Intelligence MEMOS

From: Jeremy Kronick and Farah Omran

To: Finance Minister Chrystia Freeland

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Re: **The Financial Sector Productivity Opportunity**

Rules and regulations holding back innovation and productivity in Canada's financial sector should be updated to drive wider economic performance.

In our recent C.D. Howe Institute paper, we updated our assessment of financial sector regulations and policies that hinder productivity growth through their impact on competition, the ability to attract foreign investment and the allocation of capital, and offer a way forward.

We focused on the well-established link between regulation/policy and productivity, and explore the regulatory and policy changes needed to boost Canada's overall and financial services productivity. We zero in on the financial services sector due to its unique ability to boost both its own productivity and that of other sectors by optimally allocating resources in the economy We argue for the continued removal of barriers to the development of innovative firms and their access to credit.

Over the past 18 years, Canada has lagged many OECD countries – including Australia and the UK – in terms of productivity. And with the pandemic's impact exacerbating pre-existing weaknesses and damaging productive capacity, enhancing productivity growth will be vital to drive Canada's economic recovery.

Enter the financial services sector. In Canada, the sector employs relatively more Canadians with postsecondary and postgraduate education than do other sectors, and promotes growth and productivity within the other complementary sectors that serve it.

It is absolutely necessary to have regulations in place that protect consumers and maintain the stability of the financial system. Such regulations, however, should strike the right balance between protecting against potential risks and ensuring an appropriate level of competition, particularly from niche new entrants, in order to generate innovation and, in turn, productivity growth. At the same time, regulations should ensure an efficient financial system and allocation of credit to enable innovative firms to access the capital necessary for their growth, both domestically and from abroad.

Three areas stand out for improvement:

Fintech: The current environment of under- or overregulation of fintechs creates a fragmented and complex regulatory system. As recommended by the Competition Bureau, regulations should focus on the function performed and be proportional to the risk this function poses. For example, unlike large interbank settlement payments, small retail payments such as buying a daily coffee do not risk putting the entire system in jeopardy in case of failure – and oversight should reflect this divergence in risk.

Small and medium-sized enterprises: Canada has the largest spread between interest rates on loans to small and medium-sized enterprises (SMEs) and those to large firms among the OECD countries in this study. These barriers in accessing financing become more consequential in a post-COVID world, where SMEs were hurt disproportionately by shutdowns, adding to their riskiness in the eyes of lenders. Policymakers could improve SMEs' access to capital by deepening Canada's capital markets beyond domestic bank debt financing.

Open banking: Open banking gives customers of financial institutions control over when and how to share their financial data. Implementing open banking would help spur the development of the types of tailored products and services that would create a more innovative and competitive market.

More broadly, we recommend:

- A flexible regulatory approach ensuring regulations focus on the function and the function's impact on the financial system;
- More explicit competitiveness mandates for Canada's financial services regulators to spur innovation – like we saw recently with upcoming changes to the mandate of the OSC;
- Improving coordination, cooperation and the sharing of financial market data between federal and provincial regulators; and

Ensuring that the share of mortgage and business lending in the economy reflects the true underlying risk of both types of lending through modifying how mortgage insurance premiums are priced.

Jeremy Kronick is associate director, research, C.D. Howe Institute. Farah Omran is a former C.D. Howe Institute policy analyst.

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