

# What Kind of a Financial System do Canadians Want?

## Implications of Globalization and Current Canadian Policies for the Future of the Canadian Financial System

### I. INTRODUCTION

This paper examines the longer term outlook for the Canadian financial services industry and its governance. Attention is paid to what would happen to the Canadian financial system and its governance, federal and provincial, if current trends in the international and Canadian financial services environment and in Canadian regulatory policies continued into the future.<sup>2</sup>

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In this analysis of the prospects for the Canadian financial system it is assumed that international initiatives now underway, strongly prompted by the Asian financial crisis, will succeed in maintaining a relatively stable international financial environment. The research that supports that conclusion is contained in a related study.<sup>3</sup>

### II. OUTLINE OF THIS STUDY

This study begins with a commentary on why it is necessary to rethink current Canadian financial services policy.

This is followed by a brief outline of the nature of the global environment with

particular emphasis on the fundamental forces that are driving the restructuring of the world's financial system and how that system is being reshaped.

Third is a discussion of the prerequisites for future financial system stability and efficiency including the weaknesses in financial systems that need to be addressed. It was concluded that this could be done most effectively by identifying the weaknesses in financial systems and their causes that were revealed in recent financial crises, particularly the "Asian Financial Crisis." That crisis is significant because it affected a number of countries, because it was the first crisis in the new era of enormous private sector international capital flows, and because it became the springboard for major new initiatives relating to the governance of domestic and international financial systems.

Fourth, and drawing on the preceding discussion, the paper outlines the implications of current Canadian financial serv-

ices policy for the future of the Canadian financial services industry.

Fifth, in summary and conclusion, consideration is given to what Canadian policy changes would be needed in order to ensure for Canada an efficient, stable and internationally competitive Canadian financial services sector and one that creates substantial employment opportunities for Canadians in the future. It is concluded that, considering the nature of global financial services changes, current policy unless amended will not lead to that result over the next ten years. Rather it risks undermining the competitive position of Canadian financial institutions in their home market, particularly the banks, and preventing them from evolving into significant players internationally. This process in turn increases the risks that in future years Canadian banks will be absorbed by foreign, probably US, banks.

### **III. NEED FOR REAPPRAISAL OF CANADIAN FINANCIAL SERVICES POLICIES**

It may be assumed that Canadians would wish to see the emergence of a Canadian financial system that (1) is stable and efficient and so provides crucial assistance for Canadians to enjoy a stable and rising standard of living and (2) ensures that a significant proportion of the financial system serving Canadians is located in Canada and directed from within Canada — so as to provide jobs in Canada and reflect uniquely Canadian priorities. The question could be asked, for example, whether, assuming current trends and policies, Canada might achieve the first objective, through the impact of globalization, but not the second.

The principal forces shaping the international and Canadian financial systems over the next ten years or so will be the

impersonal forces of the market place operating globally, and not the discretionary decisions of domestic and international regulatory authorities. This conclusion emerges from a detailed examination of the nature of the Asian financial crisis, as discussed later. The principal challenge of the regulators will be to ensure that the regulatory framework will produce a stable and efficient financial system within the environment of those impersonal market forces. Therefore, any study that focusses only or largely on Canadian domestic developments and ignores or downplays those impersonal international market forces in attempting to determine how Canada's financial system is likely to evolve, and what policies are appropriate, will have little practical value.

There have been voluminous official and private studies of the Canadian financial system over the last fifteen years including most recently the Special Studies and Report of *The Task Force on the Future of the Canadian Financial System*,<sup>4</sup> which appeared in September 1998. This was followed by the federal Department of Finance policy paper of June 25, 1999<sup>5</sup> and by an accompanying statement of the Minister of Finance. These studies provide excellent material relating to the Canadian financial system. They also point to some areas of useful fine tuning of the system.

Unfortunately, and in spite of all these studies, some of the recommendations that the government is now putting forward would weaken, rather than strengthen, the Canadian financial system against its competitors. They would do so because they have two fundamental deficiencies.

The first deficiency relates to the fact that those recommendations do not take

seriously into account how rapidly the world of international finance is transforming itself and what that will mean for the Canadian financial system over the next decade. They have not taken to heart the advice of the Task Force that “[The] forces of change will continue to dramatically transform the Canadian financial services sector....Regulatory policy aimed at preserving the status quo is not a viable option.”<sup>6</sup> In particular, some important official recommendations that have emerged essentially set aside the international dimension and proceed as if the Canadian system is largely a closed one, immune to international forces. The problem here is not the speed with which government is moving to implement new policy, that is from the policy paper of July 1999 to possible legislation this year, but rather its failure to recognize the implications for policy of the speed with which the competitive world, driven by technology, is changing.

It is true that official statements and documents frequently refer to the forces of globalization, but then these forces are forgotten in major recommendations. It has been left to non-official sources to raise serious questions about that approach.<sup>7</sup> The real world of globalization and its fundamental implications, as described by Thomas L. Friedman for example,<sup>8</sup> is no where to be found in those recommendations. In addition many international financial institutions have evolved rapidly even since completion of the Task Force studies. A number of major mergers and acquisitions have occurred among international banks<sup>9</sup> and the US has repealed the Glass-Steagall Act. That Act had for decades separated commercial and investment banking and banking and insurance. Within the context of this rapidly evolving financial environment

some aspects of Canadian financial services restructuring policy, as discussed fully later on, have all the appearance of fighting the last war, not the next one.

The second weakness of the policy papers arises from the fact that they are based on a very short term time horizon in terms of likely developments in the Canadian financial system. This is most explicitly stated in the reports of the Canadian Competition Bureau but is implicit in many of the policy positions outlined. The Competition Bureau in explaining its approach to appraising the merits of a proposed bank merger stated that “...The Bureau uses a two-year time frame within which to assess the likely competitive impact of a merger.”<sup>10</sup> Employing a two year time horizon in a world where impersonal and significant international market forces are shaping the system over a much longer period, is not simply irrelevant but dangerously harmful to Canada. It leads to policy conclusions that impede the ability of the financial system to adjust to new realities, including the emergence of strong new competitors from abroad.

What is missing in Canadian policy is a vision of where Canada wants the Canadian financial services sector to be a decade from now and a realistic appraisal of where it is likely to end up assuming the continuation of existing policy and current international trends. There is need to recognize that the position of the institutions today, including their profit levels, have little to do with their likely position a decade from now in a world where shifts in the competitive structure of the international financial system come swiftly.

The analysis that follows takes a longer term perspective. It identifies some of the

challenges that face the Canadian financial system in the years ahead, and considers the policy implications of those challenges.

#### **IV. THE GLOBAL ENVIRONMENT**

The single most important force reshaping international and domestic capital markets today is the quantity and quality of information available to them and the ease with which it is available. It has been noted that 19<sup>th</sup> century globalization was based on falling transportation costs — railroads, steamships, automobiles, whereas current globalization is based on telecommunications technology and sharply falling telecommunications costs — microchips, satellites, fibre optics, and the Internet.<sup>11</sup> Computing power for years has doubled every eighteen months and storage capacity that cost five dollars a few years ago has fallen to five cents. For many, E-Mail is free. Virtually every part of the world can be, and increasingly is connected to the system.

This latest version of globalization is breaking down regional, international and institutional barriers between markets, and at a pace that even a few years ago would have been unimaginable. None of this is happening according to domestic and international regulatory plans. It is being driven by the powerful and impersonal forces of the competitive market place — a market place that suddenly has become intercontinental in its span.

Those market forces are being facilitated by electronic systems that on the one hand involve enormously expensive investments in equipment, software and human resources while on the other hand, because of significant economies of scale and huge volumes of transactions, can supply individual services at remarkably low cost to the user.

Those same market forces are generating an unprecedented move toward the integration and standardization of financial services markets, of financial institutions within them and of governance policies and regulations. A fundamental and in many ways remarkable aspect of this era of financial globalization is that virtually everyone will be able to participate in it because of consumer friendly equipment and programmes and low unit cost of services. Geographic location, the historic barrier to international competition in domestic markets, means less now than it did in the past and over the next decade will mean much less still. This pooling of world wide information shared by buyers and sellers will be the most important boost to competition that has yet occurred and will rapidly make obsolete past competition based on the protective barriers of political boundaries.

Any country that attempts to oppose those trends of integration driven by impersonal market forces, or even simply ignores them in its policies, will have to be prepared to face harmful economic consequences. These consequences will not involve denying consumers access to financial services, since international institutions will be there to supply them. Rather the consequences will take the form of a domestic financial services sector that is not internationally competitive and that therefore shrinks over time in the face of international competitive forces. This, in turn reduces the nation's economic growth and also its employment in its domestic financial services sector. A key fact is that a country's actions will not neutralize those impersonal forces and so its institutions will not be shielded from their impact. The reality is that financial system resources and services are highly mobile and can in-

creasingly be accessed from almost anywhere at low cost.

One writer has described the current era in a way that does portray its irreversible significance:

...the globalization system, unlike the Cold War system, is not static, but a dynamic ongoing process: globalization involves the inexorable integration of markets, nation-states and technologies to a degree never witnessed before — in a way that is enabling individuals, corporations and nation-states to reach around the world farther, faster, deeper and cheaper than ever before, and in a way that is also producing a powerful backlash from those brutalized or left behind by this new system.<sup>12</sup>

Who, it may be asked, are the ones that can be “brutalized” in this process, as far as the financial sector is concerned? Certainly there are the individuals employed by financial institutions whose skills suddenly are made obsolete and who find retraining difficult.

Then there are the individual financial institutions that fail to understand and adjust to the new era of intense international competition, ever changing technology and new ways of delivering old and new financial products.

But there are also the financial systems of individual countries that, through the impediments of their regulatory framework, are prevented from making adjustments necessary to ensure that they will be internationally competitive. That they may remain viable and profitable for yet another few years is totally irrelevant — the perspective of the Canadian Competition Bureau notwithstanding. The relevant question for restructuring policy to address is where the financial system will be in five, ten or fifteen years time. In Canada no official policy report has asked

or responded to that question and no policy position taken addresses it.

This is dangerous for any domestic financial system including that of Canada, because the international environment is changing exceedingly swiftly and playing “catch up” will be difficult if not impossible. It seems fairly certain that international financial activity will drift toward countries that can provide the most propitious environment, including the regulatory framework. The distinction between what is international and what is domestic is fast disappearing.

Investors are already paying much more attention to international diversification of their asset portfolios than they did even a few years ago, as are international financial institutions with respect to their client base. In accessing services through the Internet, consumers become increasingly indifferent to whether the institutions involved are domestic or foreign, home-based or non-resident — a trend that is likely to dominate the next ten years of financial services development.

This process of international integration of domestic financial systems is already beginning to affect a number of policy areas and sectors. It is tending to lead to convergence of monetary, fiscal, exchange rate and tax policies; to emergence of international prices for and markets in financial services and top level executives and valued professionals; to standardization of regulatory regimes and codes of corporate behaviour and their governance; and to greatly increased importance of transparency in public and private sector activities. These tendencies will increase over the next decade.

Of particular importance are the enormous economies of scale that arise in

servicing an internationally integrated market and the capital base required to capture those economies. This requires very large investments in equipment and systems software and in highly qualified human resources. As a result an international institution that in former decades was of "optimum size," no longer is so in the current environment. Past guidelines for judging whether or not a corporation is of a size to be fully competitive are no longer useful.

Hardly a day goes when there is not a further case of industrial restructuring involving mergers, acquisitions, alliances or other arrangements. On close examination it is apparent that they involve the construction of organizations with larger capital bases, greater customer reach and the capturing of synergies through systems rationalization, including rationalization involving cross border transactions.

Just to give one example relevant to Canada, between February 1997 and October 1999 there were twenty one cases of Canada-US cross border mergers and acquisition transactions where the target company had a market capitalization greater than US\$350 million and where the Canadian company had a substantial portion of the combined equity.<sup>13</sup> In the major industrialized countries and some developing countries as well, such rapid pace of restructuring is also taking place in their banking sectors as noted earlier. In Canada it is not at present possible for the banking system to capture the efficiency-generating synergies of mergers because of the nature of government merger policy.

In the meantime the speed with which financial systems of other countries are being restructured could not have been

imagined even a few years ago. Repeal by the US Congress in 1999 of the Glass-Steagall Act of 1933 was not even envisaged as probable when most of the studies on the Canadian financial system were completed. Significantly it enables banks and insurance companies to be affiliated as well as removing barriers between commercial and investment banking. It facilitates major changes in the profile of the US financial system with larger institutions offering a wider array of services being the result,<sup>14</sup> changes that to a degree had already been underway. And as already noted global bank consolidations are continuing.

Because of this process of globalization, many domestic institutions that previously served only domestic markets will have no choice in future but to both protect vigorously their home base and use that base to expand their international activities, or be squeezed out of both markets. This is because the economies of scale made possible by modern technology can only be fully realized by having huge volumes of business, volumes so large that for smaller countries including Canada they require a market larger than the domestic one alone. It is for this reason that institutions such as the MBNA Bank and ING Bank are likely to be formidable competitors in future years. The fact that their market share in Canada is small today is irrelevant for what it will be in a decade, given the time it normally takes for individuals to adopt new opportunities and the possibility that Canadian regulations will not enable Canadian banks to reduce their non-interest costs as much as those of foreign competitors.

Currently informed Canadian investors or depositors can as easily place their funds with these foreign competitors as

with a Canadian bank and can do investment business via the Internet with a New York firm as easily as with a Canadian one. The number of “informed” financial services customers will undoubtedly increase greatly in a few years time. Furthermore, the increased knowledge available to even ordinary financial services clients means that the bar for acceptable quality and quantity of services being provided has been raised, and many institutions unable to meet that quality will disappear regardless of their national origin.

The view has been expressed that in the future only very large financial institutions with a broad international reach and highly specialized small niche players will survive.<sup>15</sup> Some might feel that Canada has a viable choice here, that is, either have internationally prominent institutions or have a domestic system of “niche players.” In reality there is no choice here for the larger Canadian banks because the emerging significant “niche players” are large international corporations themselves. Nor would there seem to be room for them in the “middle” range because they would not be in a position to capture the economies of scale enjoyed by their competitors. The only valid choice Canada has is to have an internationally competitive financial services sector that has a strong enough domestic base to operate intensively throughout Canada and, as some Canadian banks are already beginning to do, to develop various “niche” market positions outside Canada. Anything short of that would simply mean the inevitable disappearance of a uniquely Canadian financial services sector with core offices located outside of Canada.

What kind of a financial system do Canadians want? This question is best asked now because of the swiftness of

international competitive developments, as illustrated by current mergers and acquisitions, and the difficulty, if not impossibility, of retrieving lost ground. The reality is that the forces of integration are so relentless that any country whose financial services policy is designed to oppose them, or even just ignores them, instead of accommodating and adjusting to them, will be left behind. Its citizens may well still be supplied with quality financial services but by an industry that is based increasingly abroad, with career opportunities in the domestic industry shrinking rather than expanding.

## **V. PRESSURES OF GLOBALIZATION ON THE CANADIAN FINANCIAL SYSTEM**

In order to put matters into perspective it is helpful to identify more specifically still the pressures that globalization is beginning to exert on the Canadian financial system and which will almost certainly become increasingly important over the next decade. The assumption implicit in this examination is that Canadian policy will follow the lines currently set out — which are outlined in more detail later on.

**Ownership:** Investors including Canadians are becoming increasingly indifferent to the national origin of their investments and are placing growing emphasis on international diversification in their portfolio strategies. What this means is that ownership of Canadian financial institutions, as other large companies, will shift increasingly into the hands of foreign investors. In a decade or so one should expect that a majority of the equity of large Canadian financial institutions will be in the hands of foreign investors, particularly US investors. This is likely to happen simply because of portfolio

diversification and the fact that US investors have more than ten times as much to invest as Canadian investors. The proportion of Canadian bank shares owned by foreign investors has already become significant.<sup>16</sup> There is no legal impediment to this development since the restrictions on amounts of shares individual shareholders can own does not discriminate between Canadian and non-Canadian shareholders.

There is nothing much Canadian policy can do about this nor is there any economic reason why it should. The important issue however is whether the resulting company will be a major or minor player, where it will have its main base, in Canada or elsewhere, and whether or not its operations will reflect a close understanding of Canadian needs and priorities. This *can* be influenced by Canadian policy.

#### **Foreign Share of the Domestic**

**Market:** Over the next decade it is highly likely that foreign competitors will have gained a significant proportion of Canada's domestic market in financial services. This competition is emerging both from foreign institutions resident in Canada and non-resident institutions that can come right into Canadian homes and businesses by means of the Internet. Existing technology is already making this remarkably easy for ordinary Canadians. Just as the ATMs took over routine banking transactions after a certain period, so Internet banking is now beginning to replace ATMs.<sup>17</sup> Also investors can access their detailed investment accounts whenever they wish and buy and sell in minutes. It is only a matter of time before most investors do this, just as most banking clients eventually came to use ATMs.

It should be noted that this pervasive

border-eliminating power of the Internet and new technology has made obsolete past measures of domestic market concentration and policy that is based on the assumption that this has not happened, as is the case in Canada, will be biased in favour of foreign penetration of the domestic market.

Of course confidence plays a major role in determining the nature of an individual's financial transactions, and uncertainty over the risks in cross-border transactions has in the past limited them. However this is changing. International convergence of financial system regulations has already begun and in time will remove some of that uncertainty, and it is likely that international agreements on matters such as E-Money will emerge as well.

Also, Internet transactions tend to be faceless from a geographic and nationality point of view. Increasingly Canadian clients will be unaware, or at least relatively indifferent as to whether the institution with which they are dealing is Canadian or non-Canadian, or whether it is based in Canada or outside. Historic advantages that Canadian institutions had in being Canadian and being located in Canada will in time largely disappear. As a result Canadian banks will lose part of their home base market to non-Canadian investors and the weaker they are as competitors the more they will lose.

While some increased foreign penetration of the Canadian market for financial services is inevitable the extent of the penetration will depend on the competitiveness of the Canadian financial institutions. This in turn will depend on the degree to which the regulatory framework permits institutions to restructure and capture the economies of scale needed to reduce costs and remain competitive. If

policy enables the Canadian financial services sector to show a comparative advantage over foreign competitors then it will be able to retain a significant share of its home market. That is, Canadian policy can influence the final outcome but to do this it must recognize that the only successful strategy for meeting foreign competition is to have Canadian financial institutions that are as strong and efficient as their international competitors.

There are a number of changes in Canadian policy that can increase the efficiency of the system, as will be discussed later, but those changes are not currently envisaged by the Canadian government and so cannot be counted upon. While it is not possible to make precise estimates of the burden of current regulatory restrictions on the Canadian banks in terms of the efficiencies they are blocking, it appears that they are large. Based on a general impression of the kinds of cost and product synergies that have been captured in the merging of large institutions with over-lapping retail systems, it is probable that they fall in the range of 10%-30% of non-interest expenses. The greatest cost burden is excessive branch, head office, systems and product duplication. But in addition to cost savings, there are the opportunities for capturing new business made possible by emerging economies of scale. Regardless of what is the precise figure for cost saving and new business generation, it is relatively certain that no industry in this era of globalization can prevent a major loss of market share over the medium term period with operating disadvantages of those magnitudes.

**Canadian Banks' Share of the International Market:** Canadian banks, while doing very well internationally in some niche markets, have for some time

been declining in terms of the relative strength of their capital base. In 1970 two of the banks were among the twenty largest world banks but by 1984 this had fallen to only one. By 1994 the largest Canadian bank was 59<sup>th</sup> in size world wide whereas it had been 12<sup>th</sup> in 1970.<sup>18</sup> Since then a number of countries have experienced major mergers in their banking systems, in contrast to Canada, with the result that Canadian banks probably will continue to slip further down the capital base scale. Being an international competitor in the greatly expanded market made possible by technology requires a very large capital base, much larger than in simpler times;. To ignore the importance of this capital base could lead to being gradually squeezed out from the market. Mergers between the major Canadian banks would substantially improve their position among international banks.

Canadian banks have already pulled back on their international network and have pulled out of some international services where they were faced with much larger competitors.<sup>19</sup> It seems therefore that Canadian banks cannot make up for any loss of domestic market share by improving their share of international business. Indeed, their ability to develop their international business by leveraging off their domestic base would be weakened by loss of domestic market share.

What has happened here is that the "optimum size" of international financial institutions has increased. While this cannot be measured accurately mathematically, the very fact that bank consolidation is proceeding globally at a rapid pace and in response to the need to have a capital base that can support large new and costly electronic systems and service clients internationally dispersed, makes

this virtually certain. Canadian banks are impeded in following this trend by their inability to merge.

The view underlying Canadian financial services policy seems to be that the banks must be big enough since the banks appear to be performing satisfactorily today, and so there is no need to take into account future developments. This view is mistaken and potentially harmful. It is mistaken because inadequate size is already reflected in the actions of some of the banks, as noted above, and because the ongoing changes in the international and Canadian market environment will increasingly challenge the competitive position of the Canadian banks in the period ahead.

**Management and Direction of Canadian Financial Institutions:** The market for senior executives is also feeling the impact of globalization, with more and more corporations tapping the international market for executives when seeking to fill senior positions. Highly valued technical and professional employees and consultants too are operating increasingly in an international market. It is virtually inevitable that senior management of large Canadian financial institutions will have a significant proportion of non-Canadian executives over the next ten years. This is the inevitable result of the integration of markets for executives, the increasing international character of the business, and the simple fact that to be competitive a corporation will have to seek out the best executives available and not just those in its own company or country.

Again there is no economic reason to be concerned over this development. But there is great reason to be concerned as to whether those executives will be

located in Canada or abroad, particularly the US.

**Number of Financial Retail Outlets:** It has already been noted how the ATM machine replaced routine branch services and how the ATM facility in turn is being replaced by Internet banking, with telephone banking, it would appear, becoming obsolete even before it has really become well established. This development, and others such as outlets in stores, are reducing significantly the need for services supplied by local branches. Internet banking brings banking right into the home — much closer than any branch, while readily available cash and deposit machines also ameliorate the problem of distance between branches. Branches are taking on more sophisticated services but many of these could in time be replaced with increasingly effective electronic communications including low cost video conferencing technology. With it there would be no need for many of the one-on-one branch services presently being supplied.

All these developments will mean a persistent decrease in the need for branches. At the same time international competitive pressures will be such that it will not be possible for the individual banks to ignore the cost savings so involved — particularly since they are not now able to realize the cost savings and scale economies involved in mergers and acquisitions. It is probable that in a decade from now the number of economically viable branches will be half that of today. Virtually every major bank has already announced a restructuring programme involving branch closings.<sup>20</sup>

The closing of branches that no longer are cost efficient is both appropriate and necessary for competitive reasons, even

though Canadian policy appears to regard such branches as assets rather than as the liabilities that they are. However, the issue here is whether the pattern of closings in an environment where mergers are essentially prohibited is the same as and as economically efficient as the pattern that would emerge if mergers were permitted. The answer surely is that it is not. It almost certainly means that certain branches that would otherwise stay open do not, and others that should be closed are not. In this way current policy is leading to banking system restructuring that is only "second best" and not "first best" in nature. It leaves the branch system less efficient than it could be and so even more vulnerable to competitors operating without any of the cost of a branch system.

#### **Employment in the Financial Services**

**Sector:** It is not possible to determine the extent to which emerging technology will reduce employment in the financial services sector, or increase it for that matter. This in any case will be decided in the competitive market place and by the pressing need to minimize costs for competitive reasons. However, a very real concern is the possibility that employment in the Canadian financial services sector will be lost to foreign competitors through obstacles preventing the Canadian institutions from becoming as internationally competitive as possible. This would not be either an economically or socially desirable outcome and would unnecessarily mean loss of career opportunities for Canadians in Canada. Under current Canadian financial sector policy, as discussed fully below, it is likely that there will be an unnecessary loss of such career opportunities.

## **VI. PREREQUISITES FOR A**

## **STRONG FINANCIAL SYSTEM**

Adjusting to global forces from a position of home base strength is clearly necessary for maintaining a stable, strong and growing Canadian financial system. Therefore, it is useful now to examine more comprehensively the prerequisites for having a financial system that can stand up to the growing forces of global competition. By doing this it will be possible to identify which prerequisites Canada already enjoys, which ones it does not and where policy changes are needed.

The most realistic way of doing this is to examine the painful lessons for financial institutions and policy makers that have emerged from the Asian financial crisis. This event was really the first crisis in which huge private sector capital flows unleashed by the facilities of newly emerging information and communications technologies played a major role. The crisis revealed a variety of weaknesses in a number of domestic financial systems in the face of those capital flows, as well as weaknesses in macroeconomic policies. These weaknesses illustrated the challenges posed by the new era of globalized financial activity.

**Structural Policies:** One of the most significant aspects of the Asian financial crisis is that it was not caused simply by weak macroeconomic policies but rather by policies that had led to deep-seated structural problems. Domestic financial systems had for decades been protected against foreign competition which had given them little incentive to achieve state of the art efficiencies. Furthermore, detailed and burdensome domestic regulatory policies even inhibited competition between domestic institutions which made restructuring difficult and so further reduced efficiency generating

incentives. Lax corporate governance practices, weak bankruptcy laws, and undeveloped financial markets that made bank lending the only source of funds, were further weaknesses. Also, many institutions were required to make certain loans and investments to areas and institutions favoured by their governments rather than based on credit worthy criteria.

Authorities frequently provided financial assistance to weak institutions which led to serious “moral hazard” problems in the form of imprudent private sector operations and further system inefficiencies. When globalization suddenly unleashed unprecedented flows of capital the domestic institutions were unprepared and domestic regulatory regimes were overwhelmed. The result was a large number of bankruptcies of domestic institutions, their place to some extent taken by foreign institutions, and a prolonged period of inferior economic growth.

**International Governance:** The Asian financial crisis revealed the multilateral institutions, including particularly the IMF and World Bank, to be quite unprepared for dealing with the financial system problems that suddenly emerged in a number of their member countries. It underscored the need for much more effective multilateral influence on the governance of the international financial system and much more assistance to countries in improving the quality of their financial systems and its regulation. A number of initiatives to address this need are under way.<sup>21</sup> The fear that “contagion” had become a phenomenon of the global financial system caught the attention of the Group of Seven (G7) and their finance ministers and this caused initiatives to be taken.

It is somewhat ironic that at the same time as Canada, quite rightly, is taking a leading role in urging international arrangements to recognize the implications of globalization, some aspects of its domestic restructuring regulations appear to assume that globalization is not very important for the future health of the Canadian financial system.

**Macroeconomic Policies:** The Asian financial crisis proved that fiscal balance alone will not prevent financial system crises since, with one exception, the countries involved were in surplus. In Asia monetary policy frequently was late in attempting to restore stability and its attempt to maintain exchange rates at levels that had become unrealistic led to forced devaluations and loss of international confidence in the currencies affected. The economic fallout from this was severe. In South America fiscal imbalances were an additional problem. It is clear that misguided fiscal, monetary and exchange rate policies can help to undermine financial systems and that stability in them is a necessary, although not sufficient, condition for achieving financial system soundness and efficiency.

**Transparency of Regulatory and Market Activities:** One of the weaknesses revealed by the Asian crisis was the lack of market knowledge relating both to the intentions of regulators and the operations of private financial and non-financial institutions. This led to delayed market responses to troublesome situations. For example, the degree of support given to maintain exchange rates was often hidden from the market, and the capital structure weaknesses of corporations was not known even by their creditors. There was a failure to recognize that for regulatory activities to be effective they had to be understood by the market and that for

corporate weaknesses to be corrected before they became too large required adequate disclosure. The need for “transparency” in regulation and the activities of market participants is now much more widely accepted than it was before the Asian crisis. In one crucial area, as will be noted later, it is missing in Canadian policy, namely policy relating to mergers in the banking system.

### **Harmonization of Regulation with**

**Market Forces:** The Asian financial crisis has led to a fundamental change in perception as to what constitutes effective regulation. There were two major weaknesses with past regulatory approaches. First, there was heavy reliance on detailed rules such as permitted and non-permitted investment and lending activities. In time market innovation found ways around such detailed rules including through domestic and off shore activities of less regulated institutions. The result was a distorted and inefficient financial system including regulatory failure to focus on the over-all financial standing of the institutions. The second weakness was that regulatory protection of financial institutions led to serious “moral hazard” problems as institutions began to assume that if they and so their clients encountered difficulties they would be rescued by the government and its agencies.

Since then domestic authorities in many countries have begun to abandon detailed prescriptive regulations and put in their place much more emphasis on the “prudent portfolio” approach to regulation which judges the quality of an institution’s assets as a whole. Also much greater importance is now attached to transparency, timely disclosure and the auditing of internal policies and procedures. In this way market forces are harnessed to achieve regulatory objectives — as, for

example, when early disclosure reveals initial weakness and markets respond to that company’s changed credit standing. Also it is increasingly recognized that market discipline will be adequate only if private financial institutions understand that imprudent behaviour will lead to bankruptcy and not to government “bail-out.” This, too, is becoming more evident in regulatory practices.

### **The Quality of Regulatory Systems and Regulators:**

The Asian crisis demonstrated that free international financial markets do not guarantee their stability and that an effective system of regulations is essential. In this respect virtually all of the domestic regulatory systems and the regulators that were running them proved to be woefully inadequate. None of them were prepared for the regulatory challenges that emerged with the globalization of financial systems and the large inflow and sudden outflow of funds that it generated. Since then there has been substantial international activity to assist countries in strengthening both, led by the IMF the World Bank and a few other multilateral agencies.<sup>22</sup>

### **The Quality of Corporate Governance:**

Many private institutions, financial and non-financial, ended in bankruptcy during the Asian financial crisis, or were forced to merge. It became clear that lax corporate governance rules and behaviour and inadequate internal procedures for measuring and controlling exposure to risk was a major reason for the collapse of many of them. Excessive borrowing of short term funds in foreign currencies for longer term purposes, or even questionable purposes, was one example of this. Again there is now very substantial international activity in the form of recommended codes of conduct and disclosure practices that is intended to

lead to a sounder system.

## VII. CURRENT CANADIAN FINANCIAL SERVICES POLICIES AND THEIR IMPLICATIONS

The question can now be asked as to whether and to what extent Canadian financial services policy has taken to heart the various lessons that have emerged from the Asian financial crisis and from the swiftly changing international environment, and whether that policy will lead over the next decade to the kind of financial services sector that Canadians would wish to have.

It may be assumed, as noted earlier, that Canadians would wish to see evolve a Canadian financial system that is stable and efficient and ensures that a significant proportion of the financial system serving Canadians is located in Canada and directed from within Canada — so as to provide jobs in Canada and reflect uniquely Canadian priorities. This, in turn, will depend on how effectively Canadian policy responds to the challenges of globalization, including those so clearly demonstrated in the Asian financial crisis.

It should be understood that providing more jobs in Canada and addressing uniquely Canadian priorities is fully in harmony with maximizing Canada's economic growth, provided this emerges from policies that enable Canadian institutions to realize their full economic potential. There is no suggestion here that job creation should come from protectionist measures. Also the job creation that would result could extend well beyond the financial institutions themselves. Institutions with core business departments in Canada would probably draw more on other Canadian companies for outside services — legal, accounting,

public affairs, auditing, advertising, technology services and consulting in general — than would non-Canadian companies. There does appear to be some merit in the concept of “critical mass” as it relates to an industry and the related view that it can lead to a “virtuous circle” of productive job creation.

Ensuring that Canada will meet those challenges of globalization depends on a range of economic policies, not just one policy. At present *some* Canadian policies do support the maintenance of a strong financial system whereas *others* are leading to its decline. The key for maintaining a healthy Canadian based financial system lies in continuing with the former and modifying the latter.

**Merger Policy:** For some years federal policy was informally summarized as “Big Shall not Buy Big.” What this meant was never quite clear and it has become increasingly ambiguous. The federal government not only permitted but welcomed “big” to acquire “big” when one of the institutions was on the verge of bankruptcy. This happened, for example, in the case of the acquisition of Royal Trust by the Royal Bank of Canada. This then led to mergers between banks and trust companies. But the mergers between the Royal Bank of Canada and the Bank of Montreal, as well as between the Toronto Dominion Bank and the Canadian Imperial Bank of Commerce, all financially healthy institutions, were rejected by the Minister of Finance — a rejection supported by the Competition Bureau. (The latter is not permitted on its own initiative to negotiate remedies to any problems it finds in a bank merger proposal, the prerogative for permitting such negotiations to take place being retained by the Minister of Finance. This does not apply to non-bank

mergers). The Minister chose not to give authority for the negotiation of any difficulties he saw in the mergers, but rather rejected them outright.

The Competition Bureau, in appraising the impact of the mergers, took a two year time perspective. Such a short term appraisal is largely meaningless in a world in which international market changes are generating new competitors and are rapidly making obsolete former measures of “optimum size” and “market concentration.” The recently approved acquisition of financially strong Canada Trust, by any practical measure a “big bank,” by the Toronto-Dominion Bank, would fall into the category of “big bank buying big bank.” This, coming after refusal of the other mergers, again makes it difficult to find economic rationality in Canadian bank merger policy. It inevitably raises the question as to whether *ad hoc* political considerations and arbitrary judgements as to what is “big” and what is “small” are playing the dominant role in such policy, not considerations relating to the long term viability of the Canadian financial services sector.

In the June 25, 1999, policy paper of the Department of Finance, the Minister of Finance outlined proposed policies and procedures for dealing with future bank merger proposals.<sup>23</sup> While not banning mergers, the policy outlined procedures that lead essentially to the same result and so in reality constitute no real change in that policy. There are major difficulties with the policy.

First, it is fraught with political hurdles and uncertainties all along the way; it does not stipulate in advance the detailed criteria that would determine the acceptability of the merger; and it stipulates no time-table in advance for dealing with

merger proposals.

Second, it does not give the Competition Bureau the authority to recommend and negotiate remedies to any deficiencies it found in a bank merger proposal. This requires the authorization of the Minister of Finance. The risk is that any conditions he would wish to attach would neutralize the very synergies that causes a merger to make economic sense.

Third, after the long and time-consuming process is complete, the final decision still rests with the Minister of Finance, and the risk is that his decision could not be separated from current political considerations including the public mood at that particular time.

For these reasons it is improbable that a bank would dare take the risk of embarking on such a project in the near future unless major merger policy changes were made, or advance government undertakings were given. This is all the more so because of the risk for the banks involved of negative market and client responses to those indefinite uncertainties, the high cost of mounting the proposal, and the damaging impact on employee morale of a merger proposal in indefinite limbo.

The Minister has made it clear that the same general criteria he used in rejecting the previous merger proposals would continue to apply — namely, the proposals should not unduly concentrate economic power, or significantly reduce competition, or restrict the ability to address prudential concerns. It is difficult to see how more information on and responses to these issues could be generated than were contained in past submissions and in studies by academics and research institutes — which alone makes

future mergers unlikely. What is more, the Minister of Finance, in the case of the two merger proposals, refused to give authority for the negotiation of difficulties in the proposals, going with an unequivocal rejection. This leaves little ground for believing that under the proposed merger process he would change his mind and permit such negotiation.

The fear that bank mergers would reduce competition in a harmful way ignores the irreversible impact that changing technology is having on the competitive environment. Cross-border competition via the Internet is already emerging in retail banking and investments — deposits, loans, mortgages, equities etc — and this trend, as indicated by past adoption rates of new financial services technologies, will accelerate. Consumers are becoming increasingly better informed as to their alternatives in financial services, both domestically and internationally, and this too increases competition. Large international “niche players,” such as in payroll services, mortgages, mergers and acquisitions, trust business, custody services *etcetera*, even now are effective competitors and in some cases dominant ones. In this environment old measures of competition and concentration are essentially meaningless and yet current financial services policy seems to be heavily influenced by them.

Rather than recognizing that bank mergers, and those between insurance companies as well, will be necessary for Canada to have a system that is sufficiently competitive to withstand the forces of globalization, Canadian policy appears to view them as essentially undesirable. Because merging such institutions successfully takes a long time, probably up to five years, and because international competitors are already restructuring themselves rapidly through

mergers and acquisitions and so positioning themselves for the future, perpetuation of such a view is particularly risky for the Canadian financial system.

In short, the proposed approach to dealing with mergers between the large banks would not change past merger policy in any substantive way. Judged by what its results are likely to be it is a policy of making such mergers highly improbable in the near future.

The impression is sometimes left that the current debate about bank mergers represents an unprecedented situation. This is far from the case. What is unprecedented is the intention of federal government policy to prevent the banking system from adjusting to a rapidly changing business environment. For the first time in Canada’s history Canadian policy threatens the future growth, competitiveness and long term viability of the Canadian banking system.

Canadian chartered banks first became established in the larger urban areas — Halifax, Montreal, Toronto — with local private and some small chartered banks operating in smaller centres.<sup>24</sup> With better transportation and telegraphic communications, emerging branch banking became possible, first in the hinterland of their own province and then in other provinces, and the banks with the required capital bases were in the forefront of that development. The economic superiority of the branch system saw the displacement of the local banks. For example in the 1870s there were over 50 chartered banks and well over 100 local private bankers while by the 1930s, through mergers, acquisitions and bankruptcies, there were 10 chartered banks and the private bankers had essentially

disappeared. Mergers have always played an integral part in producing a Canadian banking system that is among the best in the world.

After the banking system became mature in terms of domestic geographic coverage, its new frontier became the provision of an increasing range of services — e.g. consumer and mortgage credit and later trust and investment business. This was again made possible by having an adequate capital base to support the expansion. The huge capital injection by the banks into the Canadian investment dealer industry saved that industry, at least up to now, from foreign absorption. The last domestic “frontier” in terms of range of services is full retail integration of the insurance business and car leasing, both of which are presently prohibited by federal government policy.

The only remaining major frontier for the Canadian banks is the international frontier. But their challenges here are much more difficult than those they faced in the preceding century and a half. This frontier is one that is already fully occupied by strong and very large competitors. Furthermore, the existing home base of the banks will increasingly be challenged by those same competitors so their ability to lever international developments off of home base will not, relatively speaking, be increasing, and in time will decrease. Also, this is happening at a time when, as noted earlier, the “optimum size” of international banks is almost certainly increasing and appears to exceed substantially the existing size of the capital bases of Canadian banks. The option of moving to an appropriately large capital base through mergers is not, in practice, available to them at this time.

In these circumstances the outlook for

the Canadian banks over the next decade is that they will lose ground in their home base and will not achieve their full potential in the only major frontier remaining to them, the international one. The shedding by them of foreign offices that under present circumstances are not adequately profitable and of businesses for which they are not adequately large, has already begun. In Canada, being denied the synergies that arise from mergers through elimination of branch, head office, system, and product duplications, the banks have to seek them elsewhere through other branch closures. This is clearly a “second best” type of sector rationalization since it does not lead to the most efficient system of branches and still leaves the most costly kinds of duplication in the system. With these burdens of costs imposed by regulatory determined inefficiencies, the risk is that over the next decade the banks will survive only as much reduced players in the Canadian market, relative to the non-Canadian institutions, and inconsequential players abroad.

Battling with foreign competitors over even their home markets, and with much inferior capital resources, runs the risk over the next decade or so of some large Canadian financial institutions being in financial difficulty. The opportunity of mergers between healthy institutions having been missed, the result would be mergers involving weak ones. The institutions best positioned to step in would be those with strong capital bases and this undoubtedly would be foreign institutions. Their ability to minimize damage to Canadian clients of the weak institutions and to the deposit insurance fund would be sufficient for them to be welcomed as rescuers. Even a healthy Canadian bank when contemplating the possibility of a merger would become more attracted to

merging with a foreign, probably US, bank than a Canadian one. The deal would probably be better, and it might avoid some of the political hurdles that now exist — such as outdated branch and market concentration perceptions and regulations in Canada.

It would therefore appear that current Canadian bank merger policy will have the effect over future years of weakening the ability of the Canadian financial services sector to withstand the forces of international competition and reducing their role in providing financial services to Canadians. This would be a first in the history of Canadian banking and banking policy. It would raise the question as to whether the long term intention of Canadian policy is to follow the New Zealand example where the banking sector is almost totally composed of foreign institutions.

**Sequencing of Policy Changes:** Current Canadian financial services policy seems to ignore the crucial impact that sequencing of policy changes can have on the final outcome of the Canadian financial services sector. The sequencing presently proposed runs a risk of accelerating the foreign takeover of the Canadian financial services sector in future years. This is because in practice it prevents a speedy increase in the capital bases of individual Canadian banks through mergers between them, while going ahead with changes that would enhance foreign penetration of the Canadian financial services sector. Changes that would first permit Canadian financial institutions to develop strong home bases and strengthen their ability to withstand the competitive forces emerging from globalization would increase the chances of Canada retaining a system with unique Canadian characteristics and priorities.

More specifically, government policy appears to make domestic mergers very difficult, if not virtually impossible in the near future while increasing the individual bank shareholder limit to 20% from 10% with Ministerial approval, and making it easier for foreign banks to operate directly through branches in Canada. This at a time when technology is already opening up the Canadian market to significant foreign competition. The 20% limit is fine in itself. But what would happen if a foreign bank, such as a large US bank, viewed it, together with increasingly close alliance arrangements, as a way of obtaining a head start for a full merger some time in future? Canadian policy almost appears to have part of this process in mind because the Minister of Finance has indicated that the move to 20% will facilitate the formation of strategic alliances and joint ventures. The fact that strategic alliances and joint ventures between like institutions are usually not as effective in capturing synergies as mergers, simply adds to the likelihood that strategic investments and alliance arrangements could eventually lead to full mergers. Not facilitating mergers between Canadian banks before or at the same time as facilitating greater foreign participation, increases the likelihood that future mergers will be between Canadian and large foreign banks.

It is most difficult to understand how it can be in Canada's interest to facilitate to any degree the eventual foreign take-over of Canadian banks before permitting them to build capital bases through mergers that will enable them to stand up against foreign competition. The more desirable sequence would appear to be to permit, or even encourage, mergers between Canadian institutions at the same time as facilitating increased foreign influence on the development of the

Canadian financial system. It is a question of Canadians deciding whether they would prefer mergers between Canadian institutions in the near future or mergers with foreign banks down the road. It is likely that most Canadians would prefer mergers between domestic institutions if given a choice.

**Remaining “Four Pillar” Barriers:** The government proposes to continue to maintain some restrictions as to which services can be offered by financial institutions and which cannot. This is in contrast to a number of other industrialized countries that have moved significantly forward in opening up powers of financial institutions. These restrictions constitute further barriers to the Canadian financial services industry evolving toward greater efficiency.

The Minister of Finance rejected the recommendation of the *Task Force on the Future of the Canadian Financial Services Sector* that banks be given powers of car leasing and branch insurance distribution and accepted that of the House of Commons Standing Committee on Finance that they not be given those powers.<sup>25</sup> That Committee’s Report was somewhat disappointing in the extent to which it appeared to be influenced by immediate political considerations and not by long term financial system developments. Unfortunately it even raises the question as to whether its credibility would be an issue in future financial services restructuring exercises such as merger reviews.

Distribution of insurance and direct car leasing through bank branches is common practice in a number of countries including the US. Moreover, under existing Canadian foreign entry rules and financial legislation, a foreign bank not operating as a bank or bank branch in Canada could

set up a leasing company, insurance company, trust company or other non-bank financial intermediary in Canada and thereby engage in car leasing, insurance, trust and banking activities. A Canadian bank cannot do so unless it gives up its bank charter and uses one in the US as a parent for its Canadian non-bank subsidiaries. One looks in vain for economic rationality in this Canadian policy.

But prohibiting car leasing by Canadian banks is surprising for another reason. The vehicle leasing industry in Canada is 75% to 85% dominated by non-Canadian institutions.<sup>26</sup> Permitting the banks into the sector would increase the number of competitors and reduce such domination. Here is a case of *Canadian* regulations preventing *Canadian* companies from competing for business in *Canada* and in consequence ensuring both the continuation of foreign domination and the exclusion of added domestic competition. This policy appears to have little economic rationale.

**Capital and Corporate Income Taxes:** It has been fully documented that the tax burden on large Canadian financial institutions is higher than that of other sectors, that it has increased significantly over the years and that it is substantially higher than taxes imposed on non-Canadian competitors, particularly those in the United States.<sup>27</sup> The federal Budget of February 28, 2000, proposes to reduce the general corporation tax from 28% to 21%, but only over a five year period.<sup>28</sup> This is an encouraging start but the competitive tax disadvantage will still be there for some time — and longer if the US reduces its tax rate further over the next five years, as is likely.

One particularly harmful tax is the Capital Tax on financial institutions

imposed by both the federal and provincial governments. The federal government introduced a Capital Tax Surcharge in 1995, which the Budget of February 28, 2000, extended for a further year.<sup>29</sup> Financial institutions require adequate capital to see them through unexpected losses, as in periods of recession, and financial regulators pressure them to maintain and sometimes increase their capital base. Yet the more prudent an institution is, the more tax it pays. So here is a case where one arm of government urges prudence and another, the tax department, provides incentives for imprudence. Along with that it imposes a competitive disadvantage on large Canadian financial institutions since other countries do not have such a perverse and costly policy.

The economics of capital taxes was always clearly negative for the efficiency and soundness of Canada's financial system. The Minister of Finance has agreed that they reduce the competitiveness of Canada's banking system and has indicated he will review the matter, discuss it with the provinces and announce a decision. The abolition of these taxes would be in harmony with the longer term objective of ensuring Canadians a competitive and stable financial system.

**Corporate Structures:** The Minister of Finance has announced that he intends to enable the banks to form holding companies so that they can shift certain activities into subsidiary entities that will require less regulation. Also it is intended to broaden the investment powers of the banks so that they, for example, can form wholly-owned subsidiaries and place non-bank activities in them. It is hoped that this will increase their ability to compete with institutions that are less regulated.

These are very useful moves depending on the regulations that will surround them. In fact corporate structures such as holding company arrangements should be left free for markets to determine on grounds of economic efficiency. The recent Task Force has rightly recommended that "[There] should be no restrictions on corporate structures available to financial institutions unless required by safety and soundness considerations."<sup>30</sup> Unfortunately their over-all benefits while very welcome are likely to be limited since they exclude changes enabling the Canadian banks to restructure in a manner that strengthens their capital base in a significant way.

The most important "moral hazard" problem in Canada arises from the continued existence of deposit insurance. However, as a problem it has diminished over time for several reasons. First the proportion of insured deposits to total savings instruments has declined. Second, improved vigilance on the part of the Canada Deposit Insurance Corporation, including particularly earlier intervention and the imposition of remedial measures, has reduced the losses and reduced the leeway for imprudent behaviour. Third, the introduction of risk based premiums has provided an additional incentive for prudent behaviour.

In addition to these desired changes in the deposit insurance system, one way of introducing greater market discipline into the process would be to introduce co-insurance. A recommendation to this effect has been made over the years by a number of studies including recently by one completed for the Task Force on the Future of the Canadian Financial Services Sector.<sup>31</sup> But the political obstacles for introducing co-insurance have up to this point led to its rejection by the federal

government and there are no current plans for changing this policy.

**The Quality of Regulatory Systems and Regulators:** Canada has a structure of regulation and quality of regulators — Office of the Superintendent of Financial Institutions (OSFI), Canada Deposit Insurance Corporation (CDIC) and Bank of Canada — that are high by international standards. Canada is also playing an active role in encouraging the development of increasingly effective international governance of the international financial system. Recognizing that Canada's national interest, being a relatively small country, lies in having well established rules of the game — whether in trade, defence and security, or financial services — it is important for Canada to continue to play such a role.

While some fine-tuning of the roles and operations of the federal agencies is desirable, and is envisaged by current government policy, the structure of the regulatory system is sound. This, it must be emphasized, refers to the quality of the regulators and their agencies and not to some of the regulations that they are being asked to administer.

One exception to the high quality of Canada's federal regulatory system is the provincial role in national financial regulation and the duplication it entails. The national integration of regional financial activities has made much provincial regulation redundant and inefficient. Its role has already been substantially reduced because of the overwhelming importance of federally chartered financial institutions and because of the delegation of some regulatory functions of the provinces to federal agencies.

Most of the remaining functions in the

hands of the twelve provincial and territorial authorities represent unnecessary costs of administration and compliance. Many of them remain there not for reasons of regulatory and economic efficiency but rather because of political exigencies — including the continued strong role of Quebec regulatory agencies. As such they make services of the Canadian financial system more costly and less competitive internationally than they would be in their absence. The Task Force has correctly argued that further progress should be made and has identified some areas of potential progress.<sup>32</sup> Unfortunately further progress, judging by past history, is not likely to come quickly. Indeed, recent indications that the provinces may wish to gain greater control over the securities activities of federal institutions, if successful, would go in the opposite direction. So it appears that the costs of regulatory division and duplication will be a burden on the Canadian financial system for some time yet.

**Harmonization of Regulations with Market Forces:** Canada's approach to regulation has changed substantially over the years, with a move away from detailed prescriptions of eligible and ineligible activities and more emphasis on the "prudent portfolio" approach, meaningful and timely disclosure, and internal procedures for measuring and containing risk, as well as minimum capital ratios. These moves are in harmony with the dynamics of the free market which require solid information and clear cut operating parameters to function well and support rather than undermine regulatory objectives. An obvious example is market reaction to an institution that reveals the first beginnings of some deterioration in its activities and financial performance; or information from the central bank that

convinces the market that a move upward in interest rates is economically appropriate.

**Transparency of Regulatory and Market Activities:** Market confusion over the intentions and objectives of central bank policy and actions can create instability in financial and foreign exchange markets and their institutions. The Bank of Canada has accepted the need for transparency. Its well-known inflation targets, its announced overnight interest rate, and its public explanations and other steps taken represent substantially more transparency in operations than used to be customary.<sup>33</sup> The information on Bank of Canada intervention in the Canadian dollar foreign exchange market, regular information on the level of exchange reserves and on official foreign exchange borrowing activities, as well as the floating exchange rate itself leave little chance that the exchange rate will be artificially supported without market knowledge. The federal budget process is more open than it used to be although further information on medium term fiscal objectives would be an additional improvement.

Intentions of regulators and the regulations themselves, for the most part, are understood by regulated institutions. (The exception is federal bank merger policy as already noted). Disclosure practices of the major financial institutions reveal much more to the public than in past decades. The recent Task Force also emphasized the importance of disclosure and transparency for enabling consumers to make intelligent choices and it made useful recommendations for responding to current deficiencies in this area.<sup>34</sup> So not only do sound disclosure and transparency regulations facilitate the functioning of markets in an efficient way, but they are

also necessary to enable consumers to make informed decisions.<sup>35</sup> There appears to be general recognition, a lesson underscored by the Asian financial crisis, that for regulations to be effective and economically efficient they must be in harmony with market dynamics. Disclosure and transparency is particularly important for this.

**Payments System:** Historically, direct access to the payments system was confined to the important deposit taking institutions. The government intends to relax this and give access to institutions such as life insurance companies, money market mutual funds and securities dealers. This relaxation is fully in harmony with the functioning of a competitive market and will incrementally increase competition. However, because of the importance of confidence for sustaining a payments system, changes should not result in an increase in the risk inherent in the system. This requires that new entrants should have a source of liquidity in case of difficulty and their payments system obligations should not be subordinated to others. A remaining difficulty is that insurance company assets are subordinated to policy holders.

Also, to be non-discriminatory in its impact, opening up of the payments system should be accompanied by the relaxation of other regulatory restrictions separating the "pillars."

**Non-market Control Measures:** The federal government intends to introduce regulations that, among other things, would require the Canadian banks to provide a basic account to everyone who wants it at a price and with other features stipulated by government. These anti-market measures would not just be an anachronism in a highly competitive

market but would constitute yet another part of policy compromising the efficiency and competitiveness of the system. Nor would it apply to all financial institutions, and almost certainly not those coming into Canada through cross border electronic systems. Such measures will further distort the structure of the system.

There is no question that all groups in society should have the opportunity of accessing the core financial services that they need just as they should have access to the necessities of life. This reflects the nature of the social conscience in Canada and it is an objective that is not in dispute. What must however be addressed is how best to achieve that objective. The approach of requiring the banks to act as vehicles for the achievement of social objectives for some clients, paid for by other clients and bank shareholders, has serious economic and social policy weaknesses. Bureaucratically imposed prices and features that do not reflect costs would indirectly lead to some clients and shareholders subsidizing others and would favour financial institutions outside of the regulatory net. This distortion of the system would reduce its efficiency and its productivity because of the misallocation of funds involved.

These distortions would also be harmful to the Canadian economy in general. There is currently, and quite rightly, considerable concern in Canada over the gap between Canadian and US productivity. Measures such as those proposed would aggravate rather than ameliorate that gap.

There are alternatives to achieving the desired social objectives through introducing non-market measures that would distort banking activities and reduce their efficiency and competitiveness. The

emphasis should be on rules ensuring transparency and timely disclosure concerning the activities in question so as to indicate the size and nature of any gaps in services and permit the market to solve gaps that are found by reliable information to exist. Where the issue becomes one of providing core banking services to Canadians that simply do not have the income to pay for them, this should be accommodated through existing income redistribution programmes. In this way the social objectives would be achieved without providing services to those not needing them, and without reducing the efficiency and productivity of the banking system and of the Canadian economy in general.

The government intends to establish a new Financial Consumer Agency for administering consumer protection legislation in the area of financial services and an independent Canadian Financial Services Ombudsman to hear complaints from individuals and businesses. It is not at all clear from existing evidence that they are needed to correct real problems and may serve merely to deal with perceptions. That is, they may serve a political purpose but not a significant economic one. Nor is it at all clear that they would apply evenly to all institutions providing financial services to Canadians in the future. But it is probable that they would increase the burden of regulation in terms of administration and compliance costs.

#### **Incentives to Small New Institutions:**

The government intends to ease minimum capital and ownership distribution requirements for new banks so as to enhance competition. Easing of entry conditions in a prudent way is clearly desirable and there will always be a role for smaller institutions in the system and new technology might well assist in this.

However, over a hundred years of Canadian banking and financial system experience suggests that it would be naive to believe that this will lead to significantly more competition in areas that inherently involve large systems of retail and wholesale clients. That history is one of evolution toward institutions with large networks, replacing those that are unable to develop them. It is no surprise that there have been few new banks formed over the last half century.

Where effective competition is coming from, and will do so increasingly, are large non-Canadian institutions coming into Canadian homes via the Internet and from large non-Canadian institutions in Canada.

Intended government policy with respect to *caisses populaires* and credit unions in a sense contradicts the view that future competition lies in new local institutions. While specific proposals have not yet been put forward, the intention appears to be to facilitate such institutions moving in the direction of national systems so as to reduce costs and capture the synergies that such systems provide. Without doing so their competitive position will be threatened in the decade ahead. The Canadian banks went through this process in the late nineteenth and twentieth century. Clearly it is appropriate to provide regulatory support for the move toward national credit union and *caisses* systems.

While easing access wherever prudent and facilitating through regulatory accommodation, the emergence of national systems of credit unions and *caisses populaires* is fully justified, there would be no economic justification for public subsidization of such developments. There is growing evidence that an

important reason for the productivity gap between Canada and the United States is that Canadian small businesses have substantially lower productivity than large ones and substantially lower productivity than small businesses in the United States.<sup>36</sup> Having in mind the special tax and other beneficial arrangements for small business there is some concern that subsidies to them may result in reduced national productivity. That would not be a desirable objective of Canadian financial services policy. Fortunately at present there is no indication that government intends to provide new subsidies to the *caisses populaires* and credit union systems.

#### **The Quality of Corporate Governance:**

The Asian crisis revealed the damage that can be inflicted on a financial system through weak corporate governance rules and practices. While it is difficult to measure, the impression is left that both Canadian regulators and Canadian financial institutions are not lagging in the implementation of measures designed to maintain high standards of corporate governance and of procedures and practices for controlling risk exposure. The fiduciary role, generally, of corporate directors is clearer now than in past decades and the penalties of not fulfilling fiduciary responsibilities are considerable. Maintaining high standards of corporate governance is an ongoing challenge, with new governance problems emerging frequently, but it does not appear as if this is an area where the Canadian financial system is vulnerable. Canadian corporations are beginning to document their adherence to the Toronto Stock Exchange Corporate Governance Guidelines in their annual reports.

**International Governance:** Canada has played a leading role in encouraging such

initiatives, beginning with the intervention of the Prime Minister at the Halifax G7 Summit meeting of 1995. The Canadian Minister of Finance pursued the matter at the September 1997 IMF/World Bank meetings and put forward some proposals at the April 1998 IMF Interim Committee meetings and the September 1998 Commonwealth Finance Ministers' meetings. He is also Chairman of the newly formed Group of Twenty (G20) nations, a group charged with working toward a more stable international financial system. These initiatives are clearly in Canada's national interest. In this era of globalization effective domestic regulation and the stability of domestic financial systems depend increasingly on international regulatory cooperation and on the stability of the international system as a whole.

It is somewhat ironic that Canada should be playing such a constructive role in urging the international financial community to adjust to the reality of globalization while persisting with some domestic policies that make such an adjustment more difficult for Canadian institutions.

#### **Macroeconomic Policies S Monetary**

**Policy:** The last thirty years have witnessed a substantial change in perceptions concerning the objectives of monetary policy and how such policy is transmitted to the economy.<sup>37</sup> It is now fully accepted by the Bank of Canada, and it would seem the majority of economists, that the most effective contribution that monetary policy can make to achieving a growing and job creating economy is to maintain a very low and stable level of inflation. It is also accepted by the Bank of Canada that transparency in its operations, such as its explicit inflation target of a 1-3% range and its declared operating band for its overnight interest rate and its

public explanations of actions taken, will enhance its effectiveness.<sup>38</sup> As was noted earlier, the huge volumes of domestic and international capital flows make it essential that market forces support policy actions for the latter to be successful and the only way to achieve this is to keep markets fully informed.

Dedication to maintaining a low rate of inflation therefore is now firmly established. The probability that such a policy will be compromised by political exigencies is reduced because of the relative independence of the Bank of Canada. Legislation does permit the government to cause the Bank to change its policy, but this must be done through a clear, public, directive. Such a directive has never been issued and having in the mind the political repercussions of such a move, including very probably resignation of the Governor and a public inquiry, it is not likely that such interference will occur in future. The concept of substantial independence of the central bank is one that has gained favour among the central banks of all the industrialized countries and among an increasing number of developing countries as well.

The Asian crisis as well as others demonstrated that inflationary monetary policies and policies of supporting unrealistic exchange rates lead directly to serious financial system instabilities. Fortunately, Canada's monetary policy that aims at maintaining a low and stable inflation rate should not only provide an environment for economic growth and quality investment but also for maintaining a stable financial system.

#### **Macroeconomic Policies S Exchange**

**Rate Policy:** The Asian financial crisis was aggravated by countries attempting to maintain fixed exchange rates at levels

that markets regarded as unrealistic. Canada was saved from some of the indirect repercussions of that crisis by having part of its shock absorbed by the floating exchange rate.

The Bank of Canada is also of the view that its inflation policy requires there to be a flexible exchange rate. It points out that external shocks such as a decline in world commodity prices, as well as differing inflation rates as between Canada and its trading partners, will change the real equilibrium value of the Canadian dollar. Shocks arising from political uncertainties such as threatened Quebec separation from Canada would also have to be absorbed. With a fixed exchange rate the necessary adjustment would have to come through a move downward or upward in the Canadian price level, which is more painful in economic terms and more prolonged than a change in the nominal exchange rate.<sup>39</sup>

Also, fixing the exchange rate would involve shift of sovereignty over monetary policy to the United States Federal Reserve System. This might not be significant if the economic environment had evolved to a point where exchange rate adjustments were no longer important to Canada. But it would be very significant as long as it is potentially important for achieving real growth and employment objectives. Also the argument used frequently in Europe that a fixed rate system is needed to ensure maintenance of a disciplined macroeconomic policy, which certainly would have been relevant in Canada in some past decades, is not relevant at this time. Monetary policy has achieved low inflation and fiscal policy is moving in the direction of lower debt burdens.

appropriate exchange rate policy is a subject of considerable discussion in Canada and elsewhere.<sup>40</sup> The view that greater, not less, stability in exchange rates is desirable is also evident in a large and growing body of professional research and analysis. It is evident in analysis of the limitations of domestic monetary stabilization policies in an open economy and proposals for alternative approaches for achieving such enhanced stability, such as various types of "crawling pegs." It is also evident in the large number of countries that have adopted "dollarization" of their economies — in effect abandoning domestic control of their currency<sup>41</sup> — and in the statements coming from ministerial meetings of the major industrialized countries. In Canada concern has recently been expressed that the low exchange rate for the Canadian dollar is one factor causing the foreign acquisition of Canadian companies and also the "brain drain."

But since the central objective of Canadian monetary policy is to preserve the real value (i.e. purchasing power value) of the Canadian dollar and not its value in the foreign exchange markets any sustained attempt by the central bank to raise or lower the exchange rate might require it to modify its inflation target.

Therefore, as long as there is a strong possibility that the real equilibrium value of the Canadian dollar might change significantly through external shocks of one kind or another it would be difficult to see Canada giving up its sovereignty in the area of monetary policy to the U.S. authorities at the Federal Reserve in Washington. The situation differs substantially from that in the European Union where sovereignty is shifted to an international institution in which each has a say.

There are no such institutions between Canada and the United States and if there were they would be totally dominated by the United States.<sup>42</sup>

Changes could occur to alter the situation. The relative importance of commodities to Canada may decline so as to be similar to that of the United States. Also if general inflation stays under control, and inventories are well managed, it may be that the volatility of commodity prices will be much less than in the past. Furthermore convergence of national inflation rates might have obviated the need to make real exchange rate adjustments for reasons of differing price levels and the national unity issue may become less of a factor. Such developments could lay the ground for a future fixing of the Canadian dollar to the US dollar, but this is not a likelihood in the short run.

There are steps Canada can take, outside of the conduct of monetary policy, to work toward having a stronger currency. This entails policies for increasing Canada's productivity and improving foreign confidence in the future of Canada. Making investment in Canada more attractive by reducing corporation taxes, removing regulatory barriers to increased efficiency in the various Canadian industrial sectors including financial services, and removing the threat of the break-up of Canada, are the kinds of policies that could lead to an increase in the Canadian dollar exchange rate.

But at present it appears that the combination of (a) monetary policy aimed at low and stable inflation and (b) exchange rate policy that permits market exchange rate adjustments to external shocks and in response to changes in the equilibrium real exchange rate, are positive for maintaining stable financial conditions.

**Macroeconomic Policies S Fiscal and Income Tax Policies:** Canada's past experience, as that of many other countries, points to severe limitations in using fiscal policy for stabilizing the economy. The years of the 1960s and 1970s when the employment/inflation trade off of the Phillips' Curve dominated macroeconomic policy are far behind us. Instability that in the past arose from the mistaken notion that easing up on inflation would improve economic growth is no longer a major threat in Canada. Confidence in short term stabilization through fiscal policy has been eroded because of past experience. Forecasting is prone to error, lags between fiscal actions and their economic impact are long, and political bias often resulted in deficits but not surpluses with burdensome public debt the result. There appears to be no inclination to return to a deficit and debt situation that had to be corrected over a period of years and at considerable economic cost. What is more likely is that fiscal policy stabilization will come essentially from the "automatic stabilizers" such as unemployment insurance and the progressive income tax.

Globalization has made financial capital highly mobile and has given real investment location many choices, while an increasing number of top level executives and valued professionals have international career options. The federal Budget of February 28, 2000, has begun to recognize this reality although in a somewhat modest and hesitant manner. The 5% surtax on high income taxpayers will be abolished, but only over five years, and in the meantime it will cut in at incomes of \$85,000 instead of \$65,000. Capital gains taxes will be reduced from 75% of the income tax rate to 66 2/3%. A limited amount of stock options will not be taxed when exercised, the limit being a market

value of \$100,000, but only when the shares so acquired are sold.<sup>43</sup>

It would also seem necessary for fiscal policy to recognize the need for a greater decline in the public debt burden as indicated by the debt to GDP ratio than now envisaged, particularly since the US is likely to see a further substantial decline. In 1999 the Canadian ratio of public debt to Gross Domestic Product (GDP) was about 61%, or 10 percentage points higher than the average of the G7 countries — only Italy having a heavier burden.<sup>44</sup> It was therefore somewhat surprising that the Budget of February 28, 2000, did not introduce new initiatives for reducing the size of the public debt. It stayed with the practice of allocating \$3 billion of annual contingency reserves to it, provided the reserves are not needed. It is forecast in the Budget that the ratio will fall to below 50% by the year 2004. However, the other G7 countries on average are lower than that already. International financial markets take debt ratios into account when determining credit standing, and so Canada remains more vulnerable to financial difficulties should a serious economic recession emerge than most of the other countries.

### **VIII. SUMMARY AND CONCLUSION: COMPETE OR DECLINE**

**Canadian financial services restructuring policy has two major weaknesses: it largely ignores the implications of globalization and it is based essentially on short term considerations:** Canadian policy affecting the restructuring of the financial system ignores the harsh lesson learned during the Asian financial crisis that failure to restructure leads to weak

and non-competitive institutions. It vastly underestimates the decisive and irreversible impact that forces of globalization will have on the reshaping of the Canadian financial system. While the narrative in policy documents frequently contains references to globalization, the policy proposals themselves too often ignore or dismiss its current and future impact. They tend to be based on a very short term and highly parochial appraisal of the Canadian financial environment. This has led to the maintenance of existing and proposed introduction of new regulations that run the risk of accelerating the move to substantial future foreign domination of the Canadian system. It risks denying to Canadians of the future an internationally competitive and stable financial system that provides jobs in Canada and reflects uniquely Canadian priorities. It is the first time in the history of the Canadian financial system that Canadian policy has obstructed the orderly evolution of the system in response to major changes in the domestic and international business environment.

The impersonal market forces that are creating a global system of financial services cannot be stopped or “walled off.” The only effective Canadian policy responses to deal with them are ones that create an internationally competitive system in Canada.

### **VIIIA. POLICIES IN HARMONY WITH MAINTAINING A STRONG FINANCIAL SYSTEM**

Canada already has some of the policy prerequisites for emerging in this decade with an internationally competitive financial system, but others of vital importance constitute major obstacles for

ensuring that Canada will have such a system. The policy challenge for Canada is to persist with the former and change the latter.

**Canada's monetary policy supports financial system stability:** Its monetary policy of low and stable inflation and an exchange rate that moves in line with market forces provides the essential environment for the growth and development of stable and efficient financial institutions. There is no reason to believe that this policy will change, particularly since the Bank of Canada enjoys substantial independence in the formation and implementation of monetary policy and places emphasis on transparency in its operations.

**Canada's declining debt burden strengthens its credit standing:** The move to fiscal surplus and so to a decline in the public debt burden, while concerningly slow, is clearly moving in a direction that will contribute to stability in Canadian finances. A major lesson emerging from the Asian financial crisis was that any nation that loses the confidence of international markets ends up paying a high economic price. This move to reduced debt burdens is also likely to continue if only because of general disillusionment with past fiscal deficits that failed to achieve expected economic results and left a legacy of excessive public debt.

**Canada's federal financial regulatory system and regulators are highly respected:** An important cause of the Asian financial crisis was very weak regulatory systems and regulators of inferior quality. Canada, fortunately, has a regulatory system of superior quality by international standards and it is directed by highly respected regulators. The main

problem lies in the inappropriateness of some of the regulations and not the regulators.

**Importance of transparency and disclosure is increasingly recognized:** Increasing emphasis on transparency and timely disclosure in the general approach to regulation and in the operations of regulatory agencies and the Bank of Canada is vitally important. It causes market forces to help achieve regulatory objectives rather than making their achievement more difficult. Also important is the increasing emphasis of the regulatory agencies on processes and procedures for the measurement and containment of risk by the regulated institutions, rather than trying to focus on individual transactions. A major exception to the acceptance of transparency in policy is merger policy as it related to the chartered banks, and this lack of transparency continues to be harmful as noted below.

**Some proposed regulatory changes are positive:** Proposed changes permitting the formation of bank holding companies, opening up the payments systems to a broader range of institutions, facilitating the move toward more national systems of credit unions and caisses populaires are in harmony with a move to a more efficient and competitive financial system. So are the measures that would broaden the investments a bank can hold, including through separate wholly owned subsidiaries.

**Canada's lead in urging effective international governance is important:** The lead the Prime Minister and Minister of Finance are taking in urging international arrangements for achieving and maintaining stability in the globalized financial system is clearly in the national

interests of Canada. Being a relatively small country with great dependence on international trade, investment and capital flows, Canada must depend on effective international rules of the game to protect its interests.

All these aspects of policy are positive for helping to achieve a stable and internationally competitive Canadian financial system. But they are not sufficient in themselves for ensuring that Canada will have such a system in the emerging world of globalization.

### **VIIIB. POLICIES THAT THREATEN THE FUTURE STRENGTH OF THE FINANCIAL SYSTEM**

#### **Major changes in financial sector restructuring policies are urgently**

**needed:** For Canada to end up a decade from now with an internationally competitive financial services sector that is strongly based in Canada and that provides superior career opportunities to Canadians will require major changes to its financial sector restructuring policies. Because of this a number of the policies outlined in the federal government's policy paper should be substantially amended. Not to do so would achieve the opposite from what the document says is one of its main principles, namely, that "financial institutions must have the flexibility to adapt to the changing marketplace and to compete and thrive, both a home and abroad, in order to retain their role as critical sources of economic activity and job creation."<sup>45</sup>

#### **Mergers must be seen as vital for surviving the impact of globalization**

**over the next decade:** The most important policy change needed relates to mergers. Being denied their benefits probably means that the Canadian banks

have to continue with inefficiencies that could amount to between 10%-30% of their non-interest expenses while emerging international competitors face no such handicap. Erosion of their place in the Canadian financial services market and in the international market place would be inevitable over the next decade with such a competitive handicap. Rather than Canadian policy taking a negative view of mergers between large banks and large insurance companies, and placing enormous political obstacles in their way, it should facilitate them while still ensuring the existence of rational arrangements to deal with inevitable transitional problems. A merger, for example, between two large banks and a large insurance company is the kind of restructuring that is needed if Canada is to preserve strong "home base" financial institutions and ones that can stand up to the forces of globalization at home and abroad.

The danger of delay is that the forces of globalization do not stand still and the process of merging two large financial institutions with overlapping retail systems takes a long time — probably up to five years. Once domestic and international market share is lost to foreign competitors, it is probably impossible to regain it.

An improved merger policy would be one where clear government criteria for merger approval were spelled out in advance, where the Competition Bureau had the authority to prescribe remedies for bank merger proposals (as it has when a trust company is involved) and negotiate these with the parties involved, where competition appraisals took into account the medium term impact of globalized competition, where official consideration of a merger proposal was on a relatively tight and predetermined time schedule, and generally where longer term viability

of the Canadian financial services sector rather than short term political considerations were seen to lie behind decisions taken.

**Policy changes should be sequenced in the most effective way for achieving national objectives:** Government policy appears to be unaware that the order in which changes are introduced can permanently influence the final structure of the financial system. The government intends to increase the limit on individual bank shareholdings from 10% to 20%, with ministerial approval, and make it easier for foreign banks to offer branch services in Canada. This it intends to do before it has created conditions permitting Canadian banks to increase substantially and quickly their individual capital bases through mergers. It would appear to be in Canada's vital interest to permit Canadian banks to shore up their capital strength through mergers at least as soon as facilitating foreign penetration of the Canadian system. There is a worrisome possibility that Canadian policy as now contemplated could lead some time in the future to mergers of Canadian banks with foreign banks before there are timely mergers among the Canadian banks themselves.

**Capital taxes on financial institutions should be abolished:** Capital taxes on financial institutions are directly harmful to their competitiveness and their financial soundness, and should simply be abolished. The federal Minister of Finance has promised to review the taxes but this is also a provincial matter and it is not clear whether their importance in relation to where globalization could take the Canadian financial services sector is fully understood by all involved.

**Marginal tax rates should be reduced to**

**help retain highly mobile executives and the departments they run:** Senior executives and valued professionals are becoming increasingly mobile and so will become increasingly indifferent as to where they are located. For them tax burdens are a consideration in coming to a decision on this issue. For Canadian companies that try to compensate for this by higher salaries, it becomes a competitive disadvantage. At the same time the higher corporate taxes in Canada than in the US provide an incentive for core business operations to gravitate to the US and to serve Canadian clients from the US. In this way both high personal and corporate taxes bias the location of career and business opportunities against Canada and in favour of the United States. This is increasingly important for the financial services sector because of the growing integration of the Canadian and US financial systems and the ability of supplying many financial services from any number of geographic locations.

**Federal-Provincial Financial Services Regulations:** The provincial regulation of national financial institutions has become increasingly inappropriate as regional markets have become part of one national market. While that role in practice has diminished it still entails unnecessary costs of administration and compliance. Removal of them would increase the efficiency of the financial system and the competitiveness of its institutions. Political exigencies rather than economic efficiencies are deciding the pace of change here, particularly with respect to Quebec, and so change is not likely to come swiftly — the cost of running a federation in a rapidly changing world.

**Barriers between the “pillars” should be removed:** Canada has made significant strides in removing past barriers between

the “pillars” including the 1987 change that permitted chartered banks to own investment dealers, and the removal of the separation of banks and trust companies. Remaining barriers between types of financial institutions are outdated and, for the most part, should be abolished, as they are in competing countries, including those relating to car leasing and the retail distribution of insurance products. Their continued presence simply results in unnecessary financial system inefficiencies and higher costs to Canadians. It taxes the mind to understand why *Canadian* regulations should prevent *Canadian* banks from doing business in a *Canadian* financial services sector that is currently dominated by *foreign* institutions. But that is the case with car leasing.

**Future competition will come from large foreign institutions not small Canadian ones:**

The hope of the government that increased competition can be achieved by encouraging new small entrants flies in the face of experience of the last century or more. It also fails to recognize that very real competition in the years ahead will come from large foreign institutions resident abroad and in Canada and not from small Canadian ones. There is every good economic reason to make access to the market by new entrants as easy as prudence permits. But making them too easy simply leads to future bankruptcies and, frequently, a charge on the public treasury or the deposit insurance fund. Subsidization of them appears to be negative for national productivity and so should not be a part of financial services policy.

**Non-market measures to achieve social objectives should not be such as to make the financial system less efficient and competitive:** Using regulations forcing Canadian financial institutions to

implement and bear the cost of social objectives, such as below cost accounts, leads directly to an inefficient financial system and a loss of competitiveness. Rather than pursuing a regulatory approach that distorts the functioning of competitive markets, it should focus on transparency and disclosure provisions that will lead to achievement of the objections. Where subsidization is needed on social grounds this should not be achieved by regulations that distort the system but by income distribution social programmes that do not.

The issue raised here is not the worthiness of the social objectives but rather the method for achieving them.

**Policy should be driven by long term requirements of a strong and competitive financial system and not short term political considerations:**

Of great concern is the possibility that financial services restructuring policy will be decided by short term political considerations and not ones related to the long term needs of a strong domestic financial services sector. Some of the policy positions already discussed have little or no apparent economic base to them and, as already noted, appear explainable only in political terms. The loss of credibility in Canadian financial services policy is not helpful for the future of the system. It is not helpful when players in the system begin to base their strategies and actions on assumptions that Canadian policies impeding orderly evolution will, for political reasons, remain in place for some indeterminate time. It appears probable that it would lead to business strategies and actions that would accelerate the relative decline of a Canadian owned financial services sector in Canada.

**If policy is not changed the long term**

**consequences for the Canadian financial system would be serious and irreversible:** What, it must be asked, would be the consequences over the next decade or so for the Canadian financial system if current policy was pursued in future, that is: (1) if bank mergers were in practice prohibited, made exceedingly difficult, or long delayed, (2) if discriminatory taxation of the large institutions and relatively high corporation and personal taxes in general, continued, (3) if remaining barriers between the “pillars” were perpetuated, (4) if social policy burdens were imposed on bank operations, and (5) if foreign penetration of the Canadian financial services market was encouraged before Canadian banks had an internationally competitive capital base?

The chances are that this would cause the banks to lose a substantial share of their own domestic market and become inconsequential players internationally, ending with eventual absorption by foreign banks. Even their chances of evolving into significant niche players in Canada would be minimal because niche players themselves have become international in scope. Such an outcome would be irreversible and it is difficult to see how it would serve Canada’s national interests. It would be a very high price to pay for whatever short term advantages are seen in perpetuating such policies.

Canada has already lost time in restructuring its financial sector in line with the realities of the emerging international financial system, and so has lost ground that it is unlikely to retrieve. The world of international competition has changed materially even since the publication of the Task Force Report and special studies in September, 1998. There is urgency in not permitting this deterioration to continue and for this not to happen will

require major changes in the near future to current federal government restructuring policies.

## Notes

<sup>1</sup> Edward P. Neufeld is a graduate of the University of Saskatchewan and completed his Ph.D at the London School of Economics and Political Science. He was for many years Professor of Economics at the University of Toronto, then a senior official of the Department of Finance in Ottawa including positions as Assistant Deputy Minister of Tax Policy and Legislation, and finally Executive Vice President and Chief Economist of the Royal Bank of Canada from which he retired in 1994. He has written extensively on monetary and financial matters including his 645 page volume on *The Financial System of Canada: Its Growth and Development*, Macmillan of Canada, 1972.

<sup>2</sup> The study is part of a project on *The Future of Global and Regional Integration* directed by the Institute of Intergovernmental Relations, Queen’s University, Kingston, Ontario. See Edward P. Neufeld, *Implications for the International and Canadian Financial Services Industry and their Governance of Varying Future International Scenarios*, The Institute of Intergovernmental Relations, Queen’s University, Kingston, Ontario.

<sup>3</sup> See footnote 2 above.

<sup>4</sup> See “Change, Challenge, Opportunity,” *Report of the Task Force on the Future of the Canadian Financial System*, Government of Canada, Department of Finance, September 1998. A list of its 19 research studies is found in Appendix 3. For a relatively comprehensive bibliography of past studies of the Canadian financial system and specific sectors of it see Edward P. Neufeld and Harry Hassanwalia, “Challenges for the

Future Restructuring of the Financial-Services Industry in Canada," in George M. von Furstenberg (ed.), *The Banking and Financial Structure in the NAFTA Countries and Chile*, Kluwer Academic Publishers, 1997.

<sup>5</sup> Canada, Department of Finance, *Re-forming Canada's Financial Services Sector: A Framework for the Future*, Ottawa, June 25, 1999.

<sup>6</sup> Task Force on the Future of the Canadian Financial Services Sector, *Competition, Competitiveness and the Public Interest Background Paper # 1*, September, 1998, pp. 11-19. That study has valid and helpful comments on globalization and technology. It does not address the question as to the impact that such forces would have on the Canadian financial system if major aspects of current policies were left unchanged.

<sup>7</sup> For a recent thoughtful and critical review of intended government financial services policy see Wendy Dobson, "Prisoners of the Past in a Fast-Forward World: Canada's Policy Framework for the Financial Services Sector," *Commentary* 132, C. D. Howe Institute, December, 1999. The writer is in substantial agreement with the analysis and recommendations contained in that paper.

<sup>8</sup> Thomas L. Friedman, *The Lexus and the Olive Tree: Understanding Globalization*, Farrar, Straus and Giroux, New York, 1999.

<sup>9</sup> A recent example is the acquisition on February 14, 2000, by the Royal Bank of Scotland of the National Westminster Bank PLC to form the seventh-largest bank in Europe. *National Post*, February 12, 2000 and February 14, 2000. Also on April 1, 2000, HSBC the second largest bank in the world announced a friendly take over of Credit Commercial de France, the bank with the

eighth largest retail branch system in France — the first major cross-border bank merger in Europe. Before that there was the merger of Banque National de Paris and Paribas to form one of the largest European banks, BNP Paribas. The proposal to merge Deutsche and Dresdner banks to form the largest European bank was cancelled because of disagreements between them, not regulatory objections.

<sup>10</sup> Cf., *Competition Bureau's Letter to the Royal Bank and Bank of Montreal*, December 11, 1999, p.2. A recent report by the *Global Competition Review* comparing the work of twenty three international regulators placed the Canadian Competition Bureau well down the list in quality and reported that its reputation for independence has been tarnished. See *National Post*, April 11, 2000, pp.C1, C8. A spokesperson for the Bureau questioned its findings.

<sup>11</sup> See Thomas L. Friedman, *op. cit.*, p.xv.

<sup>12</sup> Thomas L. Friedman, *op. cit.*, pp.7-8.

<sup>13</sup> The Canadian companies involved were the following: Abitibi-Price Inc., Chauvco Resources Ltd., Dominion Textiles, Norcen Energy Resources Inc., Canadian National Railway Co., Avenor Inc., Tarragon Oil and Gas Ltd., Nortel Networks Corp. (twice), Midland Walwyn Inc., Northstar Energy Corp., Placer Dome, JDS Fitel, MetroNet Communications Corp., Newcourt Credit Group Inc., MacMillan Bloedel, Le Groupe Forex Inc., Quebecor Printing, Alcan Aluminium Ltd., POCO Petroleum Limited.

<sup>14</sup> For example: Merrill Lynch & Co., the biggest brokerage firm in the United States has decided to add banking services to its operations. See *National Post*, 2 February, 2000, p.C10. The company had in earlier years pioneered the Cash Management

Account which was followed by the development of money market mutual funds as transaction accounts

<sup>15</sup> Cf., Lowell Bryan, "A Prescription for Failure," *National Post*, Dec. 15, 1999, p. C7.

<sup>16</sup> See Wendy Dobson, *op. cit.*, p. 11 and the reference there noted.

<sup>17</sup> A recent poll indicated that Canadians are ahead of other countries, including the US in adopting Internet banking. See *National Post*, April 11, 2000, p.C9.

<sup>18</sup> See Edward P. Neufeld and Harry Hassanwalia, *op. cit.* p.87.

<sup>19</sup> This is evident in comparing the banks' current foreign establishments with those of say ten years ago, or even five years ago. It is also apparent in the sales of certain operations. The most recent example of this is the sale by the Bank of Montreal of the corporate trust business of its subsidiary Harris Bank. The indenture trust services were sold to Bank of New York Co., the largest provider of such services in the US and the shareholder services business was sold to Computershare of Australia, the largest provider of such services in the world. See *National Post*, 2 February, 2000, p.C3 . Also the Canadian banks have sold their payroll businesses to large international institutions and only one Canadian bank remains in the global custody business.

<sup>20</sup> In the most recent case the Bank of Montreal announced that it wishes to reduce the number of its branches by 200 to a total of 900 and explained that from 70% to 80% of its banking transactions now took place outside of the branch. See *National Post*, February 17, 2000, pp.C1, C9.

<sup>21</sup> See Edward P. Neufeld, *Implications*, *ibid.*

<sup>22</sup> See Edward P. Neufeld, *Implications*, *ibid.*

<sup>23</sup> Canada, Department of Finance, *Reforming Canada's Financial Services Sector*, June 25, 1999, pp.22-26. The banks will prepare a Public Interest Impact Assessment (PIIA) and at present there are no detailed objective government criteria relating to what constitutes an acceptable merger. The House of Commons Standing Committee on Finance, which in the recent past has emerged as politically highly partisan in matters relating to the banks, will examine the PIIA, hold public hearings and make a report. The Competition Bureau will conduct a review, but with its two year time perspective for appraising consequences, this review will not catch how globalization is going to change Canada's financial system in coming years. Nor will the Bureau have the right to suggest specific remedies to any deficiencies it finds in the proposal, this authority being retained by the Minister of Finance. The Office of the Superintendent of Financial Institutions will review the matter for safety and soundness and this is completely appropriate. All this information will go to the Minister of Finance and he will make a final decision — which by its very nature cannot help but take short term political considerations into account, particularly since specific predetermined criteria for acceptable mergers are not available. The Minister can deny outright the merger proposals or impose conditions on it, conditions that too could have short term political considerations in mind. No tight time schedule is envisaged for this process.

<sup>24</sup> See Edward P. Neufeld, *The Financial System of Canada*, Macmillan of Canada, 1972.

<sup>25</sup> See *Report of the Task Force on the Future of*

*the Canadian Financial Services Sector: Change, Challenge, Opportunity*, Department of Finance, Ottawa, September, 1998, and *Statement by the Minister of Finance*, June 25, 1999.

<sup>26</sup> See DesRosiers Automotive Consultants Inc., *Background Report on Extending Bank Powers to Include Light Vehicle Leasing*, Research Paper Prepared for the Task Force on the Future of the Canadian Financial Services Sector, September, 1998, p.31.

<sup>27</sup> See Kevin J. Dancey, *Impact of Taxation on the Financial Services Sector*, Research Paper Prepared for the Task Force on the Future of the Canadian Financial Services Sector, September, 1998.

<sup>28</sup> *The Budget Plan 2000*, Tabled in the House of Commons by the Honourable Paul Martin, P.C., M.P., Minister of Finance, February 28, 2000, p.92-93. Chart 4.3 included there shows that in five years time the Canadian corporate tax burden will be about the same as *today's* levels in the other G7 countries, excluding the United Kingdom where the rate is much lower.

<sup>29</sup> See *The Budget Plan*, op. cit. p.264.

<sup>30</sup> *Report of the Task Force on the Future of the Canadian Financial Services Sector*, op. cit., p.198.

<sup>31</sup> See A. Warren Moysey, *Deposit Insurance and Other Compensation Arrangements*, Research Paper Prepared for the Task Force on the Future of the Canadian Financial Services Sector, p.38. The study also contains a bibliography of the other studies on deposit insurance that have emerged in recent years

<sup>32</sup> Task Force on the Future of the Canadian Financial Services Sector, *Improving the*

*Regulatory Framework*, Background Paper # 5, September, 1998.

<sup>33</sup> For a recent exposition of the transparency measures the Bank of Canada has taken as well as its current approach to implementing monetary and exchange rate policies see Charles Freedman, Deputy Governor, Bank of Canada, *The Framework for the Conduct of Monetary Policy in Canada: Some Recent Developments*, Notes for Presentation to the Ottawa Economics Association, January 25, 2000.

<sup>34</sup> See *Report of the Task Force on the Future of the Canadian Financial Services Sector*, op. cit., pp.209-210, as well as Task Force on the Future of the Canadian Financial Services Sector, *Empowering Consumers Background Paper # 3*, September, 1998, pp.24-36.

<sup>35</sup> See Robert R. Kerton(ed.), *Consumers in the Financial Services Sector Volume 1:Principles, Practice and Policy — the Canadian Experience*, Research Paper Prepared for the Task Force on the Future of the Canadian Financial Services Sector, September, 1998.

<sup>36</sup> Cf., Donald J. Daly and Michael Helfinger, *Small Business in Canada-U.S. Manufacturing Productivity and Cost Comparisons*, January 2000, and the references there cited.

<sup>37</sup> For an excellent description and discussion of this see Gordon Theissen, Governor of the Bank of Canada, *Then and now: The change in views on the role of monetary policy since the Porter Commission*, The Tony Hampson Memorial Lecture, C. D. Howe Institute, Toronto, Ontario.

<sup>38</sup> Cf., Charles Freedman, *ibid.*

<sup>39</sup> See Theissen, *ibid.*

<sup>40</sup> Cf. *Canadian Exchange Rate Policy*, Round Table Comments by Thomas J. Courchene,

John Crow, Richard G. Harris and David Laidler, *Canadian Public Policy*, September, 1999.

issues in Willem H. Buiter, "The EMU and the NAMU: What is the Case for North American Monetary Union," *Canadian Public Policy*, 25:3, 1999.

<sup>41</sup> Cf. International Monetary Fund, *Monetary Policy in Dollarized Economies*, Occasional Paper No. 171, 199 and Statement by C. Fred Bergsten, Director, Institute for International Economics, *Dollarization in Emerging-Market Economies and its Policy Implications for the United States*, before the Joint Hearings of the Subcommittee on Economic Policy and the Subcommittee on International Trade and Finance of the Committee on Banking, Housing and Urban Affairs, United States Senate, April 22, 1999.

<sup>43</sup> *The Budget Plan 2000*, *ibid.*

<sup>44</sup> *The Budget Plan 2000*, *ibid.*

<sup>45</sup> Canada, Department of Finance, *Reforming Canada's Financial Services Sector: A Framework for the Future*, June 20, 1999, p.10.

<sup>42</sup> See the very interesting discussion of these