



C.D. Howe Institute
Institut C.D. Howe

Communiqué

Embargo: For release *Tuesday, September 24, 1996*

***Reform of Canadian financial institutions
should focus on consumers, not producers,
says C.D. Howe Institute study***

Putting consumers first is the best way to ensure a sound financial system for Canadians, yet for too long regulatory changes in the financial sector have been preoccupied with an industry perspective, concludes a study released today by the C.D. Howe Institute. Changing this perspective can yield substantial and important changes to the financial sector that will benefit all Canadians, says the study.

The study, *Putting Consumers First: Reforming the Canadian Financial Services Industry*, is a collection of essays focusing on policy questions that are central to the 1997 review of the *Bank Act*, edited by Jack M. Mintz and James E. Pesando of the University of Toronto.

The contribution by Laurence D. Booth, of the University of Toronto, weighs the evidence surrounding competition and profits in the financial sector, to ascertain whether consumers face a competitive market for financial products. In looking at market power, profitability, market value, and other econometric tests of competitiveness in the banking sector, Booth cautions that each poses significant drawbacks and each produces somewhat different results. He concludes that “[a]lthough there is some evidence that banks exercise market power, in a court of law the verdict on such evidence would be that the charge is not proven, rather than that the defendant is not guilty.”

Neil C. Quigley, an Adjunct Scholar of the C.D. Howe Institute, examines the “infrastructure through which financial institutions transfer monetary value on behalf of their clients,” known as the Canadian payments system. The Canadian Payments Association (CPA) oversees the system, and has considerable power over its evolution. Quigley suggests, however, that the CPA is an inappropriate guardian of the payments system on three grounds. First, given the importance of the payments system to the functioning of monetary policy, responsibility should be turned over to the Bank of Canada. Second, the current arrangements are causing Canada to lag behind other industrial countries in the development of “real-time” settlement capability and large-value transfer mechanisms. Third, the CPA has a conflict of interest since its board is made up largely of incumbent institutions in the payments system who have an interest in restricting access to competitors.

Quigley accepts that “access to the payments system must have some restrictions.” But the development of large-value and real-time settlement mechanisms that would follow reforms would alleviate the potential risk of system-wide failures from smaller players in the system, since such mechanisms would mean entrants would have to meet certain market, as opposed to regulatory, constraints before entry into the payments system is assured.

Consultant John L. Evans looks at the rapid technological innovations that are occurring in the financial industry, not only in Canada, but internationally, and issues a stern warning that failure to recognize the speed of change threatens the viability of Canada’s regulatory framework for financial services. In a technological world, for example, “it may not be possible for governments to impose...regulatory impediments to the transborder provision of retail payments services.” Evans suggests that “entry barriers based on industry membership should be eliminated in favor of entry requirements based on minimum standards of solvency, disclosure, and behavior.” More than housekeeping will be required to take proper account of technological advances, Evans concludes. If we miss the opportunity in 1997, “Canada — and Canadian institutions — [might] have lost an important opportunity to establish a global competitive stronghold in retail financial services.”

This book is the third in a series of C.D. Howe Institute publications preceding the 1997 *Bank Act* review. The first was a Commentary by Edwin H. Neave entitled *Canadian Financial Regulation: A System In Transition*. The second was a book by Ignatius J. Horstmann, G. Frank Mathewson, and Neil C. Quigley entitled *Ensuring Competition: Bank Distribution of Insurance Products*.

* * * * *

The C.D. Howe Institute is Canada’s leading independent, nonpartisan, nonprofit economic policy research institution. Its individual and corporate members are drawn from business, labor, agriculture, universities, and the professions.

- 30 -

For further information, contact:

James Pesando (416) 978-4854
Susan Knapp (media relations), C.D. Howe Institute
phone: (416) 865-1904
fax: (416) 865-1866
e-mail: cdhowe@cdhowe.org
Internet: <http://www.cdhowe.org/eng/pr/new.html>

Putting Consumers First: Reforming the Canadian Financial Services Industry, Policy Study 27, edited by Jack M. Mintz and James E. Pesando (C.D. Howe Institute, Toronto, September 1996). 332 pp.; \$14.95 (prepaid, plus postage & handling and GST — please contact the Institute for details). ISBN 0-88806-388-1.

Copies are available from: Renouf Publishing Company Limited, 5369 Canotek Road, Ottawa, Ontario K1J 9J3 (stores: 71¹/₂ Sparks Street, Ottawa, Ontario; 12 Adelaide Street West, Toronto, Ontario); or directly from the C.D. Howe Institute, 125 Adelaide Street East, Toronto, Ontario M5C 1L7. For trade book orders, please contact: McGraw-Hill Ryerson Limited, 300 Water Street, Whitby, Ontario L1N 9B6. For college book orders, please contact: Prentice-Hall Canada Inc., 1870 Birchmount Road, Scarborough, Ontario M1P 2J7.



C.D. Howe Institute
Institut C.D. Howe

Communiqué

Embargo: à diffuser *mardi*, le 24 septembre 1996

La réforme des établissements financiers canadiens devrait viser les consommateurs et non les producteurs, affirme une étude de l'Institut C.D. Howe

Accorder la priorité aux consommateurs est la meilleure façon d'assurer un système financier viable pour les Canadiens, mais depuis trop longtemps, on considère les changements réglementaires du secteur financier sous l'angle de l'industrie. Telle est la conclusion d'une étude publiée aujourd'hui par l'Institut C.D. Howe. La modification de ce point de vue pourrait apporter des changements considérables pour le secteur financier dont tous les Canadiens seraient en mesure de profiter, affirme l'étude.

Intitulée *Putting Consumers First: Reforming the Canadian Financial Services Industry (Donner la priorité aux consommateurs : la réforme de l'industrie des services financiers au Canada)*, l'étude comprend une série de comptes rendus, sous la direction de Jack M. Mintz et de James E. Pesando de l'université de Toronto, qui portent sur les questions de politique qui sont centrales à la révision de 1997 de la *Loi sur les banques*.

Le document soumis par Laurence D. Booth, de l'université de Toronto, analyse les preuves soumises en matière de concurrence dans le secteur financier et des bénéfices que réalise celui-ci, afin d'établir si les consommateurs disposent d'un marché vraiment concurrentiel en matière de produits financiers. En évaluant le pouvoir et la valeur de marché, la rentabilité et d'autres tests économétriques de compétitivité du secteur bancaire, Booth indique que ces éléments comportent des désavantages importants et que chacun entraîne des résultats quelque peu différents. Il conclut que « bien qu'il y ait des preuves que les banques exercent un pouvoir sur le marché, cet argument ne pourrait être prouvé en cour — on en arriverait à la seule conclusion que l'accusé n'est pas coupable ».

Neil C. Quigley, attaché de recherche à l'Institut C.D. Howe, se penche sur « l'infrastructure qui permet aux établissements financiers de transférer la valeur monétaire au nom de leurs clients », connue sous les nom de Système canadien des paiements. L'Association canadienne des paiements (ACP) supervise ce système et contrôle largement son évolution. Cependant, suggère Quigley, l'ACP est une gardienne inopportune du système des paiements pour les trois raisons suivantes : en premier lieu, étant donné l'importance du système des paiements pour le fonctionnement de la politique monétaire, il s'agit d'une responsabilité qui devrait incomber à la Banque du Canada. En second lieu, les dispositions actuelles forcent le Canada à accuser un retard sur les autres pays industrialisés dans l'élaboration des capacités de

règlement « en temps réel » et des mécanismes de transfert de grande valeur. Finalement, l'ACP est en conflit d'intérêt puisque son conseil d'administration est formé principalement des établissements titulaires du système de paiement qui ont tout intérêt à en restreindre l'accès à la concurrence.

Quigley admet que « le système de paiements doit comporter certaines restrictions ». Mais l'élaboration de mécanismes de règlement en temps réel et de paiements de grande valeur qui suivrait des réformes atténuerait le risque de défaillance à l'échelle du système de la part des participants de moindre taille, puisque ces mécanismes forceraient les nouveaux venus à se plier à certaines exigences de marché (plutôt que réglementaires) avant d'être en mesure de participer au système des paiements.

John L. Evans, un consultant, se penche sur les innovations technologiques rapides qui se déroulent dans l'industrie financière, non seulement canadienne mais internationale, et il avertit que si l'on ne tient pas compte de la rapidité de ces changements, on porte atteinte à la viabilité du cadre réglementaire canadien des services financiers. Ainsi, dans un univers technologique, « il pourrait s'avérer impossible pour les gouvernement d'imposer [...] des obstacles réglementaires aux dispositions transnationales des services de paiements de détail ». Evans suggère que « l'on élimine les barrières à l'entrée en fonction de la qualité de membre de l'industrie en faveur d'exigences d'entrée fondées sur des normes minimales de solvabilité, de divulgation et de comportement ». Une simple administration interne ne suffira pas à tenir compte des progrès technologiques, conclut Evans. Si nous ne profitons pas de l'occasion en 1997, « le Canada — et les établissements canadiens — auront manqué la possibilité d'établir un bastion concurrentiel au niveau mondial dans le domaine des services financiers de détail ».

Ce recueil est le troisième d'une série de parutions de l'Institut C.D. Howe qui précèdent la révision de 1997 de la *Loi sur les banques*. Le premier était un *Commentaire* d'Edwin H. Neave intitulé *Canadian Financial Regulation: A System in Transition*. Quant au second, il s'agissait d'un livre d'Ignatius J. Horstmann, de G. Frank Mathewson et de Neil C. Quigley intitulé *Ensuring Competition: Bank Distribution of Insurance Products*.

* * * * *

L'Institut C.D. Howe est un organisme indépendant, non-partisan et à but non lucratif, qui joue un rôle prépondérant au Canada en matière de recherche sur la politique économique. Ses membres, individuels et sociétaires, proviennent du milieu des affaires, syndical, agricole, universitaire et professionnel.

Renseignements :

James Pesando : 416 978-4854
Susan Knapp (relations avec les médias), Institut C.D. Howe
téléphone : 416 865-1904
télécopieur : 416 865-1866
courrier électronique : cdhowe@cdhowe.org
Internet : <http://www.cdhowe.org>

Putting Consumers First: Reforming the Canadian Financial Services Industry, Étude de politique n° 27, sous la direction de Jack M. Mintz et de James E. Pesando, Toronto, Institut C.D. Howe, septembre 1996, 104 p., 14,95 \$ (les commandes sont payables d'avance, et doivent comprendre les frais de manutention et d'envoi, ainsi que la TPS — prière de communiquer avec l'Institut à cet effet). ISBN 0-88806-388-1.

On peut se procurer des exemplaires de cette publication auprès des : Éditions Renouf ltée, 5369 chemin Canotek, Ottawa ON K1J 9J3 (librairies : 71¹/₂, rue Sparks, Ottawa ON et 12, rue Adelaide ouest, Toronto ON), ou encore en s'adressant directement à l'Institut C. D. Howe, 125, rue Adelaide est, Toronto ON M5C 1L7. Pour les commandes commerciales, prière de s'adresser à : McGraw-Hill Ryerson Limited, 300, rue Water, Whitby (Ontario) L1N 9B6. Pour les commandes d'établissements d'enseignement, veuillez communiquer avec : Prentice-Hall Canada Inc., 1870, chemin Birchmount, Scarborough (Ontario) M1P 2J7.

Contents

Foreword	v
Introduction , by <i>Jack M. Mintz and James E. Pesando</i>	ix
Competition and Profitability in the Financial Services Industry , by <i>Laurence D. Booth</i>	1
The Efficiency of the Capital Market	3
Measuring Market Power	8
Profitability Measures	17
Market-Value Approaches	27
Econometric Approaches to Measuring Competition	34
A Concluding Comment	35
Appendix	37
Public Policy and the Canadian Payments System: Risk, Regulation, and Competition , by <i>Neil C. Quigley</i>	41
The Canadian Payments System	42
The Bank of Canada's Role	52
Access to the Payments System	59
Conclusion	65
Technological Change and the Regulation of Financial Services , by <i>John L. Evans</i>	73
A View of the Emerging Financial Management World	74
Investment Services	76
A View of the Emerging Payments System	80
Regulation: A View of Why It Works	88
Conclusion	94
The Contributors	99
Members of the C.D. Howe Institute	101

Introduction

Jack M. Mintz
and
James E. Pesando

On January 5, 1996, the Institute for Policy Analysis and the Faculty of Management at the University of Toronto organized a one-day conference entitled "Issues in the Reform of the Canadian Financial Services Industry." The purpose was to examine a set of policy questions that are central to the 1997 legislative review and that are still open for discussion.¹

In its *Interim Report on the 1992 Financial Institutions Legislation* (August 1995), the Standing Senate Committee on Banking, Trade and Commerce had written:

The subject of financial reform has too often been addressed in the past solely from an industry perspective. Reform this time should reflect a consumer, rather than company, focused orientation. (p. 13.)

The authors of the papers in the volume, including ourselves, strongly endorse this view of the regulatory and legislative framework for financial services.

¹ This point merits emphasis. For example, most analysts agree that financial services legislation should address the widely acknowledged limitations of deposit insurance in order to impose market discipline and so contain the incentives for excessive risk taking. Yet Ottawa spokespersons have made it clear that major reform of the deposit insurance system will *not* be included in the 1997 financial services legislation.

Overview

This volume contains three papers prepared for the conference. Each deals with an important policy theme.

Competition and Profitability

The first paper, by Laurence Booth, is motivated by the need for an objective assessment of the link between competition, concentration, and profitability, with particular attention to the role of the major banks within Canada's financial services industry.

It is fair to say that the size of the chartered banks (as well as their recent profitability) has itself become a major issue in the policy debate. For example, those who oppose legislative reform that would permit banks to sell insurance products from their branches argue that any reduction in the cost of delivering these services would be reflected in the banks' profits, not in lower prices to consumers.

The question, then, is whether increased concentration in the financial services industry has served to reduce competition and to increase bank profits. Yet it is a question on which public discussion often appears to lack objectivity.

What do we know about the relationship between competition and concentration? Does research support the concern that the major banks exercise too much market power to the benefit of their shareholders and at the expense of consumers?

Booth seeks to answer these questions in a dispassionate manner. To start, he provides an insightful discussion of the concept of efficiency as it pertains to financial markets. He then reviews two types of evidence that potentially bear on the issue of market power: concentration ratios (the proportion of consumer credit, mortgages, or loans extended by the five major banks or by banks as a whole), and profitability and deviations from marginal cost pricing.

Critics of the banks often use concentration ratios to buttress their argument that the size of the major banks inhibits competition. Booth points out that aggregate concentration ratios are of limited use in assessing market power. There is no simple relationship

between the number of firms in an industry and the degree of competition, and the definition of the market for a particular financial service may be difficult to establish.

He considers the possibility that one can determine whether the major banks have market power by looking for direct evidence of excess profits (measured, for example, by the rate of return on equity) relative to the level of profits that would exist in a competitive industry in which shareholders bore comparable risk. This, too, turns out to be a difficult task. Booth draws attention, as well, to the potential usefulness of stock market data in the form of market-to-book values and event studies.

Booth concludes that, on balance, existing studies do not provide convincing evidence of excess bank profits or of a lack of competition, although the rates of return on equity, once adjusted for risk, do seem to be higher for banks — and utilities — than for other Canadian industries. As he goes on to show, however, other measures that depend on things such as the ability of banks to influence prices do not seem to indicate excessive market power.

The Payments System

The second paper, by Neil Quigley, turns to the Canadian payments system, a highly visible issue on which the banks and other financial institutions have taken opposite positions. Yet, as Quigley emphasizes, the design basics of the payments system transcend the interests of the various types of institutions and raise important issues regarding both competition and efficiency.

The *Canadian Payments Association Act* of 1980 provides the Canadian Payments Association (CPA) with responsibility for operating a national clearing and settlement system. As Quigley notes, the current structure of the CPA presents several problems. In particular, it restricts the ability of market demand to promote the development of alternative settlement technologies, it appears incompatible both with emerging technological developments and with the direction of financial services regulation, and it inappropri-

ately assigns responsibility for public policy goals to a private organization.

Quigley offers two key recommendations. First, the CPA monopoly on the provision of settlement services should be withdrawn, as should the requirement that chartered banks be members of the CPA. Second, the Bank of Canada should be asked to assume responsibility for the public interest issues surrounding the payments system. Quigley argues that the public interest in the payments system, which is to promote efficiency and minimize risk, is directly aligned with the interests of the Bank of Canada.

Regulation and Technological Change

No consumer of financial services in Canada is unaware of the dramatic impact that technological innovation, particularly in computers, has had on the delivery of these services. The proliferation of automated teller machines and the imminent expansion of electronic banking (for example, the delivery of financial services by Bayshore Trust through the Internet) are visible examples. What are the implications for financial regulators of this accelerating pace of technological innovation? To what extent is the scope for financial regulation altered or constrained, particularly in light of international forces?

John Evans's paper on the subject focuses on retail financial services in an environment of rapidly changing computer, communications, and networking technologies. His analysis is necessarily informal and driven by examples, but its basic message can be stated succinctly. Emerging technologies are facilitating the development of a global marketplace for electronic financial services by eliminating entry barriers that have insulated local markets from external competition and by widening the alternatives available to consumers.

The resulting empowerment of consumers of financial services poses a significant challenge to regulators. Evans seeks a corresponding change in regulatory emphasis, from dealing with the producers of financial services to protecting the interests of consumers.

In this spirit, he argues for the elimination of restrictions on the types of institutions that are allowed to be members of the payments system and that can produce and market certain types of financial products. Rather, participation should be open to any firm that meets objective criteria relating to factors such as solvency, disclosure, and management competence.

Evans concludes that the 1997 round of legislative reform should not be a “housekeeping” one. Rather, it must be designed to accommodate technological innovation and an increased international presence, enabling market forces to better serve the interests of consumers.
