Intelligence MEMOS

From: Farah Omran and Jeremy Kronick

To: The Hon. Bill Morneau, Minister of Finance

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Re: **THE PRODUCTIVITY OPPORTUNITY IN CANADA'S FINANCIAL SECTOR**

Productivity improvement is a central challenge to Canada, and its financial services sector is the proverbial low-hanging fruit.

The sector not only employs relatively more educated workers and generates higher earnings than the rest of the economy, it has the unique ability to boost the entire economy's productivity while boosting its own. And we already possess an international comparative advantage.

Surprisingly, however, the financial service contribution to overall productivity growth is underwhelming. Using the OECD measure of industry contribution to productivity, from 2001-2017, Canada ranks behind Australia, Norway and Sweden.

How can we turn this around?

As we argue in a recent C.D. Howe Institute **report**, the place to look is regulation and policy. We need to ensure we have the right balance between safety and stability, and create an environment for competition and innovation.

Canada's financial regulatory framework insulated us from the 2008-09 financial crisis and its aftermath, but sluggish growth since the crisis suggests the pendulum may have swung too far in the direction of safety and stability. Regulation and policy should promote competition, create a desirable location for attracting capital, and ensure an efficient allocation of credit, with more credit going to productivity-enhancing businesses.

Take competition. While it can be difficult to generate the optimal level of competition in a particular industry, it is critical for regulation and policy to allow the entry of innovative firms to the market and to ensure these firms can compete with traditional players on a level playing field.

The regulation of fintechs provides a cautionary tale. Fintechs in Canada tend to be either under- or over-regulated. Those that offer payment platforms often find themselves facing regulatory gaps as regulators typically focus on their more traditional debit and credit payment card counterparts, e.g. Interac. Uncertainty is costly for any business, let alone startups.

Fintechs that lend to businesses, on the other hand, often face onerous regulations similar to those faced by their traditional bricks-and-mortar counterparts. This is unfair to small innovative firms who have to adhere to regulations meant for systemically important financial institutions.

To alleviate these concerns without sacrificing safety and stability, regulations should be more function-based and less entity-based. They should be more about what you do rather than who you are. At the same time, they need to be proportional to the risks created by a firm's particular function. For example, though certain exemptions exist, peer-to-peer lenders, like traditional lenders, have to file a prospectus for each loan that involves selling securities to investors. The functions are the same, but the cost could be prohibitive to less risky startups, damaging the potential for increased competition.

More broadly, Canada's regulatory and policy framework also affects our overall productivity through the environment it creates for attracting capital and encouraging its efficient allocation.

We **rank** behind Australia, to which we are often compared, in net foreign direct investment inflows as well as such global leaders as the Netherlands, the US, and despite Brexit, the U.K.

Many factors go into foreign direct investment decisions, including regulatory structure. Businesses with money to invest in Canada confront multiple hurdles, including different federal and provincial regulators. Uniform Canadian standards would help in adopting international best practices in financial services regulation.

Canada also scores poorly in small business lending, both as a share of total business lending and as a percentage of GDP, and it has one of the largest spreads between interest rates on loans to large businesses and loans to small and medium businesses (SMEs).

One reason why productivity-enhancing SMEs get less access to capital is simply that capital is being allocated elsewhere, in particular to residential mortgage lending. CMHC provides lenders of insured residential mortgages a 100 percent guarantee, making these loans effectively risk-free. CMHC currently charges a flat percentage for the insurance premium based on loan-to-value ratio, i.e., the ratio of the size of your loan to the value of the house, regardless of the characteristics of individual borrowers. If instead it charged different premiums based on different risk profiles, lenders might rethink how they allocate credit, freeing up more capital for business loans.

These are only a few of the many steps Canada can take to move toward a regulatory and policy framework that will boost both financial services and economy-wide productivity. The election is now over. It's time to tackle Canada's lacklustre productivity performance.

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