval -- the government was forced to introduce a draconian piece of legislation that enabled the Canada Deposit Insurance Corp. to overrule owners and seize the assets of a troubled financial institution.[24] Bill C-48 was a direct response to regulators' frustration in attempting to orchestrate an orderly sale of Central Guaranty, which was then near collapse. Central's controlling shareholders, Leonard Ellen and Reuben Cohen, had resisted regulators' pressure, leaving the CDIC with little choice but to enlist the strong arm of the law. But like most legislation quickly put together to address a crisis, the bill was criticized for the sweeping powers it bestowed on regulators without adequate consideration of the consequences. Ironically, the government had had almost a decade to study this matter, but the politics of the ownership issue had diverted its attention.

This thesis had as its aim an analysis of the factors that allowed the policy process to be dominated by a single issue to the neglect of all others. Our discussion focused on the various actors -- organized interests, bureaucrats, politicians, influential individuals -- in an attempt to provide some insight into why the process went awry and why it ended in an re-affirmation of the status quo. The scope of this thesis is not exhaustive, and therefore, there is much room for further work in this area. A more rigorous application of paradigms used in public policy analysis could, for instance, add further insights about the process. A more detailed examination of the role of the insurance lobby in altering the course of the debate could also prove useful, but was beyond our focus on deposit-taking institutions. Finally, further study of the financial reform exercise would be enhanced by a more detailed study of the dynamics of federal-provincial conflict and its impact on the policy process.

NOTES

1. "Survey of International Banking," *The Economist* (April 7, 1990), 11-12.

2. See William Coleman, *Business and Politics* (Montreal: McGill-Queen's University Press, 1988), 184.

3. Shona McKay, "Winning friends for the banking bunch," *Report on Business Magazine* (May, 1989).

4. Coleman, 184.

5. Ibid., 185.

6. Ibid.

7. Cited by Coleman, 184.

8. Coleman, 186.

9. McKay.

10. Coleman, 184.

11. Trust Companies Association of Canada, *Annual Report* (Ottawa: Trust Companies Association of Canada, 1988).

12. See Jacquie McNish, "Financial reforms overdue, CAC says," *The Globe and Mail*, April 19, 1990.

13. Coleman, 48.

14. William T. Stanbury, *Business-Government Relations in Canada* (Toronto: Methuen, 1986), 33-34.

15. Canadian Bankers' Association, *Response to Bill C-42* (Toronto: Canadian Bankers' Association, 1987), 2.

16. Coleman, 67-69.

17. Of course, other variables can come into play in determining an association's policy capacity, including such factors as the group's financial resources and its lifespan (i.e. a well-funded, but short-lived group is unlikely to shape policy over a long period of time.) However, our limitation of the criteria to four was not meant to exclude all other factors, only to underscore the standards we believe are most useful, and most universally applicable, in measuring policy capacity.

18. Mancur Olson, "A Theory of Incentives Facing Political Organizations," *International Political Science Review* 7, No. 2 (1986): 173.

19. Ezra Suleiman, "State structures and clientelism: The French state versus the notaires," *British Journal of Political Science* 17 (1987): 261.

20. Coleman, 72-77.

21. Ibid., 72.

22. McNish.

23. See Barrie McKenna, "Grand alliance is more shotgun wedding," *The Globe and Mail*, July 17, 1993.

24. "Ottawa to boost CDIC power," *The Toronto Star*, December 13, 1991.

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