Intelligence MEMOS

From: Jeremy M. Kronick

To: Canada's Financial Regulators and Policymakers

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Re: **Unleashing Productivity Gains in Financial Services**

Productivity improvement is considered the primary driver of economic growth in advanced countries because labour and capital are finite and generate diminishing returns as their utilization increases. The key role the financial services sector plays in Canadian economic growth means we would hope and expect to see the industry drive productivity in two ways: first, by improving its own output per worker and capital input (internal productivity) and, second, as a by-product of the financial intermediation services it provides to the rest of economy (external productivity).

But over the last 15 years, Canada's financial sector has lagged other OECD countries in its contribution to productivity growth, as I show in my latest C.D. Howe Institute report.

My analysis also indicates that Canada has experienced low aggregate productivity levels and growth rates over the same time period. Improving the financial sector's productivity would boost not only the sector's performance but also the economy as a whole.

Part of the explanation for these relatively poor results is that the nation has a policy approach that needs to look differently at the link between competition and productivity, a regulatory structure that does not always reflect international best practices, and less efficient allocation of capital due to disproportionate mortgage lending incentives.

Here are some steps that could help to remedy the situation.

- Remove barriers to the development of fintechs through a functional approach to regulation;
- Implement regulatory oversight that is proportionate to functional risk;
- Consider whether a more explicit productivity mandate is useful for Canadian regulators, in part based on the innovative ideas coming out of the UK's Financial Conduct Authority's focus on competition and productivity;
- Revise the *Bank Act* and *Insurance Companies Act* to allow more flexibility for banks and insurance companies to make substantial investments in fintechs and insuretechs whose primary function is the delivery of financial services (Ottawa's budget enabling legislation, tabled late last month, indicates it may be moving on this, but no details have yet emerged);
- Since it is unlikely politically to have one (or twin) national financial-sector regulator(s) with legislative/statutory powers, focus on achievable goals such as making clear what arrangements are in place between federal and provincial regulators for the sharing of market data related to, for example, the analysis of financial stability in capital markets, and strengthen links between market-conduct regulators across provinces and functions; and
- Reduce incentives for banks to lend to less productive residential mortgages by charging lenders mortgage-insurance premiums that reflect idiosyncratic risk beyond just loan-to-value ratios (see Koeppl and MacGee 2017).

Jeremy Kronick is a Senior Policy Analyst at the C.D. Howe Institute.

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