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Communiqué

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Ottawa's approach to financial sector fails to address efficiency concerns, says C.D. Howe Institute study

The policy framework paper on financial services released by the Department of Finance earlier this year reflects the politicized atmosphere of a public backlash against the big banks, concludes a *C.D. Howe Institute Commentary* released today. The study says the framework paper fails to adequately address ways to keep one of the country's most significant sectors highly efficient, well functioning, and internationally competitive, which would serve the interests of both users and producers.

The study, "Prisoners of the Past in a Fast-Forward World: Canada's Policy Framework for the Financial Services Sector," was written by Wendy Dobson, Director of the Institute for International Business, Joseph L. Rotman School of Management, University of Toronto, and both a former president of the C.D. Howe Institute and former associate deputy minister of finance in Ottawa.

Dobson notes that the international environment for financial institutions, including large banks, is being reshaped by the forces of rapid technological innovation, globalization, and industry consolidation. She also notes that most industrialized countries have modified their policy environments to ensure that their financial institutions are able to respond adequately to these forces.

In Canada, however, public concerns about the adequacy of the services that large banks offer their retail customers politicized the environment in which the Finance Department wrote its June policy framework paper. The paper contains proposals aimed at increasing efficiency, competitiveness, and flexibility mainly through some easing of the 10 percent limit on single ownership of bank shares, expanded access to the payments system, permission for large financial institutions to set up holding companies, encouragement of new, smaller entrants, and the setting up of a financial consumer agency. Dobson suggests, however, that the positive impact of these measures could be offset by the possibility that new players would likely be high cost ones, by chains on the large banks, and by an added regulatory burden, making it anti-consumer and undermining efficiency.

This contradiction, Dobson says, makes the paper's proposed solutions unstable stepping stones to the future, a fact that Parliament should bear in mind when considering the impending legislation. Ottawa has pressed its political points and now has the responsibility to depoli-

ticize the policy environment, Dobson argues. Rather than simply encouraging more high-cost players into retail services, it should focus more on the overall national interest, which urgently includes the competitiveness of the financial services sector.

Dobson makes eight recommendations. She concludes that the chances of desirable policy changes could improve significantly if the large banks responded both to the depth of the dissatisfaction lying behind the political criticism and to the strategic opportunity in retail banking implied by the demand for services that are more customer responsive.

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Communiqué

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Selon une étude de l'Institut C.D. Howe, l'approche d'Ottawa face au secteur financier ne tient pas compte des préoccupations d'efficience

Le document-cadre de politique sur les services financiers publié cette année par le ministère des Finances témoigne de la politisation de la réaction publique contre les grandes banques, affirme un *Commentaire de l'Institut C.D. Howe* publié aujourd'hui. L'auteure de l'étude affirme que le document-cadre ne propose pas de moyens de conserver l'efficience, le bon fonctionnement et la capacité concurrentielle à l'échelle mondiale de l'un des secteurs les plus importants du pays et donc de servir les intérêts des utilisateurs comme des fournisseurs.

Intitulé « Prisoners of the Past in a Fast-Forward World: Canada's Policy Framework for the Financial Services Sector » (« Prisonniers du passé dans un monde en évolution rapide : le cadre stratégique du Canada pour le secteur des services financiers »), le document est rédigé par Mme Wendy Dobson, directrice de l'institut des affaires internationales de l'école de gestion Joseph L. Rotman de l'Université de Toronto. Mme Dobson a été présidente de l'Institut C.D. Howe et sous-ministre adjointe des Finances du gouvernement fédéral.

Mme Dobson souligne que les forces des innovations constantes en technologie, de la mondialisation et de la consolidation du secteur financier modifient la scène internationale pour les institutions financières, grandes banques comprises. Elle note également que la plupart des pays industrialisés ont modifié leurs politiques pour veiller à ce que leurs institutions financières soient en mesure de relever les défis posés par ces forces.

Toutefois, au Canada, les préoccupations publiques à l'égard de la qualité des services que les grandes banques offrent aux particuliers a politisé le contexte du document-cadre de politique publié en juin par le ministère des Finances. Le document contenait certaines propositions visant à améliorer l'efficience, la capacité concurrentielle et la souplesse du secteur financier; on y proposait de relâcher le plafond de 10 % imposé à la propriété des actions des banques par un seul actionnaire, d'élargir l'accès au système des paiements, de permettre aux établissements financiers de mettre sur pied des sociétés de portefeuille, d'encourager la venue sur le marché de nouveaux participants de taille plus modeste et de mettre sur pied un organisme pour défendre les intérêts des consommateurs du secteur financier. Malheureusement, suggère l'auteure, les répercussions positives de ces mesures pourraient être neutral-

isées par le fait que la venue de nouveaux participants se traduira probablement par des coûts accrus pour les consommateurs, par le fait qu'elles alourdiront d'autant plus le fonctionnement des grandes banques et par un fardeau réglementaire accru, allant à l'encontre des intérêts des consommateurs et sapant l'efficience.

Selon Mme Dobson, ces contradictions rendent les solutions envisagées dans le document plutôt chancelantes pour l'avenir, fait dont le Parlement devra tenir compte lorsqu'il se penchera sur la législation imminente. Ottawa a avancé ses arguments politiques et a maintenant la responsabilité de dépolitiser la question, avance l'auteure. Plutôt que d'encourager l'accès de participants à coût élevé aux services de détail, le gouvernement fédéral devrait mettre l'accent sur les intérêts nationaux dans leur ensemble, ce qui englobe de manière pressante la capacité concurrentielle du secteur des services financiers.

En conclusion, Mme Dobson propose huit recommandations. Elle affirme que les chances de changements politiques souhaitables s'amélioreraient considérablement si les grandes banques prenaient des mesures tant à l'égard du mécontentement qui motive les critiques politiques qu'à l'égard des possibilités stratégiques pour le secteur des services bancaires de détail qui découlent de la demande de services plus attentifs aux besoins des consommateurs.

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Prisoners of the Past in a Fast-Forward World:

Canada's Policy Framework for the Financial Services Sector

by

Wendy Dobson

The Department of Finance's financial services framework paper raises issues that Parliament should consider in debating the impending legislation.

Ottawa and Canada's large financial institutions have become prisoners of a public backlash against the big banks, which are seen as having failed to provide adequate services to households and small business. The framework paper, written in an atmosphere politicized by this attitude, has lost sight of the need to ensure a framework that efficiently serves both producers and *all* users of the financial system — which include small and medium-sized businesses, large corporations, and governments, as well as households.

Those users are best served when the system is highly efficient, well functioning, and internationally competitive. By putting Canada's large banks in chains, Ottawa, with its ill-advised adversarial approach, will not achieve their redemption, and its policy framework will be unsustainable in the face of inexorable market forces and technological innovations. Canada's long-term economic prospects could be adversely affected.

Parliamentarians should consider this issue. They cannot wash their hands of efficiency concerns in one of the country's most significant sectors. If policy continues to shrink from this challenge, the financial services sector, which has been a Canadian strength, will become an also-ran in the world economy, and the less mobile of Canadian consumers will be the losers.

Main Findings of the Commentary

- The international environment for financial institutions, including large banks, is being reshaped by three major forces: rapid technological innovation, globalization, and industry consolidation.
- The governments of most industrialized countries have modified their policy environments to ensure that their financial institutions are able to respond adequately to these forces.
- In Canada, public concerns about the adequacy of the services that large banks offer their retail customers (households and small businesses) politicized the environment in which the Department of Finance wrote its June 1999 framework paper for financial services policy (the "Paper").
- The Paper contains proposals aimed at increasing efficiency, competitiveness, and flexibility, easing the 10 percent ownership limit, expanding access to the payments system, permitting large financial institutions to set up holding companies, and encouraging new, smaller entrants. The positive impact would, however, be offset by the possibility that new players would likely be high cost, by chains on the large banks, and by an added regulatory burden.
- The merger review process needs to be revised to make it more realistic. The open-ended process, detailed public reporting requirements that could include sensitive strategic information, and the lack of definition of a merger all need to be modified.
- Canadians should address in a more considered way the issues of foreign participation in the financial services sector. Alternative policy models need systematic study and debate. The Paper would allow only marginal increases in foreign participation; yet an alternative policy that allowed more scale for domestic institutions combined with more foreign penetration of the entire market could be a viable alternative that promoted efficiency and consumer choice.
- The Paper's internal contradictions are highlighted by a glaring flaw. Although its stated objective is to help the consumer, its decision to protect inefficient distributors of financial products is anti-consumer and undermines efficiency.
- The contradictions make the proposed solutions unstable stepping stones to the future, a fact that Parliament should bear in mind when considering the impending legislation. Ottawa has pressed its political points and now has the responsibility to depoliticize the policy environment. Rather than simply encouraging more high-cost players into retail services, it should focus more on the overall national interest, which urgently includes the competitiveness of the entire financial services sector.
- The chances of such changes would improve significantly if the large banks responded both to the depth of the dissatisfaction lying behind the political criticism and to the strategic opportunity in retail banking implied by the demand for realistically priced, customer-oriented services.

The financial services policy framework paper, *Reforming Canada's Financial Services Sector — A Framework for the Future* (Canada 1999), which Finance Minister Paul Martin released on June 25, 1999, concerns one of a growing list of public policy areas where governments are trying to tread an uneasy path between the pressures of globalization and the backlash of domestic interests.

Technological advances have recast how financial services are provided, forcing firms into markets and institutional arrangements that span many countries and time zones, resulting in fierce competition, requiring huge investments, and changing the business profiles of traditional producers. At the same time, customers have become more sophisticated and demanding. One consequence is tension between producers and the public, which wants high-quality, state-of-the-art services and accountability.

In the late 1990s, the financial services sector is in the forefront of the emerging, globalized, knowledge-based economy. Few industries have experienced more dynamic change in the past three decades than have the sector's traditional industries: banking, insurance, and securities. Rapid innovation and advances in telecommunications and computer technology have facilitated the moving of money into a global activity, one that crosses borders at ever-faster rates and in ever-greater volumes. New financial services have also proliferated, with additional competitors, such as asset- and wealth-management companies, credit card suppliers, and securities analysts, challenging traditional services providers and accelerating the rate of change.

The regulation of financial sector activities and institutions is still the domain of national authorities,[1] but increasingly regulators are scrambling to catch up with the pressures of globalization. Some governments stand back and accept the consequences of market forces. Others attempt to restrain them by erecting barriers to internationalization in the form of taxes, regulations, and added oversight. Still others facilitate the adjustment process by reducing past regulations on ownership, operations, foreign entry, and key prices such as interest rates.

It was against this background of increasingly global and fast-moving competition in financial services, colliding with national regulatory objectives, that the Department of Finance released its policy framework paper (the "Paper"). In preparing it, Ottawa commissioned several task forces, most notably the Task Force on the Future of the Canadian Financial Services Sector (the MacKay Task Force)[2] and the Payments System Advisory Committee, which reviewed access to and governance of the payments system. In addition, two parliamentary committees, the House of Commons Standing Committee on Finance and the Senate Standing Committee on Banking, Trade and Commerce, carried out public hearings and issued their own reports and recommendations. The national Liberal Party caucus also sponsored a task force, which published its own report.

Ideally, a financial sector policy framework should have several objectives: to promote a well-functioning financial system to meet the country's overall economic objectives; to im-

While the responsibility for this *Commentary* rests with me alone, a number of people from the policy community, financial institutions, the federal government, and consumer groups contributed to it at a C.D. Howe Institute policy meeting on the federal government's policy toward the financial services sector, held on July 15, 1999, and at an Institute for International Business Roundtable held on September 29, 1999, at the University of Toronto, Joseph L. Rotman School of Management. John Crow, Stephen Harris, Roger Martin, Jack Mintz, Kari Norman, Finn Poschmann, Bill Robson, Grant Reuber, Tom Ross, and Todd Smith also provided helpful comments on a draft.

1 In Canada, a shared federal-provincial jurisdiction exists in the financial services sector.

2 The Mackay Task Force report will also serve as the basis of the next round of legislative and regulatory revisions governing the sector, which are scheduled for no later than 2002.

prove the efficiency and soundness of the financial system; to safeguard the public in its dealings with the financial system; and to promote the adequacy of the financial system to meet the current and prospective needs of lenders, issuers, and borrowers in efficient, flexible, nondiscriminatory, and creative ways.

Such goals are reflected in the Paper's stated objectives, which are to

- promote an efficient and flexible financial services sector;
- ensure choice and low-cost services to consumers;
- ensure equitable consumer access to quality services; and
- improve the regulatory environment.

While these objectives are commendable at the general level at which they are set, the particular measures through which the government aims to promote them deserve critical examination. Given the breadth of the issues at stake, they reflect to a remarkable degree the government's preoccupation with public attitudes and intense criticism of the choice and access provided to small business and retail users by Canada's large banks.

The purpose of this *Commentary* is to evaluate the Paper in terms of its own objectives and to examine how it positions the Canadian financial services sector for the long term and, therefore, how it could influence Canada's worrisome productivity performance. Are the goals the right ones? Are the government's chosen instruments the best ones to achieve these goals? What would be the likely impact of this framework in the long term?

In the next section, I assess the globalization pressures on the sector. In the third section, I discuss the Canadian public's backlash against banks in historical context. In the fourth section, I identify the Paper's seven main reform proposals and evaluate them on the basis of its own objectives.

In the fifth section, I assess the Paper's overall implications, and in the sixth section I recommend modifications that should be reflected in the enabling legislation and the rules and regulations governing the Paper's implementation. A brief conclusion ends the *Commentary*.

The theme throughout is that government and Canada's large financial institutions are prisoners of negative public attitudes and a backlash. In emphasizing "the consumer" (who is nowhere defined), the government seems to have lost sight of the big picture — of a policy framework to ensure that the financial system efficiently serves both users and producers of financial services.

This is not to say that Ottawa should ignore consumer concerns or that it has ignored efficiency. Both goals are valid; the problems lie in the means chosen to pursue them.

My argument is that the interests of *all* users of the financial system — which include small and medium-sized businesses, large corporations, and governments, as well as households — are best served when it is highly efficient and well functioning (see Box 1). By putting Canada's low-cost producers in chains, the government, with its ill-advised adversarial approach, will not achieve their redemption, and its policy framework will be unsustainable in the face of inexorable market forces and technological innovation. Canada's long-term economic prospects could be harmed as a result.

The Rapidly Changing International Environment

The international environment for financial institutions is being reshaped by three major forces: rapid technological innovation, globalization, and industry consolidation. The governments of most countries of the Organisation for Economic Co-operation and Development (OECD) have recognized these forces

Box 1: ***How the Financial Services Sector Is Different***

A well-functioning financial sector plays a major role in the complex machine that is the modern economy. It is a source of growth, providing a wide range of services that assist capital accumulation through pooling funds and evaluating and managing risk. It contributes to productivity growth by channeling funds into innovative activities. Along the way, it provides the economy with new skills and knowledge.

Traditionally, several factors in this special sector — the fiduciary nature of many of its financial activities, its important role in the implementation of monetary policy, the existence of market failures such as information asymmetries, and its proneness to crisis — have provided rationales for regulation by governments.

In other words, national financial sectors are not the same as other industries. Even steel firms or airlines may, unless the government regards them as strategic, be allowed to go bankrupt or be taken over by foreign entrants if they fail to adjust to stiffened competition or technological change. But financial firms — particularly banks — often get more care. Unlike all but the largest firms in other industries, a bank that fails can have a significant impact on the rest of the economy. When depositors lose confidence, this loss can spread to other banks, leading to a run on the entire banking system. The consequences may be felt throughout the economy and spill over into the political realm.

In efforts to head off such crises, governments have traditionally entered into *quid pro quo* arrangements with banks. Governments provide them with an implicit safety net, in the form of an unstated promise by the central bank or public treasury, or an explicit one in the form of a public deposit insurance fund. In return, the banks submit to closer government oversight and regulation of their activities than is usual for a private sector industry.

Many governments also insist on domestic ownership and control of the largest banks.

and have modified their policy environments to ensure that their financial institutions are able to anticipate and respond adequately to these changes.

Technological Innovation

Driving the wave of technological innovation is the revolution in information and communications technology (ICT), which is widening the choice of services, instruments, and institutions available to users of financial services and enhancing the ability of services providers to manage risk and to meet their customers' financing needs at home and abroad.

The ICT revolution has reduced the costs of the basic technologies used by financial services. An illustration is the drop in computer time required to value a complex financial instrument, such as a call option. In 1987, this task took 5.000 seconds of computer time, on average, in US financial institutions; by 1997, the same task took 0.006 seconds (BIS 1998).

A combination of ICT-based numerical tools and advances in portfolio theory underlies new products, such as derivatives and securitized assets (assets bundled into marketable securities), which have changed the traditional business of financial intermediation associated with banks. More recently, the Internet is altering how financial business is being conducted. For example, it is shifting power from bank managers to customers, who are increasingly likely to shop around for financial products, such as mortgages, because they can now easily be compared and purchased online.

To capture and sustain the advantages of the ICT revolution, financial services providers must purchase or develop ever-newer equipment, which is proving enormously expensive. These costs can be recouped only if they are spread over large numbers of users.

Financial services providers also respond by increasing their spending on "brand" advertising to differentiate their products in the eyes of potential customers.

Thus, one of the criteria for evaluating domestic financial policy is whether it assists or inhibits financial institutions in their efforts to move toward and remain near the rapidly shifting technological frontiers and to differentiate their products. Policies that raise production costs or inhibit the scale over which technology costs can be amortized will hinder technological development by such institutions.

Globalization

The second fast-forward trend is globalization, which is reflected in the rise of crossborder capital flows and financial transactions and in foreign firms' entry into domestic markets. Consider some of the volumes of interinstitutional and international financial flows in 1997, reported by the Bank for International Settlements (BIS) and the International Monetary Fund (IMF 1998):

- Crossborder transactions in Canadian bonds and equities grew to 358 percent of gross domestic product (GDP) in 1997, a more than fourfold increase from 65 percent in 1990 (the comparable US numbers were 213 and 89 percent, respectively).
- Outstanding international debt securities worldwide were US$3.6 trillion in March 1998, an increase of 80 percent from the 1993 total of US$2 trillion.
- Nonresident holdings of Canadian public debt were 23 percent of GDP in 1997, more than double the 1983 share, which was 11 percent.
- In 1995, world exports of goods and services totaled about US$6 trillion, while *daily* turnover in foreign exchange markets was more than US$1 trillion, a sixfold increase since 1986.

These statistics illustrate in dramatic fashion the rising volume of international financial activity, particularly in foreign exchange and securities issues, which far exceed international trade and lending.

Yet these figures provide only a partial indication of the scale of international financial activities. An important aspect of international trade stems from the commercial presence of firms in countries other than their home country. Stocks of foreign direct investment (FDI), which are necessary for commercial presence, have grown dramatically, mainly among industrialized countries. By 1997, for example, total FDI flows were US$400 billion, twice the volume of 1990 and seven times that of 1980 (UNCTAD 1998, 8).

These statistics imply increasing globalization of financial markets and a steady growth in international financial integration, but these processes are far from complete. As Feldstein and Horioka (1980) famously document, domestic savings rates are closely correlated with national investment rates, a finding that implies that capital flows are not tightly integrated across borders. Helliwell and McKitrick (1998) confirm those results from OECD data more than a decade later. Thus, the potential for further development of international financial activities may be great.

The range of such activities has widened dramatically with disintermediation (the provision of financial products that directly link investors and borrowers and replace borrowing and lending through banks) and securitization, reflecting increasing sophistication on the part of financial institutions in mobilizing the economy's resources and securing linkages between lenders and borrowers.

Consolidation

Intensifying competition among major services providers in the maturing OECD financial markets has created pressures to reduce costs

and differentiate products. Excess capacity has appeared, spurring a wave of consolidation through crossmarket mergers in Europe and North America (and more recently in Japan).

This wave of consolidation is the third striking feature of the international financial landscape. Merging partners have numerous motivations: to seek size in order to compete in the global environment; to capture economies of scale in ITC spending, asset-management, and global custody services; to diversify the financial services available under one institutional roof for one-stop shopping; to mitigate risk by diversifying instruments across geography, product lines, and industries; to respond to fierce competitive pressures to reduce costs by reducing excess capacity in a country or a region; and to respond, particularly in Europe, to the perception that the single currency area requires a new breed of regional bank that can compete both within the European Union (EU) and against the US giants.

By 1998, the world's two largest banks measured by assets were German and Swiss (see Table A-1 in the appendix). The next two largest were in the United States, followed by banks in Japan, the Netherlands, the United Kingdom, Switzerland, and France. Ranked by capital base, other banks appear: Crédit Agricole Group (France), Chase Manhattan (United States), and the Industrial and Commercial Bank of China.

On the market capitalization measure, which indicates the value investors place on institutions and their strategies, many of these largest banks move well down the ranking and others appear. Those banks most highly valued in the market include Lloyds TSB (United Kingdom), Nationsbank (United States), HSBC Holdings (United Kingdom), ING Groep (Netherlands), and Wells Fargo (United States). (For ease of reference, Table A-2 sets out the world's top five insurers and securities firms.)

The list of recent bank mergers[3] in Table A-3 illustrates how widespread is this trend. The top ten merger partners are spread across the OECD countries, with three in the United States, two in Germany, and one each in the United Kingdom, France, Switzerland, Spain, and the Netherlands.

What is significant about this list is the way it reveals that most mergers have been among banks in the same home country. Some institutions have successfully executed crosspillar mergers, such as the 1997 transaction between Crédit Suisse Group and the Winterthur Group and the 1998 Citicorp-Travelers union, but these have been within-country combinations.[4] Very few of the largest have been across borders, and those that have been tend to be in Europe (such as ING-Barings in 1995) or have been executed with some difficulty (perhaps indicated by Deutsche Bank's relatively low position on the market capitalization list). Only the very largest institutions are becoming truly global and truly full-service (Citigroup and HSBC Holdings are the only banks that provide retail banking services in a large number of countries, for example).

The four Canadian banks that wanted to merge into two banks last year rank far down the global lists, with capital and assets less than half those institutions at the bottom of the top-25 lists. If the proposed mergers had gone through, however, the new banks would have ranked close to the top ten in combined capital and assets.

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3 This list excludes two major mergers: one, announced in August 1999, that will combine three large Japanese banks, Dai-Ichi Kangyo Bank, Fuji Bank, and the Industrial Bank of Japan; and another, announced in October 1999, that will combine two more: the Sumitomo and Sakura Banks.

4 More such crosspillar mergers can be expected in the US market as banks and insurance and securities firms try to survive in an industry increasingly dominated by a few large companies. The *Financial Services Modernization Act of 1999,* which took effect in early November 1999, eliminated restrictions on financial services, dating back to the so-called Glass-Steagall Act, adopted in 1933, that had prevented banking, insurance, and securities firms from entering each other's businesses.

The Domestic Backlash

Overall, banks offer two main kinds of banking services: wholesale banking, which includes equity financing, cash management, and financial risk management, as well as bank loans to large corporate customers; and retail banking, which supplies savings deposits and loans and an increasingly diversified set of investment and insurance services to households and small businesses.

Many retail banking customers charge, rightly or wrongly, that banks have become too powerful, largely ignoring these customers' interests in recent years. This backlash became a major political issue in Canada during the 1998 debate about two major bank mergers that were proposed before the completion of a review process leading to the new policy framework. The debate revealed widespread skepticism about the benefits Canadians believed they would realize from the banks' consolidating their domestic operations to give them the scale and efficiencies they deemed necessary to compete internationally.

A Look Back

Customer concerns about the inadequacies of the services provided by the major financial institutions, specifically the banks, were a major theme running through many of the submissions from households and small businesses to the MacKay Task Force and the parliamentary hearings. Such statements built on the general dislike that people in most countries feel toward their bankers and on the findings of a series of Canadian reviews sponsored in 1994 by members of Parliament and by government committees.

These reviews aired the concerns of many, particularly small and medium-sized businesses, who felt they had been unfairly treated during the 1991–92 recession. An economic downturn usually produces an increase in nonperforming loans in bank portfolios, but the concentrations of bad assets, particularly in Ontario, and the way they were handled created difficulties for many who took their concerns to their elected representatives. When the Liberals came to power in 1994, they were determined to ensure these concerns were addressed in the political arena.

Analytically, there are two issues. First, many people are convinced that they need more institutions from which to obtain loans. Such concerns imply the possibility of market failure because of undue concentration in the industry, as well as widespread perception that the Canadian banking system is uncompetitive and unresponsive to the desire that financial products and services be affordable and accessible to all.

The second issue is the frequent perception that the banks have failed in a social role. Indeed, they are subject to high expectations that they will provide community leadership and support that are reflective of their economic importance and the favored position they are seen to receive through such policies as the limits on foreign ownership, their exclusive access to the payments system, and the safety net of the deposit insurance system.

These concerns imply two basic questions for policy. First, as the MacKay report pointed out, policymakers must determine whether legitimate, creditworthy demands are going unmet, creating market gaps. Second, should Canada's banks be regarded as utilities — that is, as natural monopolies that provide essential services to which people are entitled and that are entitled to a riskless regulated rate of return? Empirical studies provide inconclusive results to answer the first question. Looking around the world to answer the second question, it is noteworthy that the only banks that might be considered utilities are state-owned ones, and they are shrinking in number as they either fail because of inadequate risk evaluation and management or are sold off in privatization programs.

Demand and Supply

The tensions in the Canadian marketplace are perhaps inevitable because of factors on both the demand and supply sides. On the demand side, customers are increasingly sophisticated and discriminating. They demand choice, quality, and low cost from their services providers, as well as transparency in the terms, conditions, and risks of financial products. They expect effective redress if they believe they are being unfairly treated.

An added concern feeds the backlash against globalization. Many individuals fear that, when market forces are allowed to operate freely, "ordinary" people are the losers. The two sets of banks that were proposing to consolidate their businesses were seen as seeking to further restrict the choices available to small depositors and borrowers. (Because the issue is less of a concern to larger businesses, to which deep and liquid capital markets give access to a range of financing options wider than bank borrowing, they were notably silent in the 1998 debate.)

On the supply side, consolidation has been under way for the past two decades as financial institutions have responded to intensifying competition by reducing costs and seeking economies of scale. The MacKay Task Force and the Senate Committee both tackled the charges of undue concentration but failed to settle the issue. The task force compared the banking concentration ratio in Canada with that in other smaller economies whose financial sectors we tend to use for comparison. Canada's five large banks controlled 81 percent of domestic banking assets in 1997, a slightly larger share than that of comparable institutions in the Netherlands, Australia, and Switzerland, which stood at 75, 69, and 66 percent, respectively (Canada 1998b, 150). Anecdotal evidence in both reports implies that other OECD countries have a significant second tier of smaller financial institutions that take deposits and make loans to households and small businesses, providing the latter with more choice.

Such statistics are notoriously difficult to compare because of the large differences in financial structures and in the business strategies of financial institutions. In some OECD countries, state-owned or state-controlled savings institutions play prominent roles. Because these institutions serve certain social objectives, the rate of return is not as important as in private sector institutions, which means the playing field is not a level one. Germany still has a system of state-owned banks; other countries, such as Japan, rely heavily on a savings system based on the post office. Switzerland has a system of small cantonal and regional savings banks. The Netherlands has Rabobank Nederland, a large private cooperative banking institution dating back to 1900 that provides almost all agricultural credit and nearly half of the small and medium enterprise (SME) business (Canada 1998c, 121).

Table A-4 shows the cross-national comparison of the distribution of financial assets across institutions, and also indicates bank concentration in Canada. But the banks' share of total financial assets in Canada, relative to the situation in other countries, reflects the facts that by 1996 Canadian banks had developed business strategies that took them into most segments of the financial industry and that Canada, unlike continental Europe, had developed corporate securities markets.

Repositioning

In responding to the international and technological forces of change, Canada's financial sector has reshaped itself in two ways. First, traditional firms have gotten more and more into each other's businesses of deposit taking and lending, insurance, trust, and securities activities. Competition has increased as the

various types of institutions offer increasingly identical products.

As might be expected, the second trend is one in which other players specialize in particular products and services and innovate in how these are marketed and distributed. Canadian firms have responded both by repositioning themselves to compete across the spectrum of distribution channels and products and by refocusing and specializing. The large full-service banks face new players, often foreign firms, offering traditional and new products through the mail and through telephone-based and electronic distribution channels, which are lower cost and more convenient than traditional branch and agency networks.

This repositioning means that the banks' large share of assets reflects a wide range of products, but also that the asset share measures provide no indication of the range of institutions competing to supply the same products, particularly basic products such as savings deposits and loans. Almost all of the institutions listed in Table A-4 now vie with other types of firms for households' retail savings, mutual fund deposits, investment services, and loans.

In Canada, these competitors include banks' securities arms[5] and their trust arms, both of which supply wealth-management services. They include small, independent investment dealers and specialized financing companies, as well as insurers who also supply wealth-management services. Banks, however, have been heavily restricted in their insurance offerings and are barred from retailing insurance and providing auto leasing services in their branches.

More precise indicators of the competitiveness of Canadian banks include service charges and the spread between loan rates and deposit rates. The most recent evidence indicates that service charges (measured as a share of total deposits) were 80 percent of those in the United States in 1992 and *dropped* to 50 percent in 1997; in other words, Canadian bank service charges have been declining relative to those in the United States. Spreads were remarkably stable in Canada between 1978 and 1997; at about 2 percent, they were among the lowest in the Group-of-Seven (G-7) major industrialized countries (Smith 1998). Spread comparisons can be misleading however, since it is difficult to control for risk. In Canada-US comparisons, for example, it is possible that US banks are willing to price for risk whereas Canadian banks may simply deny the credit.

Summary

The backlash against the banks is a complex issue based on popular dislike of banks, a sentiment found in most countries, and a perception that full-service banks' retail operations have not been as customer-oriented as many Canadians think they should be. Objective indicators of competitiveness in the industry do not indicate market failure or the existence of widespread credit market gaps. Thus, policy must carefully weigh the impact of the turbulent forces of international competition and technological change that the institutions face against measures that would respond to domestic complaints.

The Policy Paper: An Evaluation

In this section, I evaluate the seven major reform proposals in the Finance Department's policy framework paper, grouping them by its stated objectives.[6] Each proposal is introduced

5 After banks were permitted to purchase or develop investment dealers in the early 1990s.

6 The Paper also contains several formalizations of intent, such as demutualizing large insurance companies and allowing foreign banks to set up branches in Canada. These are not dealt with at any length in this *Commentary* because the policy changes are already being implemented.

with a short description of its background, followed by consideration of its advantages and possible disadvantages.

Promotion of Greater Efficiency and Flexibility

The primary thrust of three of the Paper's proposals — easing ownership restrictions, permitting banks to have holding companies, and permitting bank mergers (subject to a review process) — is to increase the efficiency, competitiveness, and flexibility of the financial sector.

Changing the 10 Percent Ownership Rule

At present, ownership policy varies between the banks and other federally regulated financial institutions. Banks must be widely held: specifically, no individual, domestic or foreign, is permitted to own more than 10 percent of any class of shares. The Paper proposes easing these restrictions by raising the single-owner limit on voting shares to 20 percent of banks and demutualized insurers whose equity is more than $5 billion. It would also allow a 30 percent limit on the nonvoting shares of these institutions, subject to a "fit and proper" test to ensure that these larger shareholders are "not a source of weakness to the regulated institutions" (Canada 1999, 3) and to "impose some degree of Canadian perspective at the governance level" (Canada 1998b, 177–178).

The reasons for the old policy were to ensure wide ownership of banks, whether the bulk of the shares were held by foreigners or not, and also to make more effective a series of other restrictions, such as those ensuring that financial and commercial activity were separated (to reduce the associated risks of self-dealing that would undermine safety and soundness).

Now, the MacKay report argues, as the pillars separating banks, securities, trust, and insurance companies are eliminated, common ownership rules should be created. The 10 percent restriction, it notes, is outdated in a world where institutional consolidation is increasingly commonplace and transactions occur through pooling of interest and share exchanges. The 10 percent rule also constrains the potential for new entrants. Easing the ownership restrictions would increase the attractiveness of Canadian banks as joint-venture partners. And since no discretionary approval seems to be required from a regulatory agency or from the minister of finance, the stage would be set for market-based transactions.

The proposal has certain disadvantages and uncertainties. First, the Paper does not define the application of the "fit and proper" test, leaving open the possibility that it would involve administrative discretion that is open to political pressures. Second, the permitted increase in the concentration of ownership could affect the governance of the major financial institutions.

Most notably, the stage would be set for an increase in foreign control of these institutions, which would imply greater weight on innovation and competitiveness. But would such shareholders accept pricing and productivity-augmenting strategies that would be acceptable to the same Canadian consumers who have been so critical of the banks up to now?

At present, aggregate foreign ownership of the large banks runs as high as 35 percent in the case of the National Bank and 24 percent of the Royal Bank (Canada 1998a, 78), but this ownership is widely held. The Paper's proposal would make possible single ownership of 20 percent of a bank's shares and prevent individuals or groups acting together to achieve greater control. Ideally, best-practice corporate governance requires that directors take account of the interests of all shareholders, not

any one in particular. In practice, however, it is difficult to ignore the views of a strong director, particularly if he or she represents a major shareholder.

Permitting Regulated Holding Company Structures

Financial services firms in the United States, the United Kingdom, and other industrialized countries are currently allowed to form holding companies (which allow firms to spin off from the bank itself into subsidiaries such activities as credit cards and other non-banking activities). Canada has not had such provisions.

Now the Paper proposes permission to organize holding companies that could invest in five main areas:

- regulated financial institutions (banks, trust, and insurance companies);
- financial services providers (of credit cards and of loans to small businesses and consumers);
- financial agents and advisors, such as investment counselors and payroll services providers;
- complementary services, such as Interac and armored car activities; and
- other activities, such as information and real property brokerage services.

For banks, the holding company structure would be incorporated under the *Bank Act*. Oversight of the holding company and its entities would be consolidated, consistent with the Bank for International Settlement's "Core Principles for Effective Banking Supervision," released in 1997.[7] The proposed 20 and 30 percent ownership rules would apply. So would the prohibition on commercial activities that now applies to banks.

This proposal has the potential to increase the efficiency of the large financial institutions by allowing them to restructure in ways that would open new possibilities for economies of scale and scope, for capital raising, and for strategic alliances. Banks and demutualized insurance companies would be able to move activities now undertaken in-house (and therefore subject to the banking or insurance regulatory regime) or in subsidiaries into affiliates that would be subject to varying degrees of regulation depending on the activity. Thus, for example, a bank, an insurance company, a mutual fund company, and a credit card company could work together within the new corporate group.

The acid test for this proposal would be whether the banks and insurance companies saw and acted on its advantages. The Paper does not provide the information necessary for such key business decisions, and it should be clearly spelled out in the legislation. For example, what investments would actually be permitted, and how would they be regulated? Would holding companies be allowed to invest in auto leasing? Would the large insurance companies be subject to market conditions after the grace period of three years permitted following their demutualization, or would they continue to be protected from market forces? What would be the rules for allocating capital to various businesses in a holding company? What would be the related-party rules? Where exactly would lighter regulation be permitted? And what would be the taxation rules?

From a broad prudential perspective, one concern is that of keeping failure in one part of the enterprise from spreading more widely, for example, into the deposit-taking (and therefore insured) part of the enterprise. From a narrower perspective, it would be necessary to ensure that holding companies did not become vehicles for reducing or avoiding taxation, regulatory requirements, or capital requirements.

7 These core principles include guidelines for best practices in banking supervision.

Defining the Merger Review Process for Large Banks

Canada's longstanding rule that "big shall not buy big" has ruled out mergers among its largest financial institutions. The Paper proposes to end this prohibition by creating a process under which mergers would be extensively reviewed to ensure that they were in the best interests of the institutions, Canadians, and the Canadian economy.

In particular, the government proposes to establish a formal and transparent review process for the large banks (those with equity exceeding $5 billion). Three criteria would apply. Mergers could not unduly concentrate economic power, significantly reduce competition, or reduce flexibility to address prudential concerns.

Merger proposals would have to include a public interest impact assessment (PIIA) presenting the costs and benefits of the change, including the impact on sources of financing for households and small and medium-sized businesses, the implications for branch closings and service delivery, and the effects on international competitiveness, employment, and technology. The PIIA would be examined by the House of Commons Finance Committee, which would also conduct public hearings. At the same time, the Competition Bureau and the Office of the Superintendent of Financial Institutions (OSFI) would conduct their usual reviews and be authorized to negotiate any requited remedies. The final authority on the mergers would rest with the minister of finance, who would have legislative authority to enforce remedies or other undertakings given by the merger partners.

At first glance, this proposal may appear to be a significant new departure, but a closer look suggests it is less than meets the eye. While the Paper would end the explicit prohibition and it defines the merger review process, that process is onerous and unrealistic enough to make it exceedingly unlikely that the large banks would subject themselves to it. Yet the definition is intended to create some certainty for potential merger partners, and the process that is set out is an elaboration of what was required of the four banks proposing to merge in 1998. They failed to meet what are essentially the same criteria, so the only reason to expect a different outcome in future would be the different application of those criteria.

The criteria themselves are unclear since they lack a definition of "economic power."

The Paper's proposed elaborated process also has significant potential disadvantages. It would be discriminatory. Huge mergers, such as those between TransCanada PipeLines and Nova in 1998 and Macmillan Bloedel and Weyerhaeuser Canada in 1999 received Competition Bureau and other regulatory review in the public interest, but they were not subjected to public hearings.

Moreover, the proposal is highly politicized. Public concerns were clearly uppermost in the minds of the Paper's drafters. From the perspective of merger proponents, the process would impose major costs and increase uncertainties about the eventual outcome of a business decision. And that process apparently would be open ended, rather than subject to defined time constraints.

For all these reasons, the proposed process would likely act as a significant deterrent to the economic rationalization of Canada's large banks and their adaptation to rapidly changing international market conditions.

Increased Focus on Consumer Interests

Two of the Paper's proposals aim to enhance choice and low-cost services for consumers by encouraging new entrants to the financial services sector, by increasing the types of institutions that have access to the payments system, and by expanding the financial coopera-

tive sector, which includes *caisses populaires* and credit unions. Another provision of the Paper seeks to protect consumers by denying the banks permission to offer auto leasing and insurance services through their branches.

Before exploring these portions of the Paper, I must point out that it contains no definition of the *consumer*. The idiosyncratic and shifting implicit definition used in the Paper seems designed more to support the prejudices of the large banks' critics than as a basis for sound policy. For the purposes of this *Commentary*, I assume that the intent of the term is to identify *users of retail financial services*, such as households and small businesses.

Encouraging New Entrants to the Financial Services Market

To promote competition in the domestic market, the Paper encourages new entrants, mainly smaller institutions, by offering liberalized ownership rules and reduced minimum capital requirements for new financial institutions, as well as permission for foreign banks to compete in the domestic market through branches, rather than solely through subsidiaries.

The Second Tier. To nurture a cadre of small financial institutions, the government proposes ownership rules for three size classifications of banks — small, medium, and large. Small banks would be institutions with equity of less than $1 billion. They could be wholly owned by a single shareholder, including a commercial enterprise. Medium-sized banks would be institutions with equity of $1 billion to $5 billion. They could be closely held, but would be required to have a 35 percent float of voting shares. Large banks would be those with capital in excess of $5 billion. They would be subject to the 20 and 30 percent ownership rules.

These measures are an attempt to respond to concerns expressed by the MacKay report that Canada does not have a well-developed second tier of financial institutions that are smaller in size and able to compete with large banks in regional or local markets. As the Paper says, only two new Schedule I banks have been established in Canada since 1987. The foreign banks active in Canada are engaged primarily in wholesale banking business, and trust companies mainly serve special purposes and local areas. (The country also has 2,200 individual credit unions and communities that respond to community and employee needs. An effort is under way, encouraged by the federal government, to overcome the fragmentation of the credit union system.)

The Paper fails to note that a number of the second-tier institutions in Canada have either failed during economic crises in earlier years or have been acquired by larger, more efficient institutions. It also omits that fact that those OECD countries with sizable second tiers of smaller financial institutions created them many years ago. The writers implicitly assume that, since 207 new banks appeared in the United States in 1997 alone, Canada should pursue a similar system. What is not stated is that, while many new institutions do appear in the US market, many fail. Indeed, the US system is moving away from small, inefficient, local institutions. Canadian history is dotted with the failure of small, inefficient, high-risk community or regional institutions, such as the failed Canadian Commercial Bank, the Northland, the Continental, the Mercantile, and the Bank of British Columbia.

The Paper's proposal for small and medium-sized categories is designed to encourage start-up institutions, and the objective of increasing competition is an important one. The question is whether the instruments chosen are appropriate. It is not clear that new institutions would be established. The Canadian market is already a mature one, with intense

competition among the large institutions seeking to enlarge their market shares in retail banking. Thus, the impact of new entrants in the near to medium interim would likely be marginal. In addition, the riskiness of such institutions would be high, and their rates of return could be low. A glance at recent annual reports of the Canada Deposit Insurance Corporation (CDIC), which give the return on assets by institutional category, shows that the average return on assets for the smaller institutions is often close to zero.

The possibility of more higher-cost, low-return small institutions raises two questions: How quickly would the authorities be prepared to move to close such institutions if they were failing? Would the federal government restrain itself from bailing out troubled institutions that might have been encouraged by its own policy changes?

If the authorities failed to act promptly and on stringent soundness criteria, they would contribute to moral hazard (taking more risks on expectation of a public bailout than if there were no such recourse). While the thrust of recent administrative reviews of the financial system has pushed toward prompt action to wind up weak institutions, the politicized environment of the past few years does not provide confidence that such decisions would, in practice, be free of political pressures. A small bank's getting into trouble would be unlikely to pose a systemic threat, but financial markets tend to view such events negatively, with fallout for all domestic institutions.

Foreign Banks. The Paper also formally proposes to allow foreign banks to compete in the domestic market through branches rather than through subsidiaries. The power of the branches would be limited to the wholesale market, a market that is already globalized and one in which users already have substantial access to offshore facilities.

Thus, this proposal likely would not affect competition in the retail market. Perhaps foreign banks should be allowed into that market. The problem with such a scheme is that of access to the payments system and deposit insurance. Who would bear the risk of a US bank that operated in Canada? If it failed, would its depositors be compensated by Canadian or US authorities? In the EU, the single passport for financial services relies on the principle of home-country control and regulation of financial institutions — a German bank operating in the Netherlands has access to the payments system set up under the European Monetary Union and is regulated by German authorities.

If these problems could be solved in the Canadian case, foreign branching in the retail sector could increase domestic competition, enhance innovation, and use less risky institutions as the instrument to achieve this objective.

Broadening Access to the Canadian Payments Association

The Paper recommends giving life insurance companies, investment dealers, and money-market mutual funds access to Canada's payments system. This proposal is another significant one for reforming the domestic competitive environment to benefit users of Canada's financial services.

The Canadian Payments Association (CPA) was created in the 1980s as a network to facilitate financial transactions to pay for goods, services, and assets. Payment can take a number of forms, including currency, cheques, debit and credit cards, and, increasingly, electronic means such as stored-value cards. To play the intermediary role of collecting payments to settle obligations, an institution must be a member of the CPA, which operates two national clearing and settlement systems.

CPA membership is now limited to deposit-taking institutions that are regulated

by the federal and provincial governments, but since 1996 an advisory committee, appointed by the federal government, has reviewed the structure and operation of the system. On the basis of that report, the government has concluded that it would be safe to broaden access to the system to increase the competitive advantage of financial institutions other than banks, such as the life insurance companies, securities dealers, and money-market mutual funds. Competition in core banking activities would be promoted as life insurance companies, for example, gained an opportunity to capture a portion of their annual $35 billion payout to their clients through deposits that could be transferred with a negotiable order vehicle such as a cheque.

This proposal raises two concerns. The first is that, while new entrants would be welcome, it is not clear what impact they would have on the safety and soundness of the entire system. Second, the minister of finance would decide which products or services would be admitted to the payments system. This provision would mean that the minister, through effective control over the rules of the payments association, would also be able to control access to its services. This discretionary authority would require clear criteria for entry and fairness and transparency in its application.

Denying the Banks' Request to Offer Leasing and Insurance

The banks had asked that they be given additional business powers to offer leasing and insurance services through their branches. The Paper refuses this request.

Although a significant decision, it is tucked away in the Paper's list of reforms to empower and protect consumers. An announcement that has significant implications for the objectives of promoting efficiency in the financial services sector and of ensuring choice and low-cost services to consumers, it states:

> the government agrees with the House of Commons Standing Committee on Finance that these regimes [measures to foster competition and promote consumers' interests] should be given time to work before any changes can be considered in bank business powers in the areas of car leasing and insurance networking. (Canada 1999.)

The MacKay Task Force had argued the advantages to consumers of a fully open and competitive trading and investment environment for Canada's financial services sector. After completing a cross-national study, it concluded that introducing competition into the insurance market would reduce costs, particularly to low-income Canadians, and expand the size of the market and that "consumers, not the regulatory framework, should determine how insurance is purchased" (Canada 1998c, 98). It also found that the combined share of banks and auto manufacturers in the United States is about 80 percent. The latter's share alone in Canada is 80 percent, a very high degree of concentration.

The task force recommended that all federally incorporated deposit-taking institutions should be allowed to retail insurance and offer auto leasing services in their branches. It recognized a concern that allowing banks to sell insurance might provide them with too much consumer information and thereby reduce competition. But its research showed no evidence that markets in Europe have been seriously disrupted by the practice of banks' underwriting and distributing insurance products. Indeed, there is some (admittedly not strong) evidence, the task force noted, that the lower costs and higher productivity achieved through bank distribution have led to overall expansion of the market.

Similarly, the task force research indicated that banks in most developed countries are allowed to engage in automobile leasing; Canada is the only outlier. In effect, Canadians depend on foreign providers for this service.

Recognizing that this high degree of concentration would require time for the players to adjust to added competition, the task force recommended a transition period ending on January 1, 2002.

The Senate Banking Committee agreed with the MacKay Task Force's recommendations with some qualifications (that life insurance be opened only in three years and that property and casualty insurance not be opened). The House Finance Committee recommendation of "no for now" prevailed, however.

The federal government refused the task force and Senate Banking Committee recommendations because of the power of the auto and insurance distribution lobbies. The decision was also closely linked to the popular concern about tied selling that surfaced in the public debate and hearings. Opponents expressed concern that the result would be more opportunities for such alleged abuse (although the only evidence is anecdotal).

The government's decision is a glaring flaw in the Paper. In refusing the average Canadian greater competition in these two product areas, it is sending the negative and contradictory message that, even though its stated objective is to help the consumer, its action is anti-consumer by protecting inefficient distributors of financial products. The lapse reverberates in the concerns I have expressed about the payments system.

Consumer Access

One of the Paper's major proposals and several of its lesser ones aim at the goal of ensuring consumer access.

Creating a Financial Consumer Agency

The major proposal here is to create a new financial consumer agency (FCA), which would improve oversight and consumer awareness to ensure that "the rights of consumers as a group are respected" (Canada 1999). This agency would, most significantly, report to the minister of finance and enforce the consumer-oriented provisions of federal financial institution statutes. Thus, it would take some of the current OSFI mandate.

Associated with this proposal are a number of others. One would require banks to issue annual public accountability statements. Another would promote transparency and disclosure by financial institutions; yet another would respond to concerns about consumer privacy.

Given the major emphasis on consumer interests in the task force reports on which the Paper is based, it is not surprising to see proposals for additional regulatory and review agencies. The FCA would not improve overall economic welfare, but it would provide some benefit to consumers — and some added expenses. Its establishment would involve significant costs, most of which apparently would be paid by the banks. Once established, such an agency would have to find things to do, and the costs, both direct and involved in compliance, would surely escalate through time. Eventually these costs would be passed on to consumers, a factor that does not seem to have been taken into account in formulating the proposal.

A second concern is that the price ceilings the FCA might be empowered to impose could well turn into price floors — the agency might implicitly condone collusion.

The third issue, as already stated, is that all these proposals to protect and empower the consumer nowhere define the *consumer*. Is it, as this *Commentary* assumes, users of retail financial services? Surely the interests of other users, such as small and medium-sized businesses, large corporations, and even governments, deserve consideration?

A fourth issue is that the FCA would represent an extra layer of regulation and oversight

in the Canadian system, an addition to the OSFI, the CDIC, the Department of Finance, Industry Canada (which is concerned about privacy and small business), and the more than 70 provincial regulatory agencies. This proliferation of oversight in Canada contrasts sharply with the trend in, for example, the United Kingdom, where various agencies are being replaced by a single supervisory agency.

The Paper also proposes establishment of an independent Canadian financial services ombudsman (CFSO) to handle individual consumer complaints and report annually to the minister of finance. Funding would come from memberships; the banks would be required to join, and all Canadian financial institutions could do so. This independent ombudsman would replace or augment the Canadian Bankers' Association (CBA) ombudsman. In effect, the government is seeking to replace the CBA's self-regulation approach and to require the banks to fund the alternative — one more cost imposed. Whether the anticipated benefits in dispute resolution would materialize remains to be seen.

Other Reform Proposals

The Paper contains a number of other proposals, some more sensible than others.

Credit Unions and Cooperative Banks. Two related proposals seek to strengthen and encourage competition among retail institutions that are now small and essentially local. One of these proposals is to establish a national service entity for credit unions, which are now fragmented outside Quebec (where the Mouvement Desjardins has become a full-service financial conglomerate with a strong base built on local *caisses* (Canada 1998c, 111). A similar proposal is to establish a framework for cooperative banks so that they could operate on a national basis, along the lines of Rabobank Nederlands, a Dutch private cooperative bank.

These measures are sensible and potentially significant, and they should be pursued. Rabobank's long history does, however, limit its relevance to what might be feasible in a modern, mature financial market.

Capital Taxation. The Paper also contains a promise to reexamine, with the provinces, capital taxation policy to see whether an alternative revenue-raising measure can be identified. This commitment to find a tax that does not place large Canadian-owned banks at a competitive disadvantage relative to their nonregulated and foreign competitors, as the capital tax does, is long overdue in a world of mobile capital.

Public Accountability Statements. Other measures in the Paper reflect the recommendations of the MacKay Task Force. One would require banks to prepare annual public accountability statements. This measure would be discriminatory in that it would apply only to financial institutions with more than $1 billion in equity. Institutions of not-insignificant size that, for example, securitize credit card and other receivables, would not be required to issue such statements. Surely this measure, given its policy justification, should apply to all organizations. (The Paper contains an extensive list of contributions to society that institutions are implicitly required to make.)

Coercive Tied Selling. A second proposal aims to prevent coercive tied selling. This proposal responds to anecdotal evidence as indicated earlier, which applies only to banks rather than to all financial institutions.

Statistical Reporting. A third proposal would require better statistics on SME business financ-

ing. This measure would also be potentially discriminatory in that Schedule I banks account for half of SME debt financing. Would the institutions that supply the other 50 percent also to be required to submit such detailed reports?

It is also worth noting that each of these measures would have to be paid for. In the end, the added costs would be handed on to customers.

Standard Low-Cost Accounts. One measure, to ensure access to a standard low-cost account, addresses a reasonable issue in an unnecessarily interventionist manner. Ottawa's goal is to ensure that all Canadians can obtain basic banking services, but the Paper provides specifics even on pricing and the number of transactions that should be available.

Many Canadians agree with the general thrust of such a proposal. But it is another matter for the government to design how such access should be provided. If there is a market to be served, the banks should be required to design a basic package that they can provide at reasonable cost. They should then be allowed to find the lowest-cost way of meeting the requirement.

Determining the pricing and contents of such a package through the regulatory framework would be a misuse of that framework and likely would be counterproductive. With no incentive to innovate, the account would be more expensive than necessary. And without clearly specified eligibility requirements (presumably to embrace those on welfare or disability benefits), there would be room for substantial abuse, something the government probably does not intend.

Regulatory Improvements

The thrust of the Paper's fourth objective is to make regulatory improvements. The focus is on prudential regulation and measures to enable the CDIC and the OSFI to respond to the evolution of the financial services industry.

The MacKay Task Force had recommended merging the CDIC with analogous institutions in the life insurance industry (the Canadian Life and Health Insurance Compensation Corporation, also known as CompCorp). The House Committee accepted the idea with the proviso that it first be studied in more detail, but the Senate Banking Committee rejected the proposal, and the Department of Finance followed suit.

The MacKay Task Force's recommendation rested on the assumption that Ottawa's guarantee for deposits via the CDIC influences the competitive playing field between deposits and similar instruments supplied by insurance companies, such as short-term deferred annuities. One of the reasons for rejecting the proposal is that the CDIC and CompCorp insure different instruments. Only bank deposits pose systemic risk. Extending the government's financial commitments to insurance products would increase those commitments enormously and violate the systemic risk principle of such insurance. (Moreover, life insurance companies can gain access to CDIC's guarantee by setting up subsidiaries.)

The public debate also produced proposals to merge the OSFI and the CDIC, an argument the government rejected. But the Paper says that the way CDIC standards are administered would be streamlined and the OSFI would be given additional supervisory powers to deal with the potential for increased risk associated with the additional competition the government seeks to introduce into the system. It would have added powers to discipline or remove directors of financial institutions who misbehave, to deal with related-party transactions, and to impose administrative money penalties for noncompliance with undertakings or violations of legislation and regulations.

Implications of the Reform Proposals

Canadians should expect that a major policy paper of this kind would promote a well-functioning financial system that advances the country's economic objectives, strengthens the efficiency and soundness of the financial system, safeguards the public in its dealings with that system, and ensures the system's adequacy to meet current and prospective needs of producers and users in efficient, flexible, nondiscriminatory, and creative ways. In this section, I discuss some of the Paper's main implications in the light of these criteria for good policy.

More Players

One of the Paper's main thrusts is to promote domestic competition by widening entry to the payments system and by encouraging more small players, including small, wholly foreign-owned banks, which, presumably, the government hopes would provide Canadians with what they say they want — a wide range of deposit and lending services and credit availability to small businesses.

It is unlikely, however, that these services would be forthcoming from any institutions but the existing full-service players. In 1998, a widely cited foretaste of the future was Wells Fargo's provision of small business credit by mail; by late 1999, Wells Fargo had turned its sights elsewhere.

Encouraging smaller players is worth the try, but past experience with them in the Canadian market does not give much hope for the future. They have tended to be higher-cost, low-return players, insufficiently diversified in their asset base or inadequately managed to thrive.

Some of the potential foreign players could be expected to aim at the wealth-management sector of the market — which is not what policy intends. Others could be expected to service the retail market (which might include big retailers, such as Sears and Canadian Tire). But would they be willing to make the huge investments necessary to provide any but the most basic banking services?

The Issue of Scale

The Paper sidesteps the option of promoting an efficient, high-quality financial sector based on a small number of low-cost players that are allowed to achieve scale through mergers. Encouraging more small players implicitly assumes that they can operate successfully without seeking the economies of scale.

The issue of scale is worth examining in a little detail now that much of the smoke created by the 1998 bank merger proposals has cleared. Going forward, Canadians will still have to face the issue of the large banks in the mature Canadian market seeking to increase efficiency and to grow through domestic mergers. Policymakers ask why they cannot grow through crossborder mergers so that the issue of domestic concentration would not arise. The other option to achieve scale, it should be noted, is to undertake crosspillar mergers.

Case Studies

Case studies in the MacKay report review the policy rationales for allowing consolidation in the United States (which is not really comparable to Canada because of its market size and its history as one of the world's most fragmented financial markets) and in Australia, the Netherlands, and Switzerland. In the three latter cases, governments decided to allow financial institutions to merge in order to achieve the critical mass deemed necessary to compete in the global marketplace (although the Australian government decided that its four major

banks may not undertake mergers until certain credit availability criteria in the small business sector are met). Canada's policy framework rejects this strategy, though not the goal.

Academic Literature

The academic literature on scale is dominated by studies of US institutions, mostly banks. Some studies on Japanese and European banks are available, but there are very few crossborder studies and almost no international comparisons.

The US studies generally indicate that cost savings on the order of roughly 20 percent can be achieved through rationalization of operations and through greater managerial efficiency. But such studies are complicated by other evidence that diseconomies of scale set in when very large institutions merge; this evidence is backed up by qualitative judgments that, as size increases, more decisions (such as those on lending) are made by rules than by solution-oriented management judgments.

Where the literature is particularly weak is on the qualitative economies of scale, particularly in banking. Practitioners argue that the size of a bank's balance sheet influences the risks it can take, its brand, its reputation, and, linked to all of these, its access to low-cost capital from international sources. Those internationally recognized banks that are well up the list in Tables A-1 and A-3 tend to do business with other large, well-known institutions, which gain access to lower-cost capital and are able to participate in large, profitable syndicated financial transactions. In addition, the capital costs of leading banks are now huge because of the costs of technology, human capital, and advertising required to establish brand-name recognition.

If left to themselves, banks tend to grow rather than strip themselves down to leaner, more focused entities. This tendency may have a lot to do with their cost structures, which are very difficult to document and study in a systematic way.

As Table A-3 indicates, most of the largest bank mergers in the 1990s have been domestic mergers — that is, between banks (rather than crosspillar) in the same country. Few are crossborder outside Europe.

There is, of course, no clear rule about success since the perceived (and realized) benefits of mergers depend on managerial abilities to realize potential synergies and economies of scale after the fact. But the literature captures many of the potential benefits of domestic mergers: cost reduction; increased efficiency; new economies of scale in spending on technology, asset management, and custodial functions;[8] and the larger balance sheets and lower costs of capital necessary to retain domestic customers in wholesale banking (which foreign entrants are most likely to try to woo away). The social costs of consolidation are equally well known: increased concentration, reduced customer choice, job losses, and branch closures.

The Canadian Situation

Canadian banks could increase their scale by seeking crossborder mergers with (or acquisitions of) smaller US banks, which would bring access to foreign knowhow, capital, and technology; help to retain Canadian wholesale customers who would otherwise go abroad; and presumably preserve choice, jobs, and branches in the retail operations in Canada.

The costs and risks of crossborder mergers are, however, considerable. Finding the right partner is difficult, and executing the merger of different cultures and institutions that have been regulated differently is a major challenge.

Several Canadian banks have acquired small US banks over the years, but it is difficult

8 Indeed, Canadian banks have moved in recent years to merge their back office functions, such as cheque processing, in order to capture the large economies of scale available in such transactions.

to find a partner with which a pooling of interests and a share exchange are possible. For historical reasons, the US banking system is uniquely fragmented, with many small banks focused on very localized business. The five largest Canadian banks are national full-service institutions, but they have smaller balance sheets and market capitalizations than the largest US banks with similar businesses (about half the capital and assets of those at the bottom of the top 25 in Table A-1). The weak Canadian dollar is an additional obstacle at present.

These are some of the reasons Canadian banks argue they need to grow at home in order to internationalize.

An alternative exists. When the proposed mergers were denied in 1998, several banks changed their business plans so as to direct available finance to their successful lines of business and starve the unsuccessful ones. Over time, market forces will bring about greater specialization among the five large banks. (Differentiation is already apparent in their international operations.) More lively competition will appear in the Canadian marketplace as banks move away from their historical goal of being identical full-service players. The process will likely be slow.

One way to accelerate it would be to allow domestic mergers with the *quid pro quo* that the new partners aim to split themselves into more focused companies representing their major lines of business; for example, a merged entity could essentially divide itself into a corporate bank, a wealth-management institution, and a retail-only bank, each competing actively in the home market. While the merged entities of Table A-3 show no signs of stripping themselves down in this way, that is no reason Canadian banks could not change the rules of the game, to use strategic management parlance.

The Paper effectively continues to deny Canadian banks the option of domestic mergers. This approach denies them their preferred means to grow (with the exception of carrying out crosspillar mergers and acquisitions, such as that of Canada Trust by the Toronto-Dominion Bank in 1999) unless they sell themselves to widely held financial institutions that are foreign owned (presumably by Americans). The possibility is quite real, therefore, that Canadian banks will become foreign controlled, or they will simply become minor-league players with relatively high production costs, a high cost of capital, and technology that is not state of the art.

Refusing domestic mergers hinders technological innovation, which requires scale for spreading costs. This proposition has been the subject of debate, it should be noted, with some arguing that banks can achieve their technology goals by buying new technologies off the shelf — that is, by outsourcing. This may be true for small and medium-sized institutions, but it is a management, not a policy, decision.

Foreign Ownership

Any discussion of scale among Canadian banks implies the issue of foreign ownership, since one strategic policy option, nowhere discussed, would have been to allow domestic mergers and to offset the impact on concentration of supply by allowing greater market access for foreign services providers as other countries, such as the Netherlands, have done. It is worthwhile to consider the case for and against foreign ownership as a way of promoting greater efficiency and flexibility in the financial services sector.

The economic benefits of foreign participation in a domestic financial system are well known. Foreign services providers, first and foremost, enhance domestic competition. They also bring knowledge of the latest products and risk-management techniques; they upgrade the skills of the people they employ; they often provide high-quality financial services at lower cost; and they diversify a coun-

try's financial system, both in terms of the choice of products and the way they are delivered to users of their services and in terms of ownership of and access to the resources of the foreign owners.

The costs or risks of greater foreign ownership (or, conversely, the case for Canadian control) are more qualitative. The MacKay report provided a thoughtful examination of Canadian control of the industry. It observed that, when firms are Canadian controlled, key strategic decisions are more likely to be made from a Canadian perspective, that the key head office jobs are more likely to be based in the country, and that the country benefits from the tax revenues generated by the industry. But it also points out:

> No single argument is sufficiently persuasive to justify retaining Canadian control as a public policy objective. Rather it is the weight of argument which leads the Task Force to conclude that it is not appropriate to abandon such a policy. (Canada 1998b,173.)

The government's proposals call for "enhancing the international competitiveness of the sector in light of the globalization of financial services, while at the same time maintaining strong, vibrant domestic financial institutions" (Canada 1999). If the government had been serious and thorough in weighing the costs and benefits, it would have given more weight to allowing larger, more globally competitive Canadian institutions, while opening up to more foreign competition. In sidestepping this option, the government is subjecting Canadians to a very real danger that the competitive players at home will be rendered less competitive by the overall approach in the Paper and fall further behind in terms of global best practice and efficient supply of services.

Discrimination and Higher-Cost Services

One of the Paper's internal contradictions is that it is discriminatory, something a major policy paper of this kind should not be. It professes to serve consumer interests, while it would deny the banks permission to offer auto leasing and insurance in their branches. It would leave consumers with higher-cost distribution systems — which, in the case of auto leasing, are owned by foreigners and in insurance are supplied by inefficient producers.

The Paper would also increase the regulatory burden on successful low-cost producers while constraining their options to enhance their competitiveness and productivity. The regulatory burden would grow in several ways. First, the added regulatory overlay of the FCA and the new accountability mechanisms would apply to banks but not to non-banks. Why should new entrants choose to be banks?

Second, in a number of instances the government has chosen intervention and regulation over market forces to achieve many of its consumer objectives. The proposed FCA, CFSO, and public accountability statements are all designed to ensure that banks are more responsive to communities and customers, but these interventions would themselves increase the incentives to close marginal branches as quickly as possible.

Third, both the new ownership rules and the holding company structure are considered to be second-best alternatives to mergers, or banks would have chosen them before now.

Fourth, the Paper proposes new sources of administrative discretion and potential political pressure, which could erode system soundness. Ministerial discretion would extend to new areas, such as membership in the payments system, and areas that seem to be open to political pressure, such as winding up failing institutions.

Focus on the Consumer

The Paper's emphasis on the consumer forces financial institutions to reevaluate their customer services models, which is a healthy, if not widely welcomed, focus. Consumers stand to gain from the added choice if new institutions are established; they stand to gain from better-quality service resulting from innovations introduced because of added competition and new entrants with new models and new ideas; and they stand to gain from lower costs.

Consumers also appear to gain in that it is ostensibly their interests that the FCA would advance. But the Paper indicates that producers would cover the costs of the agency, which means that consumers ultimately would pay. They would also lose from the Paper's intention of confining them to inefficient distributors of auto leasing and insurance products.

Long-Term Growth

The Paper's authors have not considered the overall impact of its measures on the economy's long-term growth and efficiency. A well-developed financial services industry is a source of long-term growth in an economy. Financial services contribute to growth because these institutions have the skills to pool the capital of savers, the skills and resources to manage the risks presented by borrowers and other users, and the know-how to ensure that capital is used efficiently. These are the institutions that facilitate innovation and entrepreneurship by making capital available, appropriately priced for the risks, to unproven new enterprises. The information and communications technology revolution is also revolutionizing the ability of banks and other financial institutions to manage risk in ways that would have been impossible even five years ago and enabling them to serve small businesses more effectively.

Canada's big banks and insurance companies also contribute to the long-term growth of the knowledge-based economy because they are, above all, knowledge-based businesses. They employ large numbers of people and equip them with sophisticated skills in decisionmaking, electronic applications, and risk management. Many of these individuals move on to start up their own businesses or to work in other sectors of the economy.

Summary

Taken together, some of the Paper's key decisions (on ownership, holding companies, and access to the payments system) would allow the large financial institutions to innovate, although much is still to be defined in legislation and regulations. These measures, particularly wider access to the payments system, would increase competition.

But many of the recommended measures, such as effectively denying banks domestic mergers and business powers and adding to the regulatory burden, would have a negative impact on competition and efficiency. They may enjoy short-term public popularity, but they would condemn both producers and users of financial services to long-term servitude.

Recommendations

The foregoing are significant issues that Canadians' elected representatives should take seriously in debating the Paper and its implementing legislation. A high-cost, overregulated financial sector will not be a vibrant source of productivity growth and employment for the next generation of Canadians. The onus lies on government and the financial institutions to make alterations in the framework document and the industry.

With these concerns in mind, I offer eight recommendations for changes that should be considered in going forward.

1. *The objective of policy should be to improve the quality and efficiency of financial services, not to increase the number of players.*

The Paper is ambivalent about allowing a competitive marketplace. It puts existing, relatively low-cost producers (the large banks) in straitjackets with respect to how they carry on their business. It does not envision the use of competition in an optimal fashion. It counts on new entrants to increase competition and create a second tier of smaller financial institutions.

Whether the hope of encouraging new entrants to a mature market is realistic remains to be seen. Some view the effort as worthwhile and unlikely to run serious risks. Yet there *are* risks.

New entrants are unlikely to offer what Canadians say they want: a wide range of services and credit supply to small business. These will be provided only by current full-service players. In addition, financial history is replete with examples of small financial institutions' being wiped out because they lacked the diversified assets, geographic base, and management skills necessary to manage the risks of economic downturns and other adversities.

The authorities argue that bank failures should not be viewed as catastrophes but as normal business possibilities. The key issue, they say, is the *handling* of weak or failing institutions — by taking prompt action to wind them up. This argument flies in the face of evidence that the failure of financial institutions can be contagious because of the fragility of confidence. The vow of prompt action also lacks credibility in the light of the politicization of the Paper.

To dispel these doubts, the government should develop a formula, such as exists in the United States, that spells out the windup process. The criteria for defining a weak or failing institution should be clearly spelled out so that they can be fairly applied in a transparent way. The formula could be evaluated every five years and modified to ensure that it works effectively.

2. *The federal government should move to depoliticize the policy environment.*

A troubling feature of the Paper is the highly charged and politicized atmosphere in which it was written. One of the outcomes is its discriminatory elements. Ministerial discretion replaces competitive market outcomes. It lacks a well-thought-out definition of the consumer and what that consumer's interests are. It favors nonbanks over banks in the business powers decisions; it gives insurance companies access to the payments system but denies banks a *quid pro quo*.

The Paper is also interventionist, proposing increased ministerial and administrative discretion in several ways. Large bank mergers would ultimately be decided by the minister of finance. Standard bank accounts would be designed administratively, rather than by the banks. The minister would decide who gains access to the payment system and how products are distributed, rather than leaving it to the market.

These political decisions ignore the MacKay report's recommendations, for example, that the *quid pro quo* for widening access to the payments system should be wider business powers for banks. The political choices also seriously mix the Paper's signals. It claims to be pro-consumer, yet it would continue to saddle consumers with higher prices than would prevail in a market that allowed free entry.

Together, these two features undermine confidence in the regulatory framework as the means to ensure the efficiency and soundness of the financial system at a time when confi-

dence is an important and fragile commodity. This is part of the Paper's unfortunate ambivalence about the pressures of globalization and the domestic backlash.

These discriminatory and interventionist tendencies should be reconsidered and reversed in the legislation. The discriminatory decisions about business powers eventually must be reversed; the role of oversight should be to monitor market outcomes and intervene only in the face of market failure, which has not been proven in these instances. The government should seriously consider modifying the process for merger review and consumer regulation to make them crisper and more oriented to the national interest by balancing the interests of both consumers and producers. It should delegate to the OSFI or the Bank of Canada the authority to close failing institutions and to make decisions about parts of the payments system. Leaving these powers in the hands of the minister sends the message that the Department of Finance is getting into implementation instead of setting policy. Although the minister ultimately is accountable for both, this signal is the wrong one to send.

3. *The merger review process should be more realistic*.

The available international research is ambiguous as to whether banks continue to be efficient beyond a certain size. Whatever the research says, in the end it is the banks that must compete in the international marketplace, and it is they, not policymakers, who should decide their business strategies.

The federal government must ultimately decide if proposed mergers serve the public interest, but its recent actions have been inconsistent. In 1998, the minister of finance refused to allow two proposed mergers, arguing that reducing the number of large banks from five to three would undermine the safety and soundness of the banking system, reduce competition, concentrate business credit decision-making, and restrict Canadians' choice. Yet in 1999, the acquisition of Canada Trust by the Toronto-Dominion Bank was perceived to serve the public interest[9] by leaving the number of banks intact and avoiding the other negative impacts.

Going forward, Canadians must decide whether they want the federal government to chain the large financial institutions to the domestic market or allow them to become more competitive forces in the international marketplace. The Paper's implicit rejection of the latter option contrasts to the stance of governments in other comparable countries. With the sole (and temporary) exception of Australia, Canada is the only OECD country that fails to equip its banks with a fully stocked arsenal of strategies to compete successfully against their increasingly gigantic international competitors.

The Paper's approach to the merger review process illustrates how the government imprisons the banks by allowing them theoretical freedom but subjecting them to multiple stages of official and public review. If it formalizes such a process, no merger proposals are likely to forthcoming. It is difficult to believe that Ottawa is serious about lifting the proscription on such transactions.

The merger review process needs to be revised because it is unrealistic and discriminatory in several ways. No other kinds of business in Canada face the onerous requirements proposed for bank mergers. The Paper's proposals reflect a lack of understanding of risk management and confidentiality that characterize business transactions in the marketplace. A definition of the process is a step in the right direction, but the multistage process is misguided. It appears to be open ended, imposing no time or resource constraints.[10] In the

9 Though still subject to review by the Competition Bureau, the OSFI, and the minister of finance.

10 In contrast, the Senate Banking Committee was specific, recommending a review period of four months total, including one month for the ministerial decision.

current politicized environment, few managers or directors of publicly owned institutions would be willing to incur the open-ended reputation, cost, and strategic risks implied by such a process.

Moreover, the public interest impact assessment would require a cost-benefit analysis of a proposed transaction that could also be onerous and time consuming. The mechanism is reminiscent of the environmental impact statements introduced elsewhere in the economy in the 1970s. Although these statements mostly mollified public opinion, they probably also increased goods-producing firms' awareness of the social costs of private business transactions. The parallel does not hold up in knowledge-based services.

Additionally, impact assessments for bank mergers would have to be used with great care to preserve confidentiality of sensitive strategic information. Up to now, strategic information on merger transactions has been disclosed only to the relevant minister on a highly confidential basis.

The Paper's focus on transparency provides few signals that the government would be sensitive to these issues. Nor does it define what constitutes a merger.

Thus, considerable refinement is required in this proposal. It should define the transaction, provide for a better-defined, crisper public review of the public interest that recognizes the realities of competitive business transactions in knowledge industries, and specify a time line for a decision.

4. *Canadians should address the foreign ownership issue.*

Going forward, if the federal government is serious about its intention to enhance the international competitiveness of the financial services sector in the light of its globalization, foreign ownership should be seriously analyzed and debated. The Paper proposes to redefine widely held ownership to allow for more crossborder transactions, other than mergers, and it encourages foreign institutions to enter the second tier. These proposals are insufficient to offset the risks of the Canadian financial sector's falling behind in terms of global best practice and efficiency.

The government will have to try harder to face up to the challenges and opportunities of globalization. This issue will not go away. Besides *talking* about competitiveness in international markets, Ottawa would better serve the public interest and awareness by examining

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alternative models for the Canadian financial system to ensure the country's main institutions are world class.

Such an examination would undoubtedly include more encouragement (or less discouragement) of serious foreign entry to the Canadian market. It would include study of the implications of a merger between a Canadian and a foreign bank that goes beyond the issue of where the merged institution might place the head office. And it would examine such options as balancing greater concentration among domestic producers with the added competitive pressures foreign entrants provide.

In implementing its current proposals, the government would have to expend more effort to make them work. One way to do this would be to solve the problems noted earlier concerning foreign retail banks' access to the payments system and to deposit insurance in the event of a crisis.

5. *Administrative and regulatory layers should be reduced and consolidated, not increased.*

Given the major political emphasis on consumer interests in the task force reports on which the Paper is based, it is not surprising to see it recommending establishment of an additional regulatory and review agency to focus on those interests. But creating such an agency, reporting to the minister of finance, would involve significant costs, which the banks would have to pay. Those costs, which would surely rise over time, would be passed on to the consumer, a factor the proposal's writers seem to have ignored.

In addition, the proposals to protect and empower the consumer nowhere define who the consumer is. Does this mean that General Motors is a consumer?

Finally, the new agency would be an additional layer of regulation and oversight within the Canadian system. Other countries are tending to reduce the number of agencies involved in supervision. Canada is moving in the wrong direction, which will disadvantage its financial institutions in seeking to be internationally competitive.

6. *Rules on ownership and holding companies should be spelled out more completely.*

The new flexibilities that may be provided to banks to organize their businesses could be a major change from the status quo. But a number of questions arise.

What would be the "fit and proper" test to ensure the soundness and integrity of the 20 percent share owners? It is difficult to envisage a truly foolproof one. Would it be the only test applied to approve share acquisitions? How would the government prevent share owners from acting together? Would the 20 percent rule be a realistic response to the consolidation of the international financial industry? It is difficult to see this rule holding for long since the impact of 20 percent ownership on control can be the same as 30 or 40 percent.

Similarly, the holding company proposal needs to spell out in more detail the implied supervision. How much would regulatory constraints be reduced on nonbank businesses? Would capital requirements be reduced for lower-risk businesses? Of even greater significance would be the rules to be drafted to implement this proposal. In what range of financial activities would banks be allowed to invest? What limits would be set on minority interests in investments? What would be the rules on related parties or on taxation?

Answers to these many questions must be provided as far as possible in clear, simple legislation that is creative in its approach to organizational flexibility and is consistent with and builds on the existing rules for prudential supervision and disclosure. It should also leave as little room as possible for discretionary decisions.

7. *The regulatory framework requires further improvement.*

One issue in the proposed revision to the regulatory framework relates to institutional mandates. The MacKay Task Force thought the OSFI should take on consumer protection and the responsibility for balancing competition and innovation with safety and soundness. Both the House Committee and the Senate Banking Committee argued that the OSFI should continue to focus on safety and soundness. The Paper proposes the latter course, assigning consumer protection to the FCA and redress to the new ombudsman. The new agency would be given enforcement responsibilities currently carried out by the OSFI, making it an additional regulatory body.

Widespread support for a consumer watchdog seems to exist, but it relates to the interests of households and small businesses that use retail financial services. Why should such a group have regulatory responsibilities? It should play the desired consumer advocacy role and be funded by those interests, not the financial institutions. Instead of proliferating regulatory agencies and the regulatory burden, Canada should be consolidating them.

A second issue relates to decisions on membership in, and therefore access to, the payments system. The government should reconsider whether it is giving the correct signal by giving such decisions to the Department of Finance, rather than to the OSFI or the Bank of Canada. I believe the latter course would be more advisable.

Finally, the tone in the financial regulatory environment needs to become less adversarial. Industry representatives and regulators need to work together to promote efficiency and safeguard the public.

8. *The banks should respond to consumer criticisms as a strategic priority.*

Both the banks and the government are imprisoned in an unsatisfactory status quo, despite all the reports and hearings. The Paper's message to the banks is, we will keep you in chains by constraining your business options and increasing your domestic competitors until you become more responsive to Canadian consumers (presumably households and small businesses). The effect of these policy restrictions is to constrain Canada's low-cost producers and increase the uncertainty they face.

One way out of this contradiction lies in the hands of the banks. The intensity of consumer and political sentiment suggests more than hostility. It signals a pentup demand for a more responsive service model of retail banking *for which people might be willing to pay*. Banks may have a strategic opportunity in responding to this demand. At any rate, they face a constraint until they respond.

Surely it is possible for Canadian financial institutions to be both customer responsive and profitable, as Canada Trust has demonstrated. Canadians are likely to respond to such innovations. They have been among the world's fastest adopters of financial innovations such as automated teller machines and debit cards, which can substantially enhance customer convenience and choice and solve the public policy constraints by providing access to remote users and underserved markets through telephone- and electronic-based services (Canada 1998a, 15).

Conclusion

The contradictions in the federal government's framework paper on financial services policy that this *Commentary* has outlined must be resolved, sooner or later. The potentially significant proposals for holding companies can increase organizational flexibility for the large financial institutions and open new strategic possibilities. New players and expanded access to the payments system will increase

domestic competition. But the impact will be offset by the possibility that more players will likely be high cost, by the chains placed on the large banks, and by the added regulatory burden. These contradictions make the proposed solution unstable for the Canadian financial services sector over the long term and an uncertain stepping stone to the future.

Some people argue that the Paper represents the best set of compromises possible in the adversarial environment in which it was prepared. The public and private sector players bear some responsibility for the environment and for the decisions. But all Canadians will pay the price for the contradictions in the long term.

Does any of this matter? Will the threats and opportunities from rapid integration of capital markets, the Internet, and other technological change provide Canada's financial sector with the incentives and the means around the obstacles created by a policy framework seen as increasingly irrelevant? This possibility exists.

More likely, however, market forces will send both the customers and producers of financial services offshore. Restrictions on economies of scale and scope raise transaction costs. Customers seeking to reduce those costs will use the Internet and integrated capital markets to move their business to lower-cost, more innovative, better-connected offshore providers. Canadian financial firms will follow them.

Crossborder value chains are currently most visible in the goods-producing sectors, such as electronics and automobiles. What is less well recognized is that the financial sector has been *ahead* in arranging crossborder operations. In the goods value chains, production and marketing segments are located at sites around the world that are the most economically attractive. Since these segments are linked electronically, costs and taxes in one location can be avoided by moving activities to other locations. If Canada fails to be a low-cost producer of financial services, customers, producers, and some of the best jobs will move out of the country.

The federal government has pressed its political points and now has the responsibility to depoliticize the policy environment. It should focus more on the overall national interest, which urgently includes the competitiveness of Canada's financial services sector, not just encouraging more high-cost players in retail services. The political chances of such changes could improve significantly if the banks responded both to the depth of the dissatisfaction lying behind the political criticism and to the strategic opportunity in retail banking implied by the demand for realistically priced, customer-oriented services.

The financial services industry is rapidly consolidating whether Canadians like it or not. Political leaders cannot both wring their hands about Canada's faltering productivity performance and wash their hands of efficiency concerns in one of the country's most significant sectors. If policy continues to shrink from this challenge, the financial services sector, which has been a Canadian strength, will become an also-ran in the world economy. The less-mobile among the Paper's much-mentioned Canadian consumers will be the losers.

Table A-1: ***The World's Largest Banks, year-end 1998/99***

	Ranked by Capital			Ranked by Assets			Ranked by Market Capitalization[a]	
				(US$ billions)				
1	Citigroup (US)	41.9	1	Deutsche Bank	732.5	1	Lloyds TSB	60.2
2	BankAmerica Corp (US)	36.9	2	UBS	685.9	2	Nationsbank	51.4
3	HSBC Holdings (UK)	29.4	3	Citigroup	668.6	3	HSBC Holdings	48.4
4	Crédit Agricole Groupe (France)	25.9	4	BankAmerica Corp	617.7	4	Citicorp	42.0
5	Chase Manhattan Corp. (US)	24.1	5	Bank of Tokyo-Mitsubishi	598.7	5	ING Groep	41.7
6	Industrial & Commercial Bank of China (China)	22.2	6	ABN AMRO Bank	504.1	6	UBS	41.3
7	Bank of Tokyo-Mitsubishi (Japan)	22.1	7	HSBC Holdings	484.7	7	BankAmerica Corp.	41.2
8	UBS (Switzerland)	20.5	8	Crédit Suisse Group	474.0	8	Chase Manhattan Corp.	36.8
9	Sakura Bank (Japan)	19.9	9	Crédit Agricole Groupe	457.0	9	Bank of Tokyo-Mitsubishi	30.4
10	Bank One Corp. (US)	19.7	10	Société Générale	447.5	10	Wells Fargo	30.2
11	Fuji Bank (Japan)	19.6	11	Sumitomo Bank	439.7	11	Banc One Corp.	29.9
12	Deutsche Bank (Germany)	18.7	12	Dresdner Bank	427.3	12	Fortis	29.5
13	Sanwa Bank (Japan)	17.7	13	Sanwa Bank	418.4	13	Crédit Suisse Group	29.1
14	Crédit Suisse Group (Switzerland)	17.6	14	Westdeutsche Landesbank Girozentrale	408.4	14	Deutsche Bank	27.8
15	ABN AMRO Bank (Netherlands)	17.5	15	Norinchukin Bank	407.6	15	US Bancorp	26.3
16	Dai-Ichi Kangyo Bank (Japan)	17.2	16	Dai-Ichi Kangyo Bank	396.7	16	Barclays Bank	24.2
17	Sumitomo Bank (Japan)	16.2	17	Industrial & Commercial Bank of China	391.2	17	ABN AMRO Bank	23.9
18	Bank of China (China)	14.7	18	Sakura Bank	389.4	18	National Westminster Bank	22.6
19	Robobank Nederland (Netherlands)	14.7	19	Commerzbank	381.4	19	Sumitomo Bank	22.1
20	Industrial Bank of Japan (Japan)	14.5	20	Banque Nationale de Paris	379.0	20	Banco Bilbao Vizcaya	21.5
21	First Union Corp. (US)	13.6	21	Industrial Bank of Japan	370.4			
22	Barclays Bank (UK)	13.5	22	Chase Manhattan Corp.	365.9			
23	National Westminster Bank (UK)	13.4	23	Fuji Bank	358.2			
24	Tokai Bank (Japan)	13.3	24	Barclays Bank	353.4			
25	Dresdner Bank (Germany)	13.0	25	HypoVereinsbank	337.2			
	Canadian banks, for reference							
	Royal Bank of Canada	7.5			171.0			
	CIBC	7.3			175.3			
	Bank of Nova Scotia	7.0			151.4			
	Bank of Montreal	6.6			144.3			
	Toronto-Dominion Bank	4.9			111.4			

[a] Pre-merger market capitalizations, where relevant.

Sources: *The Banker* 1999; *Financial Times of London* 1999.

Table A-2: ***The World's Largest Securities Firms and Insurers, 1998***

Rank	Company (Country)	Assets	Net Income
		(US$ millions)	
	The Top Five Securities Firms		
1	Merrill Lynch (United States)	212,091	1,259
2	Morgan Stanley Dean Witter (United States)	168,682	3,276
3	Lehman Brothers Holdings (United States)	95,168	736
4	Crédit Suisse First Boston (Switzerland / United States)	212,923	–154
5	Salomon Smith Barney Holdings (United States)	123,818	818
	The Top Five Insurers		
1	AXA Group (France)	449,556	52,683
2	Allianz Group (Germany)	401,406	46,805
3	Nippon Life (Japan)	374,801	51,128
4	Zenkyoren & Prefectural Insurance Federations (Japan)	297,477	46,154
5	Dai-Ichi Mutual Life (Japan)	261,164	35,030

Note: Statistics are for fiscal year 1998.

Source: *Wall Street Journal* 1999.

Table A-3: ***Major Mergers and Acquisitions in Financial Services, by Country, as of June 1999***

		Global Ranking[a]	Capital	Assets
			(US$ billions)	
United States				
Citicorp Travelers	Citigroup	1	41.9	668.6
BankAmerica NationsBank Barnett Banks	Bank America Corp.	2	36.9	617.7
Banc One First Chicago NBD	Banc One Corp.	10	19.7	261.5
First Union Signet Core States		21	13.6	237.4
Wells Fargo Norwest Corp.		30	12.4	202.5
Fleet Financial		50	7.4	104.6
Bank Boston		80	5.0	73.5
United Kingdom				
HSBC Holding PLC		3	29.4	484.7
Republic New York		110	3.4	50.4
France				
Crédit Agricole Banque Indosuez	Crédit Agricole groupe	4	25.9	457.0
BNP		27	12.8	379.0
Paribas		40	9.9	309.4
Switzerland				
UBS SBC	UBS	8	20.5	685.9
Germany				
Deutsche Bank		12	18.7	732.5
Bankers Trust		74	5.4	133.1
Bayerische Vereins Bayerische Hypo	Hypovereins Bank	32	11.9	337.2
Netherlands				
ING Bank BBL	ING Groep	26	13.0	326.8
Generale Bank ASLK-CGER Fortis Bank Netherland	Fortis Bank	41	9.9	323.6
Spain				
Banco Santander		37	10.7	180.8
Banco Central Hispano		98	4.3	95.7
Italy				
Credito Italiano Coriverona Banca CRT Cossomorca	Unicredito	45	8.4	171.7
Canada, for reference				
Royal Bank of Canada		49	7.5	171.0
Bank of Montreal		58	6.6	144.3
CIBC		52	7.3	175.3
Toronto-Dominion Bank		84	4.9	111.4

[a] For 1998/99, by capital.

Source: *The Banker* 1999.

Table A-4: ***Financial System Structures, Selected OECD Countries, 1996***

	Australia		Canada		Netherlands		Switzerland		United Kingdom	
	Number	**Share[a]**	**Number**	**Share[a]**	**Number**	**Share[a]**	**Number**	**Share[a]**	**Number**	**Share[a]**
Commercial banks	32	43.6	11	47.0	84	47.0	935	58.0	135	23.0
Foreign-owned banks	18	2.8	50	3.4	[b]	[b]	291	8.0	333	30.0
Other banking institutions	0	0	3	5.4	14	12.0	1,150	30.0	[b]	[b]
Mortgage credit institutions	25	1.2	0	5.2	3	0.7	[b]	[b]	na	8.4
Finance companies	103	4.3	0	1.6	[b]	[b]	[b]	[b]	na	2.1
Other credit institutions	1,760	9.9	na	11.3	[b]	[b]	962	3.5	na	1.7
Insurance companies	165	17.6	na	7.8	7	13.0	[b]	[b]	na	15.4
Pension funds and foundations	139,000	14.6	7,000	16.6	98	26.5	[b]	[b]	na	15.3
Other insurance institutions	669	6.3	na	1.7	9	0.4	[b]	[b]	na	3.6

Notes: Shares may not add to 100 due to rounding; na = data not available.

[a] Percentage of total financial assets.

[b] No data provided for the category.

Source: OECD, unpublished data.

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