Background Working Papers On Financial Institutions Issues

Financial Institutions and
Markets Division
Department of Finance

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Department of Finance Canada
Ministère des Finances Canada

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PREFACE AND CONTENTS

Compiled in the present package are seven working papers on trends and policy issues in the Canadian financial sector. These papers were produced by Capital Markets Division in the Department of Finance, from January to May, 1984. These are working papers whose intent is to provide background for discussions of issues of current interest; they do not represent official views of the Government of Canada. The sequence of the papers is as follows:

CANADIAN FINANCIAL INSTITUTIONS: TRENDS AND POLICY PERSPECTIVES

JANUARY 1984

A Working Paper for
Discussion and
Consultation

CAPITAL MARKETS DIVISION
DEPARTMENT OF FINANCE

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1. INTRODUCTION

The Canadian financial system is passing through a period of rapid and accelerating change. Inflation, legislative changes, changing market opportunities, technological change, and interest rate volatility have all played a part in fostering change. These developments have led financial institutions to re-assess their current roles and to re-evaluate their future prospects. New financial instruments are being developed, institutions are diversifying their activities, and new institutional forms are emerging. Inevitably, this has led to pressure for a re-assessment of the structure of financial regulation.

Some institutions are seeking modifications to the regulatory structure to "even out the playing field". They argue that all types of institutions engaged in similar activities should be able to compete on an even footing. However, many institutions are also expressing concern about the implications of removing the traditional barriers that have separated the activities of the various institutions. They argue that allowing unconstrained competition among institutions that differ greatly in size may lead to the demise of the smaller institutions.

Governments, meanwhile, must look at the public interest and the implications for efficient functioning of capital markets. The need for some regulatory change seems clear and is reflected in the urgency with which financial institutions are pressing for a review of legislation which affects them. Yet there is no consensus on the extent or direction of change that is desirable. This discussion paper seeks to place into perspective the developments that are changing the financial landscape and to review the public policy concerns that will need to be addressed as the review of financial legislation proceeds.

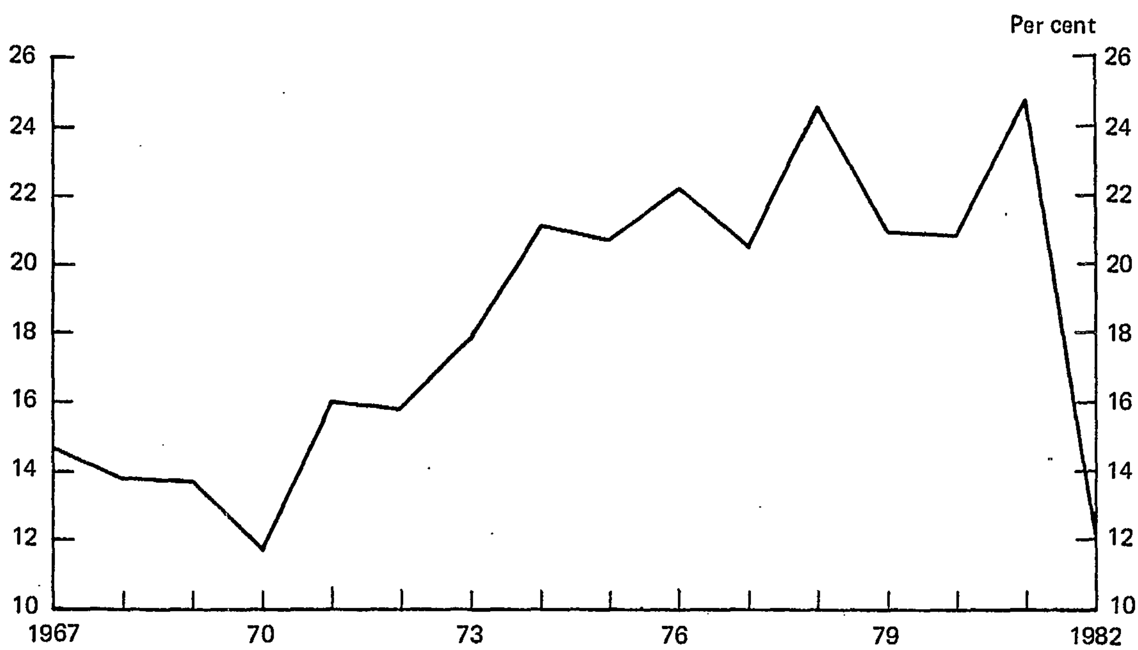
2. AN OVERVIEW OF THE STRUCTURE OF THE CANADIAN FINANCIAL SYSTEM

The existence of financial markets reflects the fact that some individuals, institutions and indeed entire sectors in the economy generate savings while others require credit. The nature and characteristics of financial markets, the institutions that operate in them, and the instruments created for use within them, represent the solutions to the basic requirement of transferring funds from lenders to borrowers in the most efficient and convenient way possible.

The total flow of funds through the financial markets can vary significantly over time. Through the first half of the 1970s, for example, the total borrowing of the non-financial sector in Canada, expressed as a percentage of the Gross National Product (GNP), rose steeply. It remained high through the second half of the 1970s and the first years of the 1980s before plunging steeply in 1982 with the onset of the recession (see Chart 1).

Chart 1

Total Borrowing of the Non-Financial Sector as a Percentage of Gross National Product 1967-1982



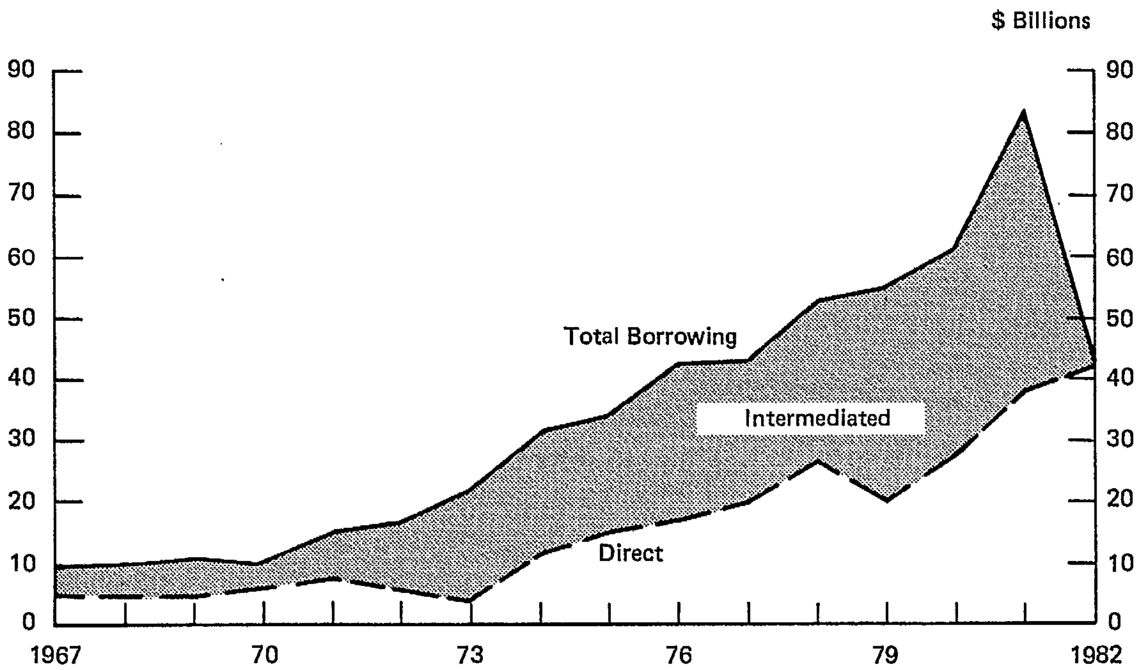
Source & notes: See statistical appendix.

Financial markets bring together borrowers and lenders in two ways: in direct financing, borrowers and lenders transact business directly, with or without the aid of a broker or other financial agent; in intermediated financing, the lenders' funds are accumulated by intermediaries and lent out in an entirely separate process to borrowers. Direct financing is open mainly to governments, Crown corporations and large private corporations. Intermediated financing is available to small borrowers and is also an option for borrowers, such as large private non-financial corporations, who participate heavily in the direct markets. From the investment side, the direct market is also utilized mainly by the large investors. Small investors generally invest their funds through intermediaries, although many individuals also have holdings of stocks and Canada Savings Bonds.

Through the 1970s and into the early 1980s, the relative importance of direct financing declined and reliance on financial intermediation increased, as shown in Chart 2. This reflected several factors: (i) rapid growth in demand for mortgage and consumer loans, which are financed largely

Chart 2

Net Direct and Intermediated Borrowing of the Non-Financial Sector 1967-1982



Sources & notes: See statistical appendix.

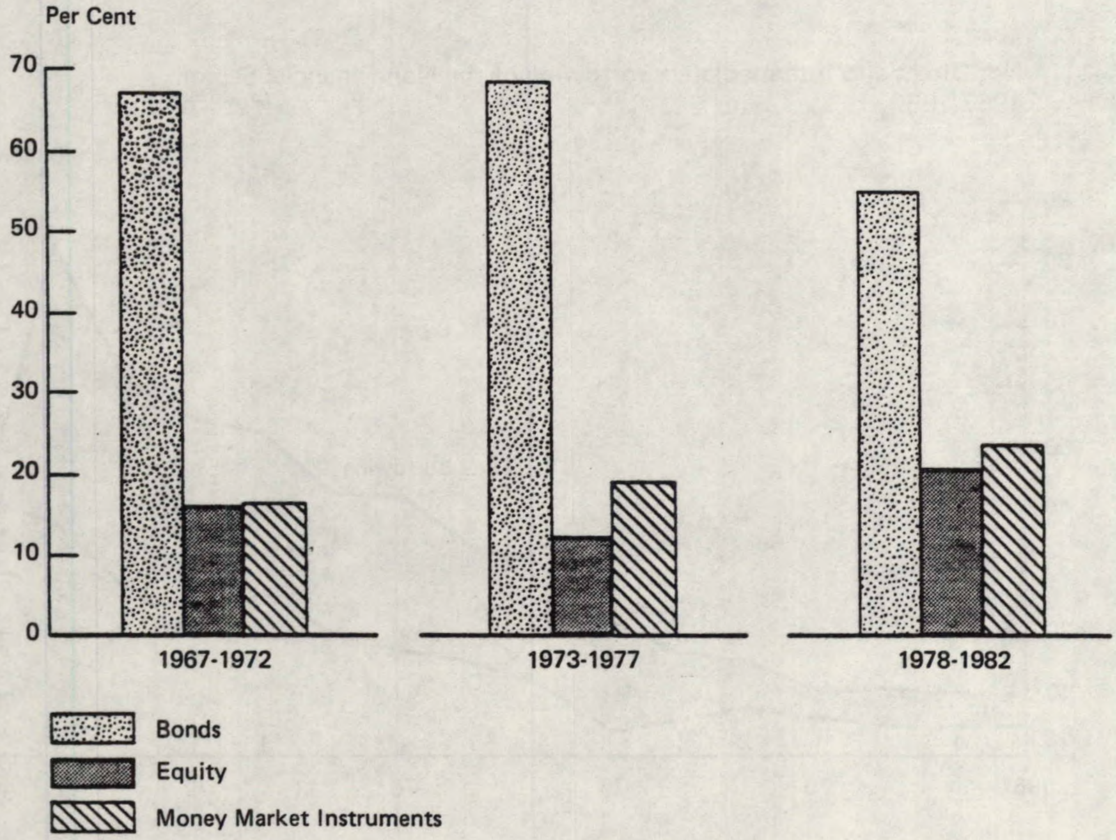
by financial intermediaries; and (ii) a shift by non-financial corporations away from bond and equity financing to bank loans. In 1982, however, this trend was broken. Net intermediated borrowing came to a halt when consumers began to pay down credit balances and the corporate sector repaid loans. Direct financing, on the other hand, was maintained as the corporate sector issued large amounts of new equity to restructure balance sheets, while the government sector issued a large volume of bonds to finance growing deficits.

DIRECT FINANCING

The relative importance of bonds, equity and money market instruments in total direct financing has changed significantly over the course of the past decade and a half (see Chart 3).

Chart 3

Distribution of Direct Market Financing by Type of Instrument; Period Averages, 1967-1972, 1973-1977, 1978-1982



Source & notes: See statistical appendix.

During the 1970s, equity issues were low as stock markets were persistently depressed. In the late 1970s, increased investment in term preferred shares provided a boost to the equity market. Term preferred shares, however, unlike common and preferred shares, can be tendered back to the issuer at a specified time and price and, therefore, bear a greater resemblance to debt than to "permanent" equity. It was not until the stock market revival which began in August, 1982 that there was a resurgence of issues of preferred and common stock. The bond market was also weak through the latter half of the 1970s and in the early 1980s as interest rate and inflation rate uncertainty increased the risk of using long-term, fixed-rate instruments for borrowing or lending. These same factors, however, led to the very strong growth in the money market which provided both investors and borrowers with the flexibility desired in those circumstances. As a consequence of these developments, corporate debt-equity ratios increased, and the term structure of outstanding market instruments shortened considerably.

FINANCIAL INTERMEDIARIES

Table 1 below shows the assets held by the major groups of financial institutions in 1967 and 1982, and their shares of total financial-system assets in those years. The main trends in the last decade and a half have been the increase in the share of assets held by deposit-taking institutions and the decline in the share of assets of contractual savings institutions as a group.

Table 1
Financial Assets of Canadian Financial Institutions, 1967 and 1982

	Billions of dollars		Per Cent of System Assets	
	1967	1982	1967	1982
Major Deposit-taking Institutions				
. Chartered Banks	24.0	194.6	32.0	37.1
. Trust and Loans	7.0	49.8	9.3	9.5
. Cooperatives	3.3	35.1	4.4	6.7
Contractual Savings Institutions				
. Life Insurers	12.8	43.6	17.0	8.3
. Trusteed Pension Funds	8.0	68.6	10.7	13.1
Other Financial Institutions				
. Private	14.1	92.7	18.8	17.7
. Public	5.9	40.6	7.9	7.7
Total	75.1	525.0	100.0	100.0

Source and notes: see statistical appendix.

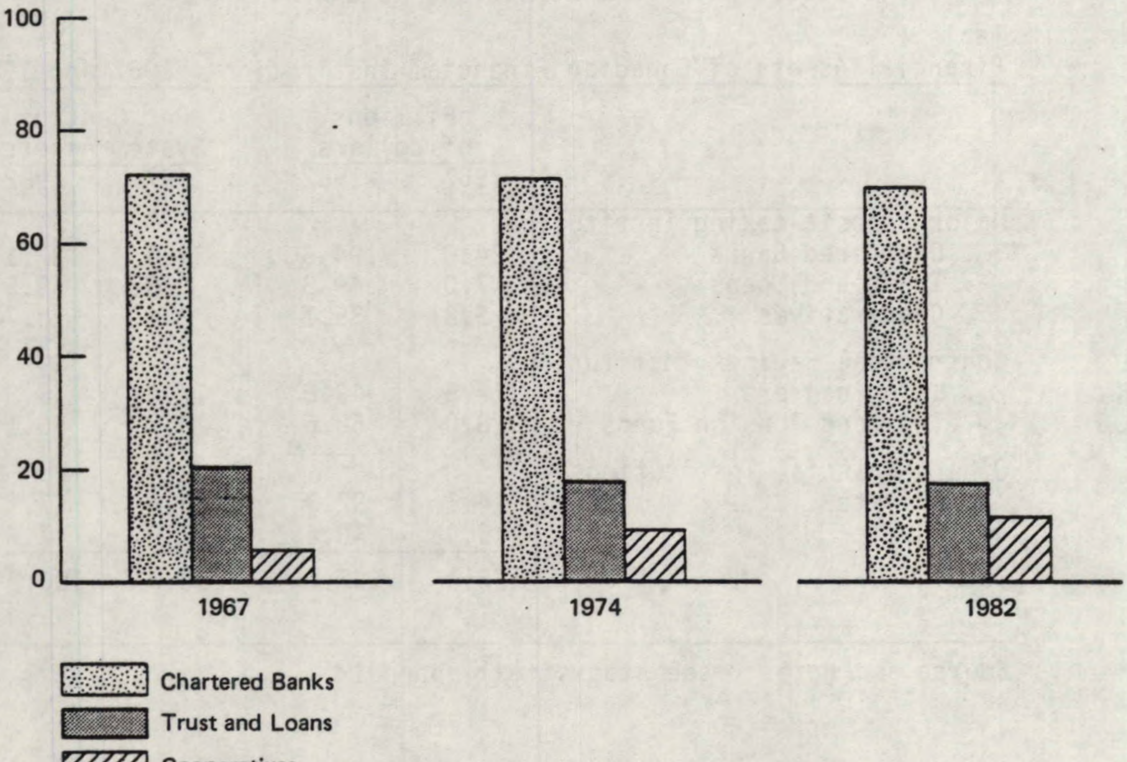
The size of financial asset holdings understates the importance in the financial system of institutions which provide services on a fee basis. The investment dealers, for example, have comparatively small asset holdings but play a central role in direct markets as they participate in the underwriting and distribution of most new issues of corporate and government securities and act as brokers for secondary trading. Trust companies, meanwhile, in their fiduciary function administer assets which exceed in size their holdings of intermediated assets. Insurance companies also play an important role in managing segregated assets.

Deposit-taking Institutions

The successful growth performance of Canadian deposit-taking institutions in the last decade and a half reflected rapid growth in deposit liabilities - about 15 per cent per annum between 1967 and 1982. In this period, the cooperative institutions managed to almost double their share of deposit liabilities from 6 per cent in 1967 to slightly less than 12 per cent in 1982. The chartered banks and trust and mortgage loan companies, meanwhile, both experienced a modest decline in their shares of deposit liabilities (see chart 4).

Chart 4

Shares of Deposit Liabilities Held by Deposit-Taking Institutions 1967, 1974 and 1982



Source & notes: See statistical appendix

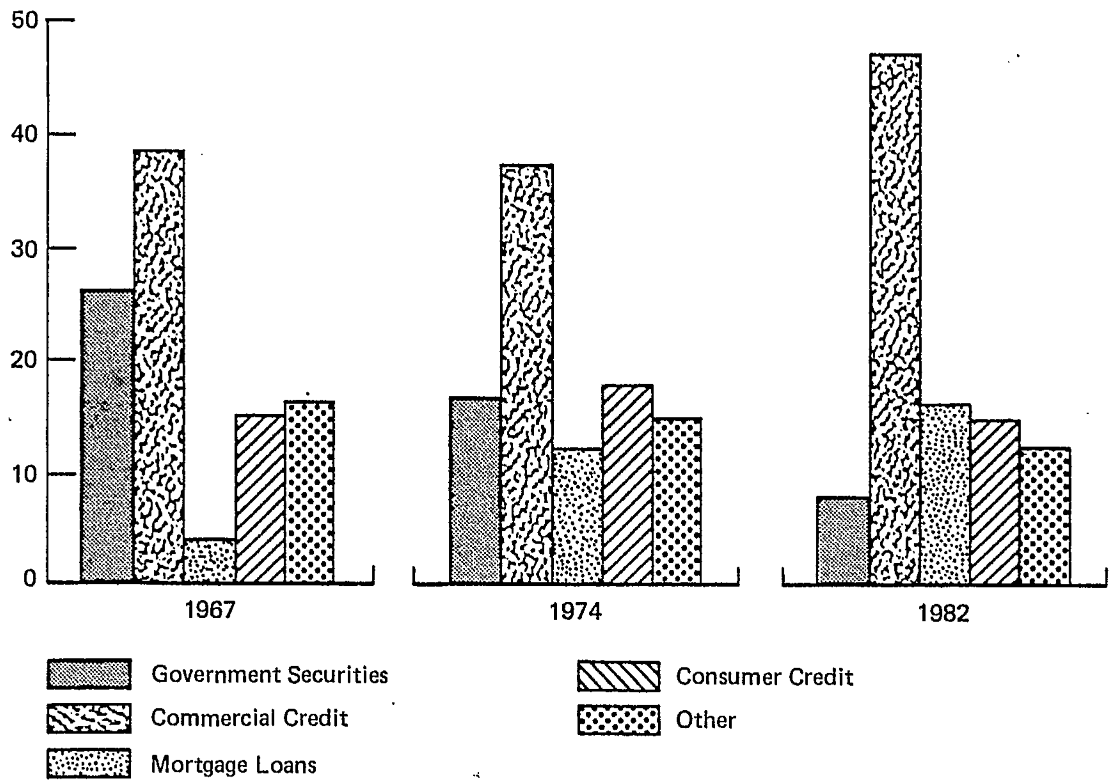
Two importance developments which affected trends in this period were: (i) the removal in 1967 of interest rate ceilings on chartered bank loan rates, and the lowering of reserve requirements on term deposits, which enhanced the banks' ability to compete for term deposits; and (ii) the introduction of deposit insurance, also in 1967, which enhanced the ability of the near banks to compete with the chartered banks for deposits.

The Chartered Banks

The chartered banks are the major suppliers of commercial credit in Canada and business loans constitute the largest item in their asset holdings (see Chart 5). Mortgage loans, however, have been the fastest growing asset in their balance sheet over the past decade and a half. Consumer loans, meanwhile, have increased only marginally as a share of

Chart 5

Chartered Banks: Structure of Financial Assets
1967, 1974, and 1982

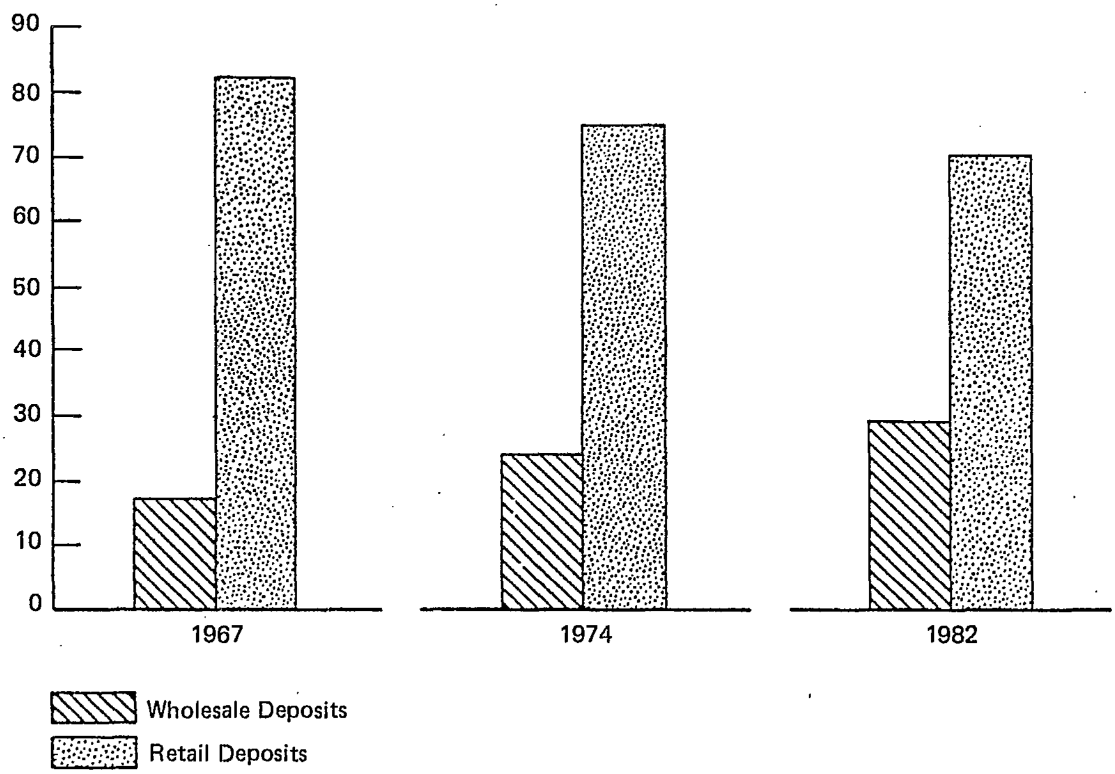


Source & notes: See statistical appendix assets although the banking system has significantly increased its share of that market over the period. With the growth in these asset categories, the banks have reduced the share of assets held in government securities. In recent years, bankers' acceptances, while not a source of balance sheet growth, have been a rapidly growing source of fee income for the banks, as well as an increasingly important alternative form of financing for business.

An important development on the liability side of the banks' balance sheets has been the growth of wholesale deposits in conjunction with the growth of the money market (see Chart 6). Wholesale deposits are of particular importance as a source of funds to the foreign-owned banks which do not have large branch networks to gather retail deposits. Another significant trend since 1967 has been the increase in term deposits as a share of deposit liabilities.

Chart 6

Chartered Banks: Wholesale and Retail Deposits as Shares of Canadian Dollar Deposit Liabilities, 1967, 1974 and 1982



Source & notes: See statistical appendix.

In the 1970s, the chartered banks increased significantly the extent of their foreign currency business. Indeed, since the mid-1970s, the growth of foreign assets and liabilities has substantially exceeded growth of Canadian dollar operations. Foreign currency assets now account for over 40 per cent of the chartered banks' total assets compared to 22 per cent in 1967.

Trust and Mortgage Loan Companies

As financial intermediaries, trust and mortgage loan companies are funded almost entirely by term savings deposits and invest predominantly in mortgages (see Chart 7). Their personal and commercial lending activities are limited. Personal loans constituted only 3.5 per cent of assets in 1982, and commercial loans only 2.5 per cent. Their role in business finance has increased somewhat in the past decade and a half, however, through purchase of corporate bonds and debentures.

Chart 7

Trust and Mortgage Loan Companies: Structure of Financial Assets
1967, 1974 and 1982

Source & notes: See statistical appendix.

A significant factor in the growth of trust companies' fiduciary activities in recent years has been the management of trusteed pension funds. Commissions from real estate sales and management have also been taking on increasing importance in their operations.

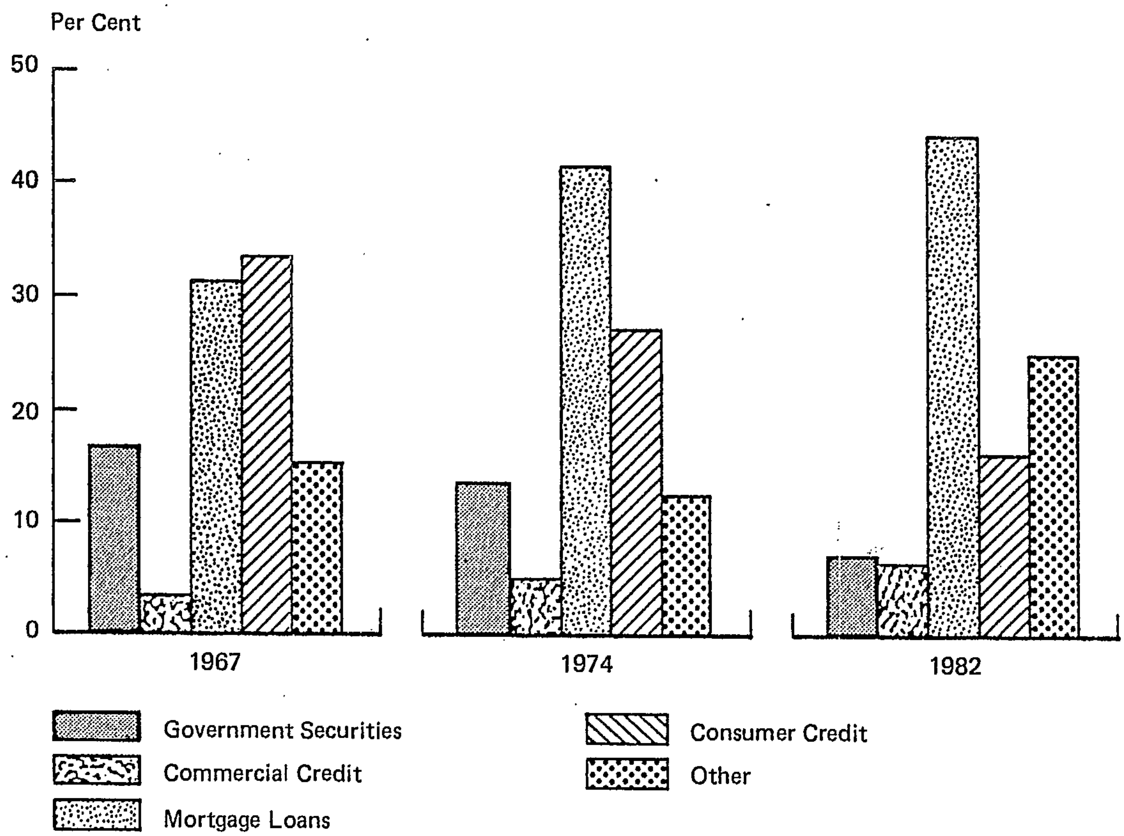
Credit Unions and Caisses Populaires

Credit unions and caisses populaires are savings institutions with assets consisting chiefly of consumer and mortgage loans. They are local, non-profit institutions organized under provincial statutes. Provincial centrals provide the local societies with liquidity protection and an outlet for their surplus funds. The Canadian Cooperative Credit Society (CCCS), a national umbrella organization which represents all the major cooperative institutions outside of Quebec, provides the same service to the provincial centrals, as well as a number of administrative and other services. The Quebec-based Desjardins Group has a similar three-tier structure with local caisses populaires, regional unions, and a provincial umbrella organization with a number of financial and non-financial affiliates.

Deposits account for over 90 per cent of all liabilities with non-transferrable shares accounting for the remainder. On the asset side, personal loans and mortgages predominate (see Chart 8). Mortgage loans have grown

Chart 8

Local and Central Credit Unions and Caisses Populaires: Structure of Financial Assets, 1967, 1974 and 1982



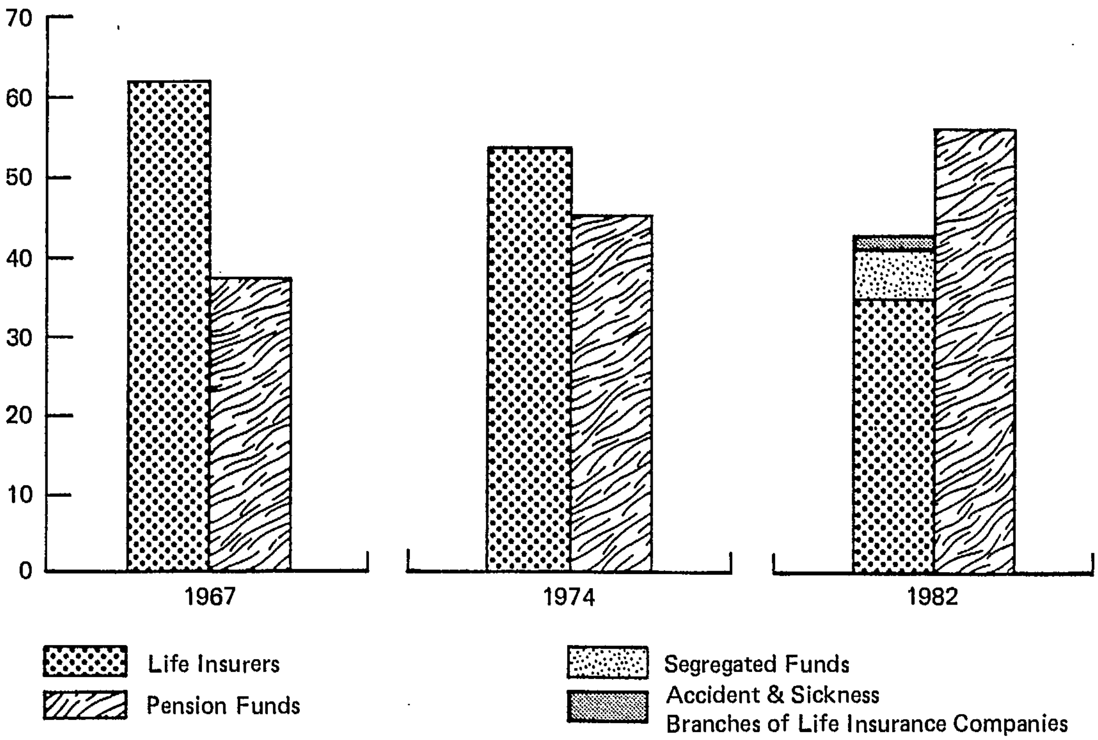
particularly quickly in the past decade and a half and the cooperatives have increased their share of the mortgage market from 5.7 per cent in 1967 to 12.1 per cent in 1982. On the other hand, consumer loans have declined significantly as a share of assets and the cooperatives have seen a small decline in their share of the consumer credit market. Commercial credit, although still a minor part of the cooperatives' balance sheets, has been gaining steadily in importance. Over all, the total asset growth of the financial cooperative sector has, in the period since 1967, outstripped the asset growth of any of the major deposit-taking institutions.

Contractual Savings Institutions

These institutions, which include life insurance companies and pension funds, acquire their funds on a contractual basis. Due to the relatively predictable nature

Chart 9

Shares of Contractual Savings Held by Financial Institutions
1967, 1974 and 1982



Sources & notes: See statistical appendix

of their revenues and outlays they can pursue longer-term investment strategies. In the last decade and a half, there has been a decline in the share of contractual savings in intermediated liabilities. As well there has been a shift of contractual savings out of life insurance and into pension funds (see Chart 9).

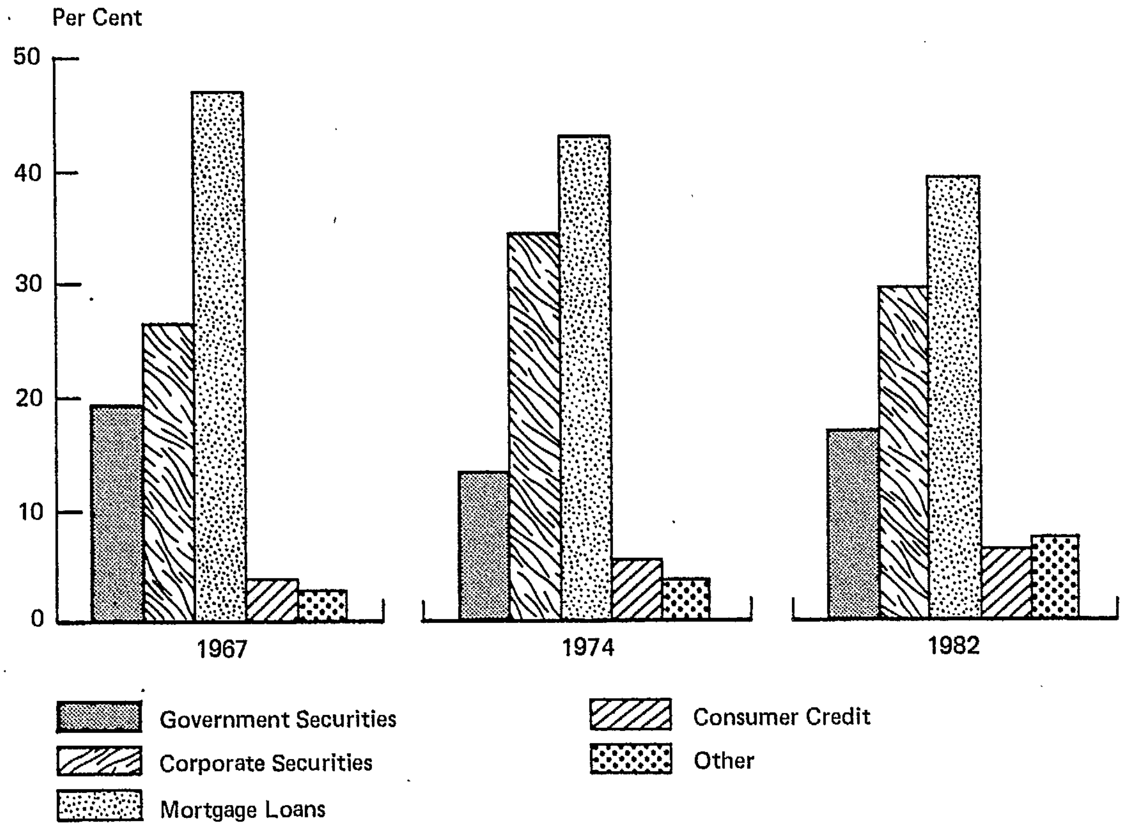
Life Insurance Companies

Life insurance companies sell two major types of instruments: insurance contracts and annuities. Their balance sheets grew relatively slowly throughout most of the postwar period reflecting the decline in popularity of their major contractual savings vehicle, endowment insurance, and the switch to group and term insurance. Annuities of all types (individual, group, deferred and immediate) now account for over half of premium income. The short-term individual deferred annuity is a close substitute for a deposit instrument and competes in the savings market with term deposits and guaranteed investment certificates offered by banks and trust and loan companies. During the recent period of rapidly rising interest rates, some life insurance companies began to offer daily interest deferred annuities.

In their investment activities, insurance companies are subject to explicit limits on proportions of portfolios which can be invested in certain types of assets and to a variety of "eligibility" criteria for specific investments. Insurance companies invest heavily in mortgages although they have, in recent years, virtually withdrawn from the individual residential mortgage market and now concentrate on commercial and industrial mortgages. At the same time, mortgage loans have declined fairly significantly as a share of assets. On the other hand, the share of assets of combined holdings of government and corporate securities, the other major types of investment, has remained relatively constant over time, although there have been fluctuations in the relative proportions (see Chart 10). Life insurance companies increased their direct holdings of real estate, in the 1970s, both as an inflation hedge and for tax purposes. Management of segregated funds is also a growing source of fee income.

Chart 10

Life Insurance Companies: Structure of Financial Assets
1967, 1974 and 1982



Source & notes: See statistical appendix.

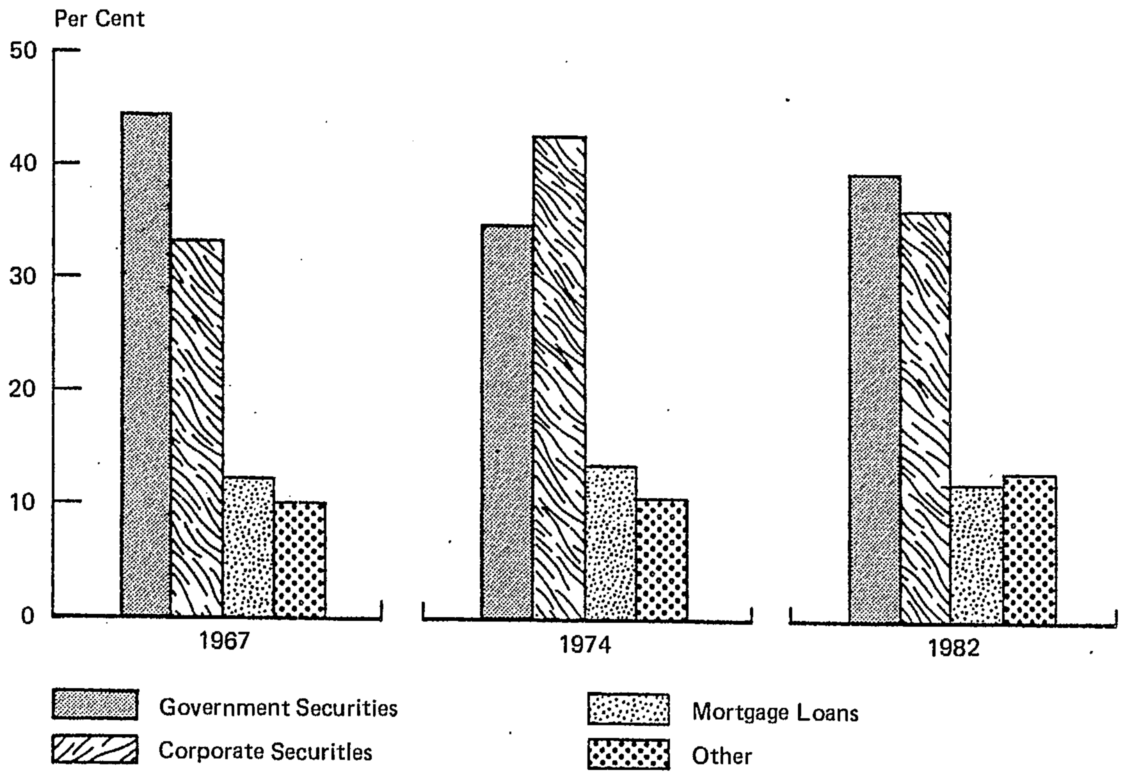
Trusteed Pension Funds

In the postwar period, pension funds have experienced rapid growth and have become a major source of long-term capital. This rapid growth reflects a number of factors including the spread of pension arrangements, increased richness of pension plans, and tax incentives for retirement savings. Pension funds, like life insurance companies, are subject to a number of portfolio restrictions and "eligibility" tests for particular investments.

The balance sheets of trusteed pension plans are dominated by government and corporate securities, which, combined, account for three quarters of asset holdings. As in the case of the life insurance companies, this proportion has remained fairly constant over time although the distribution between public and private securities has varied. Mortgages increased somewhat as a share of assets through the 1970s before declining again in the 1980s. Otherwise there have been no major trends (see Chart 11). Direct holdings of real estate have also become more important in the pension funds' portfolios, largely because of the potential inflation hedge they provide, but also because of the poor performance in the 1970s of equities, the traditional inflation hedge.

Chart 11

Trusteed Pension Funds: Structure of Financial Assets
1967, 1974 and 1982



Sources & notes: See statistical appendix

Other Financial Institutions

In addition to the main groups of intermediaries, there is a wide variety of smaller, usually highly specialized firms that have found niches to fill in the financial system. A number of types of companies are involved in business finance through financial leasing, venture capital, and the financing of inventories and accounts receivable. Other companies provide consumer loans, although these have declined significantly in importance over the last few decades. There are also a variety of investment funds which permit small investors to participate in a wider array of investments than they could individually. Finally, there are financial institutions that do not, by and large, engage in financial intermediation but rather provide underwriting and brokerage services. These include the investment dealers and the general insurance companies. Altogether, this varied group of institutions accounts for roughly one-fifth of financial system assets. Despite some significant changes in the composition of the group over time, this proportion has not changed very much in the last decade and a half.

There are also a number of Crown corporations which function as financial intermediaries. Federal institutions include Canada Mortgage and Housing Corporation, Farm Credit Corporation, Federal Business Development Bank, and Export Development Corporation. As intermediaries, these institutions can be characterized as residual lenders in their respective areas. There are also a number of provincial financial institutions, the largest of which are the Alberta Treasury Branches, which carry on a variety of intermediary functions. Together, they have accounted for slightly less than 8 per cent of financial system assets, with no major trend in this share in evidence.

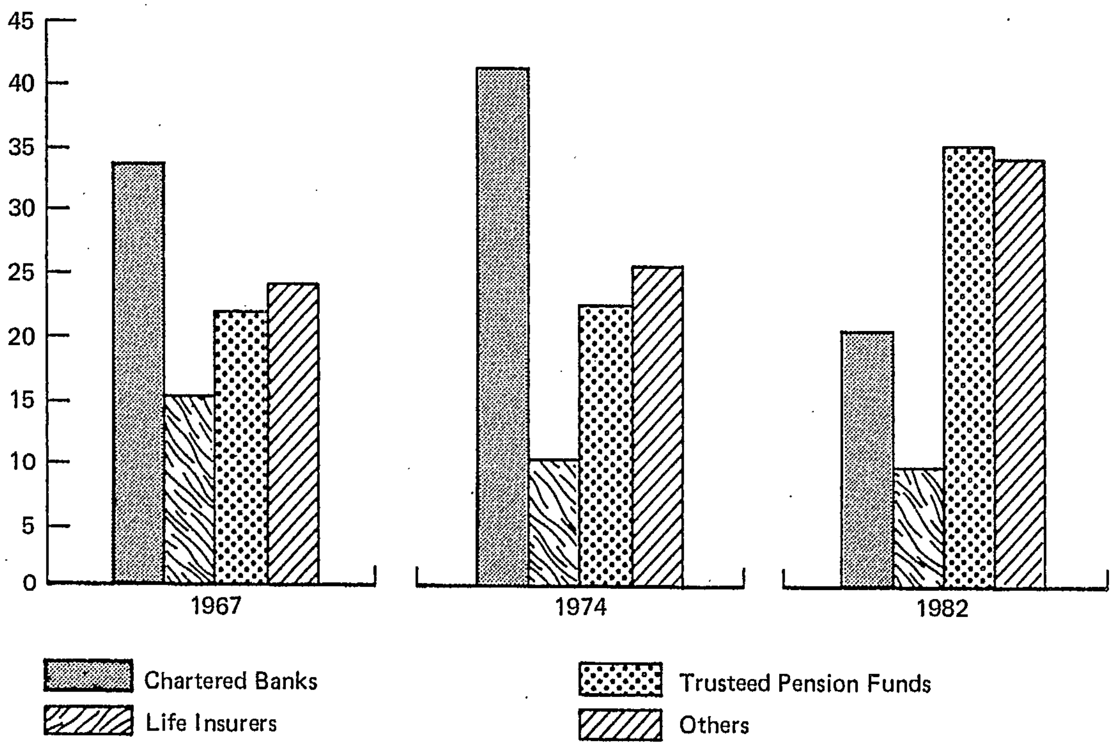
MARKET DEVELOPMENTS

Government Finance

Government debt includes Treasury bills, savings bonds and marketable bonds from all levels of government. The non-financial sector has over the past decade and a half, held approximately two-thirds of government sector debt while financial institutions have held the remaining third. Since the mid-1970s, there has been a steep decline in the share held by the chartered banks, offset partially by an increase in the share held by pension funds. The chartered banks accounted for about 20 per cent of the outstanding government debt compared to more than 40 per cent in 1974. The pension funds, on the other hand, have built up their share from 23 per cent in 1974 to more than 35 per cent in 1982.

Chart 12

Holdings of Government Securities by Financial Institutions
1967, 1974 and 1982



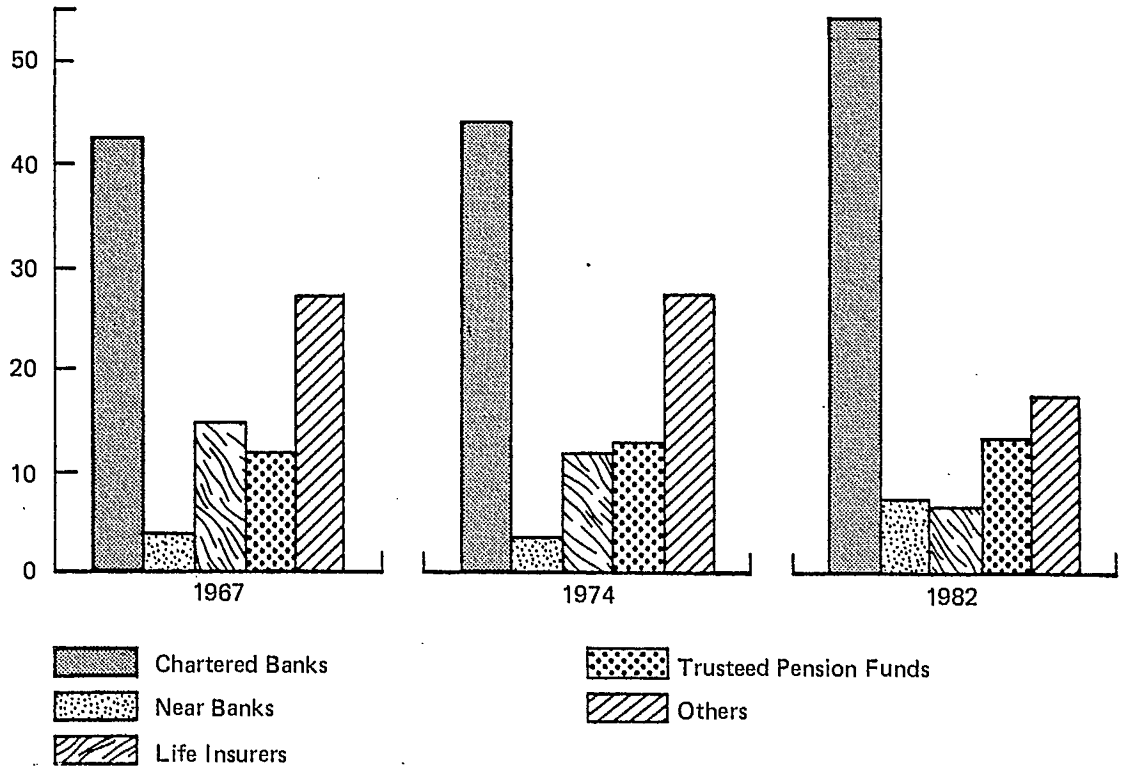
Sources & notes: See statistical appendix

Business Finance

Finance institutions have been growing steadily more important as sources of business financing, both as holders of corporate securities and as suppliers of commercial credit. Since 1967, financial institutions have increased their share of total external business financing from less than one-third to more than one half. Among financial institutions, the chartered banks are the most important suppliers of business financing, primarily through the medium of commercial loans. In 1967, the banks supplied about 44 per cent of the financing obtained by non-financial business from Canadian financial institutions. In 1982, this share had increased to 55 per cent. The next largest share in 1982 was held by the trusteed pension plans which supplied about 13 per cent of the corporate financing sourced from Canadian financial institutions (see Chart 13).

Chart 13

Financial Institutions, Shares of Total Business Financing
1967, 1974 and 1982

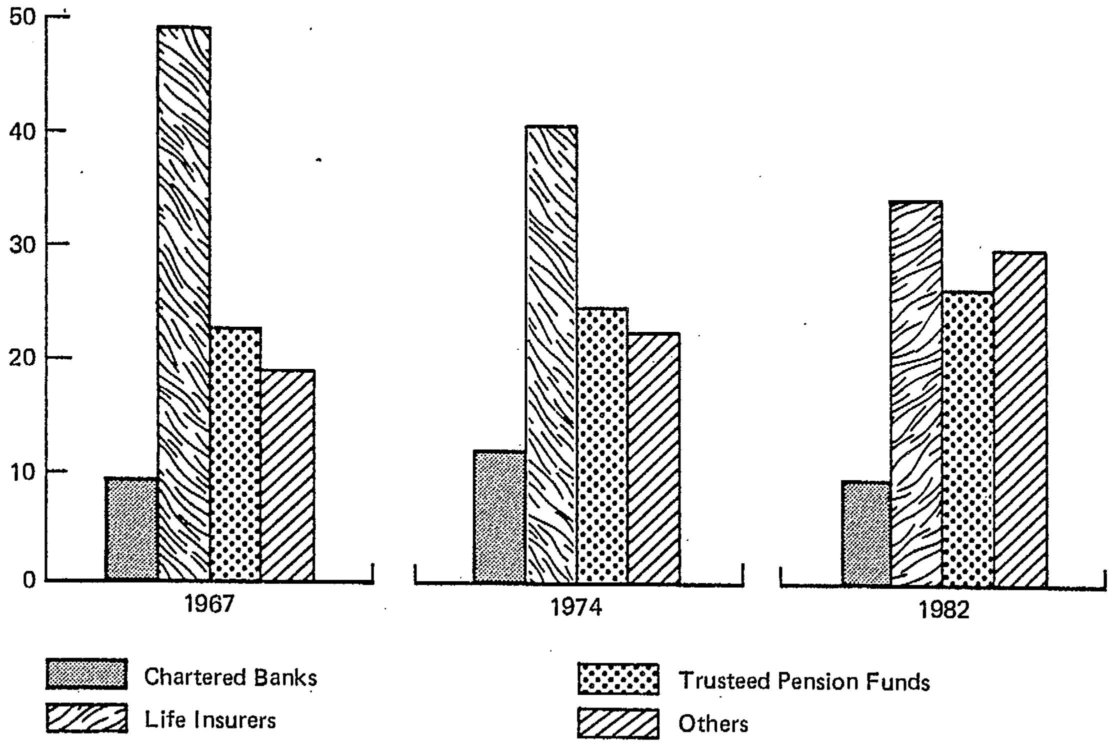


Sources & notes: See statistical appendix

Bonds have declined as a share of total business external financing from about one-fifth in 1967 to about one-sixth in 1982. Financial institutions hold a substantial proportion of the value of outstanding corporate bonds and in fact increased their share over the period. Of the amount held by financial institutions, life insurance companies and trusteed pension funds accounted for over 60 per cent. The life insurance companies' share has fallen fairly significantly, however, from about 49 per cent in 1967 to about 34 per cent in 1982, while the pension funds have had a partially offsetting increase in their share from about 23 per cent in 1967 to about 27 per cent in 1982. Banks and near banks, the other major bond holders, have accounted for about one-fifth of the total held by financial institutions over the period (see Chart 14).

Chart 14

Holdings of Corporate Bonds by Financial Institutions
1967, 1974 and 1982

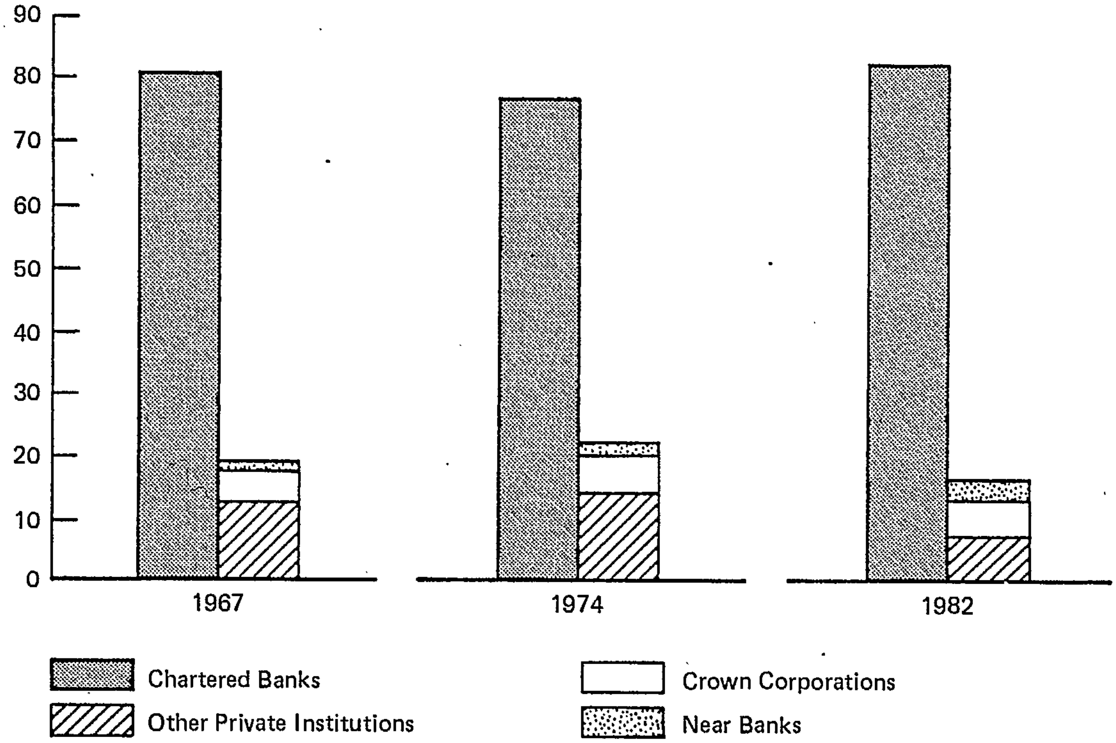


Sources & notes: See statistical appendix

Commercial credit, meanwhile, has increased significantly in importance as a source of business external financing, its share having risen from about one-fifth in 1967 to almost one-third in 1982. The largest suppliers of commercial credit are the chartered banks. Over the past decade and a half, they have accounted for about four-fifths of commercial credit outstanding. The near banks have made small inroads in this market but their presence is still marginal. On the other hand, the amount of commercial credit supplied by small, specialized companies has declined over the period (see Chart 15).

Chart 15

Commercial Credit Extended by Financial Institutions
1967, 1974 and 1982



Sources & notes: See statistical appendix

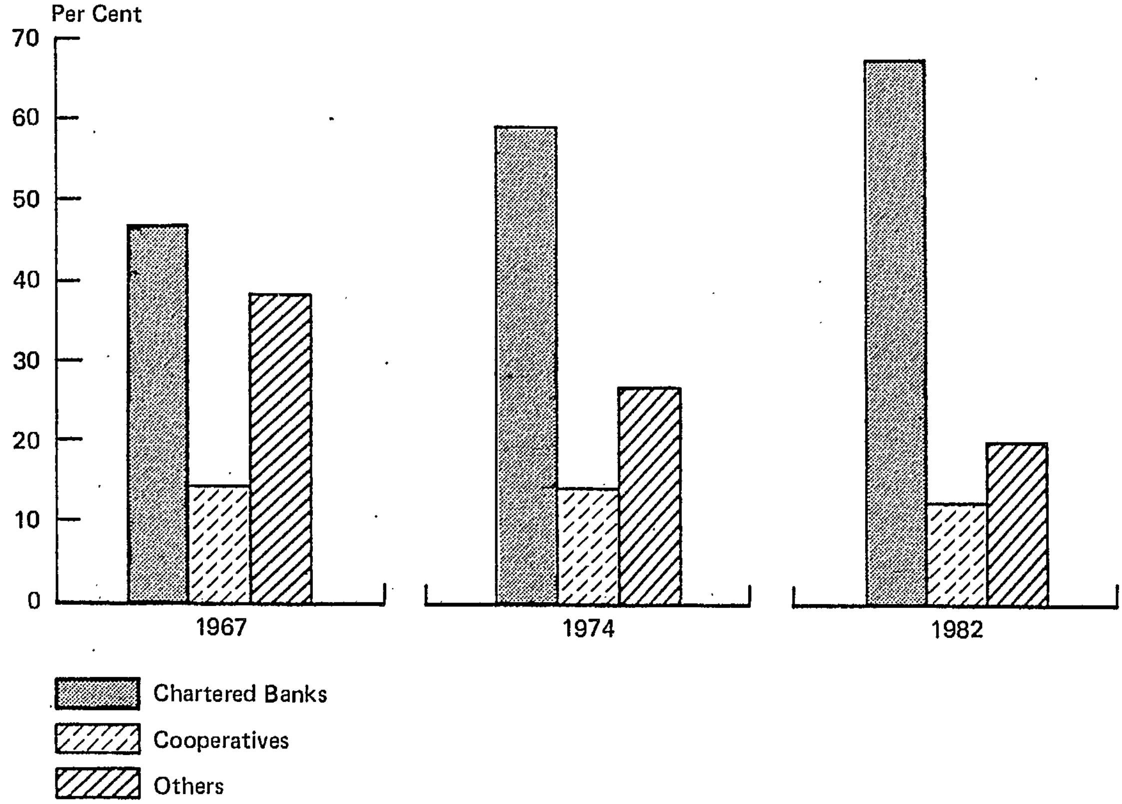
Outstanding equity accounts for a significant proportion of business external financing. It appears that this proportion has been in decline during the past decade and a half although problems associated with the valuation of outstanding equity make precise assessments impossible. Financial institutions have accounted for a growing portion of outstanding equity holdings, in part due to the rapid growth of trusteed pension funds which traditionally invest substantial portions of their portfolios in equity. Pensions funds, in fact, held about two-fifths of the outstanding equity accounted for by financial institutions during the past decade and a half. In another development, the chartered banks acquired equity holdings. Whereas, in 1967, the chartered banks did not hold any equity at all, by 1982 they accounted for 15 per cent of the outstanding equity held by financial institutions. By and large this reflects the emergence of term preferred shares, which are, in fact, loan substitutes rather than genuine equity.

Consumer Credit

Consumer credit outstanding grew at an annual average rate of 11.6 per cent during the past decade and a half, a relatively slow rate of growth in comparison to growth in some other financial markets. During this period, financial institutions significantly increased their share of outstanding consumer credit and now account for over 96 per cent of the market. Among the financial institutions, the chartered banks were the most successful in capturing market share. Of the proportion of consumer credit held by financial institutions, the chartered banks increased their share from about 47 per cent in 1967 to over 67 per cent in 1982 (see Chart 16). The largest loss in market share was experienced by the consumer loan companies. Their share of consumer credit outstanding shrank from over 30 per cent in 1967 to less than 10 per cent in 1982. The near banks as a group marginally increased their share although the credit unions and caisses populaires experienced a modest decline.

Chart 16

Consumer Credit Extended by Financial Institutions
1967, 1974 and 1982



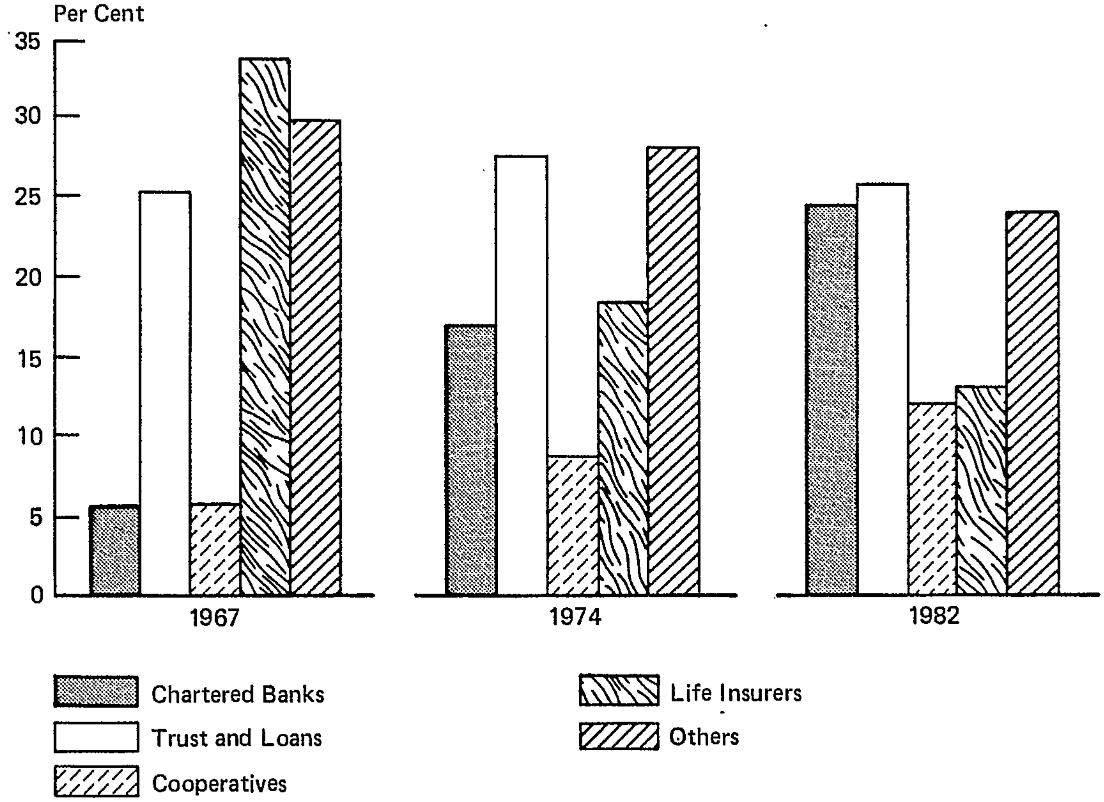
Sources & notes: See statistical appendix

Mortgage Credit

Financial institutions account for the bulk of mortgage credit outstanding. Among the financial institutions, the chartered banks experienced the most rapid growth in mortgage assets. In 1967 the chartered banks held less than 6 per cent of the outstanding mortgage credit accounted for by financial institutions, all under National Housing Act provisions. By 1982, they had increased their share to almost 25 per cent. The near banks also prospered in this market, increasing their share from 31 per cent in 1967 to 38 per cent in 1982, most of this increase being accounted for by the cooperative credit institutions. The insurance companies, on the other hand, saw their share decline from 34 per cent in 1967 to only 13 per cent in 1982.

Chart 17

Mortgage Credit Extended by Financial Institutions
1967, 1974 and 1982



Sources & notes: See statistical appendix

3. THE EVOLUTION OF THE FINANCIAL SYSTEM AND THE PRESSURE FOR REGULATORY CHANGE

One notable consequence of the various developments noted in the preceding chapter was a visible decline in the distinctions among various groups of institutions. This "blurring of distinctions" served to focus attention on a regulatory structure which treats different types of institutions in difference ways.

It is possible to identify some of the more fundamental forces driving these developments:

- the increased level and volatility of inflation and the increased interest rate uncertainty which came as a direct result;

- legislative changes which led to increased competition across institutional lines;

- influences emanating from the United States.

Some developments were more obviously linked to one factor than to another. Nevertheless, these factors formed a rather complex nexus and their individual contributions to, or influences on, the evolution of the financial system over the past decade and a half can be difficult to distinguish.

INFLATION AND THE BLURRING OF DISTINCTIONS

In the 1970s, both the volatility and the average level of inflation increased sharply relative to previous decades. Interest rates reflected these trends and became more variable and higher on average. Interest rate uncertainty influenced lenders and borrowers to shorten the terms of assets and liabilities. For financial institutions, meanwhile, interest rate volatility increased the risks involved in maturity transformation (e.g., borrowing at short terms and lending at long terms).

The shortening term of liabilities and assets appears to have had generally negative impacts on institutions which specialized in long-term assets and liabilities while having generally positive impacts on the growth of those institutions which dealt primarily with shorter-term instruments. (Pension plans proved to be the exception to this trend; the compulsory nature of many pension plan arrangements may have been a factor in their ability to expand their share of financial-system assets during this period.) The trend towards shorter-term instruments also led financial institutions specializing in long-term instruments to seek out or develop sources of short-term funds. This seems to have been a factor, for example, in the development of short-term deferred annuities by the life insurance companies.

The growing risks in maturity transformation, meanwhile, led financial institutions to place a growing emphasis on matching the terms of assets and liabilities. By matching terms, financial institutions passed the risk of unanticipated interest rate changes to lenders and borrowers. Thus, for example, as the terms of liabilities of mortgage lenders shortened, the terms for which mortgage funds were made available also shrank. Long-term mortgages disappeared while mortgages with terms as short as six months became available. The desire to achieve better matching between terms of assets and liabilities was also one factor in the growing interest of trust and mortgage loan companies and the cooperative institutions in variable-rate commercial lending during this period.

The crowding of financial institutions into short-term intermediation and efforts to diversify their activities were both factors in the "blurring of distinctions" among them. The recent inflation experience, therefore, has played a key role in generating this phenomenon. Moreover, to the extent that regulatory constraints have become impediments to financial institutions in their initiatives in these directions, this inflation experience is also partly behind the pressure for regulatory change.

REGULATORY CHANGE AND THE BLURRING OF DISTINCTIONS

There have been a number of important legislative changes which have served to reduce the distinctions among financial institutions, particularly among the deposit-taking institutions. As regards deposit-taking, there were several changes of particular importance: the development of deposit insurance which enhanced the ability of the trust companies to compete with the chartered banks; and the lowering of reserve requirements on chartered banks' term deposits along with the removal of the ceiling on chartered banks' loan rates which improved the banks' ability to compete for term deposits. The increased competition in the deposit market led, in turn, to increased competition in the provision of ancillary services. As a consequence, deposit-taking institutions today provide fairly standard packages of financial services to their deposit holders.

On the investment side, the Bank Act revisions of 1954 and 1967 allowed the chartered banks to make, respectively, consumer loans and conventional mortgage loans. The chartered banks have developed a significant presence in these markets which at one time were closely associated with the near banks. On the other hand, the near banks have been developing a presence in commercial lending, albeit to a much lesser extent. In the case of the cooperative credit institutions, this trend has been facilitated, in some provinces, by legislative changes.

More recently, two regulatory changes have potentially set the stage for the development of some competition between chartered banks, which wish to provide their customers with access to discount brokerage services, and full service brokers. Although historically banks had not been prohibited from dealing in securities, in practice the activities of banks and full-service brokers tended to be very clearly separated. When the Ontario Securities Commission (OSC) deregulated brokers' commissions and fees and thus allowed the establishment of discount brokers, the chartered banks, whose securities-related activities had been clarified by the 1980 Bank Act, sought to take advantage of their power to offer access to discount brokers' services to their customers.

The Green Line Investor Service proposed by the Toronto Dominion Bank would be an interest-bearing deposit account which could be used to purchase equities through a discount broker. The bank would charge a transaction fee. This service is similar to one provided by full-service brokers who pay interest on their customers' cash balances and of course handle their securities transactions. The two services are not perfect substitutes since banks may not provide investment advice whereas the brokers do, and the bank account offers payment services whereas the brokers' accounts do not. Nevertheless, the two services would, to some extent, compete with one another.

There are a number of interesting observations to be made regarding the role of regulatory change in the evolution of the financial system. First, regulatory change can foster conditions that lead eventually to pressure for further regulatory change. For example, the large and highly competitive presence of the chartered banks in consumer and mortgage lending, the major activities of the near banks, is undoubtedly one factor in these institutions' seeking new growth opportunities in other markets, and particularly in commercial lending. Thus, the regulatory changes which removed the barriers on bank entry into the consumer and mortgage lending markets have helped in turn to generate the competitive pressure to remove constraints on the commercial lending activities of the near banks.

A second observation concerns the sequence of regulatory change. In the relatively slower-paced world of the 1950s and 1960s, regulatory change often took time to fundamentally alter the competitive balances. In the more sophisticated, rapidly adapting financial world of the 1980s, new opportunities tend to be quickly seized. Several pieces of legislation are due for revision in the very near future. All the concerned institutions are anxious to have their legislation considered first and this is quite understandable. With regulatory change, it really matters "who's on first".

A final observation is that, in many instances, if regulatory practice is slow to change, financial innovation can achieve more or less the same results for financial institutions. Developments in the life insurance industry provide a useful illustration of this point. For example, life insurance companies are prohibited from taking deposits. However, by innovating within their regulatory constraints, the life insurance companies have effectively entered the term savings field in direct competition with deposit instruments offered by the deposit-taking institutions. Also, life insurance companies have been moving into the pension field through instruments such as group deferred annuities and through management of segregated funds, even though they lack the fiduciary powers to gain direct access to trusteed pension plans. Life insurance companies are not, of course, the only institutions exploring such innovative possibilities. However, these examples serve to illustrate that regulations are not in fact air-tight and significant possibilities for "blurring of distinctions" exist even without regulatory change.

U.S. DEVELOPMENTS AND THE IMPLICATIONS FOR CANADA

The U.S. financial system has also been passing through a period of rapid change. As in Canada, increases in the level and volatility of inflation and interest rates, and regulatory changes have been important factors. The pace and focus of regulatory change have, however, differed. This reflects both the fundamental difference in the structure of the U.S. financial system relative to the Canadian system, and the fact that state-federal jurisdictional sharing in the U.S. is different from provincial-federal jurisdictional sharing in Canada. Nevertheless some of the developments in the U.S. are of significance to Canada as they have the potential to influence the evolution of the Canadian financial system.

Interest Rate Deregulation

One of the major factors behind the moves to deregulate the U.S. financial system was the interaction of inflation with the regulatory structure. Deposit-rate ceilings (Regulation Q), exposed deposit-taking institutions to outside competition for deposits when inflation pushed market rates above those ceilings. Eventually this led to a wave of innovation, which in turn resulted in interest rate deregulation.

In the U.S., two types of depository institutions have existed side by side since the early nineteenth century - commercial banks and thrift institutions, with the latter including savings and loan associations and mutual savings banks. Commercial banks traditionally provided short-term commercial loans funded largely by demand deposits. The thrift institutions, on the other hand, extended mainly long-term mortgages, funding them with individuals' savings deposits.

Beginning in 1974, when short-term interest rates moved above the ceilings on banks' deposit rates, mutual fund organizations in the U.S. began to establish money market funds, which offered both liquidity and market rates of interest and were thus deposit substitutes. Brokers also began to accommodate their customers with innovations such as asset management accounts, which allowed customers to hold cash and securities, and also offered cheque writing privileges, margin loans against the securities in the account, and market rates of interest on any excess cash balances. The money market mutual funds and asset management accounts proved to be successful innovations and their rapid growth led to a massive shift of funds out of the banks, and particularly out of the thrift institutions, into non-banking firms. The larger banks, which relied to a great extent on large certificates of deposits and were in effect money market institutions, were less affected by the deposit drain than the smaller banks and thrifts which relied largely on retail deposits.

In view of these developments, Congress undertook in 1980 to phase-out the Regulation Q ceilings on savings deposit rates over a six-year period. In 1982 new legislation accelerated the phase-out of interest rate controls, granted thrift institutions some commercial lending powers in order to reduce their exclusive dependence on mortgage loans, and permitted the commercial banks and thrift institutions to offer new accounts which were free of interest rate limitations - specifically Super Now accounts and a new money market deposit account (MMDA) which is equivalent to a money market mutual fund.

Diversification of Financial Institutions

Regulation of financial institutions in the U.S. is divided among a number of institutions and as well between federal and state levels. State and federal regulators have, at times, held opposing views on various issues providing the opportunity for some financial institutions to choose the "regulator of least resistance" as they seek to diversify their activities.

In an important development in 1983, banks were allowed to engage in securities brokerage when the Federal Reserve Board agreed to the Bank of America's acquisition of Charles Schwab and Company, the largest U.S. discount broker. A significant number of banks have since started to offer discount brokerage services. Banks are now seeking to expand their business powers to include the underwriting of corporate securities and, indeed, would like to offer customers the full range of retail brokerage services. In this regard, it has been reported that law makers in at least a dozen states are considering legislation that would give state-chartered, non-federal-reserve-member banks broader powers to underwrite securities.

In another important development, the barrier between commercial banking and the business of issuing insurance was breached when, in March 1983, South Dakota allowed bank holding companies to establish subsidiaries under state charter to issue insurance. This circumvented federal regulations which separate banking and insurance. Other states are reportedly working on similar bills.

At the same time, non-banks have been expanding into the banking business. Under the Bank Holding Company Act a non-bank company is not allowed to own a bank. However, the Act defines a bank as an institution that must offer chequing accounts and make commercial loans. Several non-bank companies have bought banks and sold the commercial loan portfolio to other banks, retaining only deposits and consumer loans, and thus staying within the law. This activity has raised considerable controversy and a temporary moratorium has been declared on such acquisitions.

Non-bank firms have also been expanding into the financial services industry by purchasing full-service brokerage firms. Prudential, the largest American insurance company, American Express, the largest travel services company, and Sears Roebuck, the largest retailer, have all purchased brokerage firms and, together with Merrill Lynch, are now offering a multitude of financial services.

However, bank holding companies are as yet barred from purchasing full-service brokerage firms under the Bank Holding Company Act. Recently, the Treasury Department has tried to deregulate bank holding companies. The Treasury's proposal would permit bank holding companies to become diversified financial services firms through arms-length subsidiaries. These subsidiaries would be permitted to engage in a variety of financial activities including insurance underwriting, investment banking, and brokerage. Deregulation of bank holding companies, it is felt, would enhance competitive equality since banks would be able to expand into other financial services while competing firms would be able to expand into banking.

Implications of U.S. Deregulation for Canada

The breakdown of barriers between financial institutions in the U.S. has several implications for Canada, especially in view of the close relationship between the financial markets in the two countries. While the blurring of lines in the U.S. financial system has been prompted by some of the same factors that have led to blurring in Canada, there were clearly some factors which contributed to this trend in the U.S. which do not exist in Canada. Most notably, in contrast to the U.S. experience with Regulation Q, interest rate ceilings in Canada were removed before they had an opportunity to seriously affect the functioning of the capital markets. As well, as has been noted, the existence of overlapping regulatory regimes in the U.S. has often led institutions to choose the regulator of least resistance in an attempt to expand their activities. There is less room in Canada to avoid regulation in this fashion, particularly since the banks, which are the largest Canadian financial institutions, are regulated solely by the federal government.

These factors aside, there are effects which can be anticipated as a result of developments in the U.S. First, Canadian institutions may seek to expand into the U.S. to take advantage of the deregulated U.S. market. As well, American financial institutions which operate in Canada - including large securities firms and foreign bank subsidiaries - may seek to engage in activities in Canada which they are permitted to undertake in the United States. At the same time, some of the more innovative Canadian financial institutions may respond to the "demonstration effect" from the U.S. market and seek to expand the range of their activities in Canada.

4. FINANCIAL INSTITUTIONS POLICY AND POLICY GOALS

Financial institutions are perceived as being far more closely supervised and regulated by government than other private sector corporations. Indeed, they function within a highly complex regulatory structure. This reflects both their central role in the economy and their unique position of trust in handling large amounts of funds belonging to the general public.

The nature of the Canadian regulatory structure reflects, to a certain extent, the way the financial system developed. Financial companies were formed with specific activities in mind and legislation was framed accordingly. Each set of institutions thus came to have its own legislation and regulatory structure. A second important influence on the development of the regulatory structure was the sharing of jurisdiction over financial activity between the federal and provincial governments. The federal government has sole jurisdiction over "banks" and "banking", terms which are, however, undefined. The provinces, meanwhile, have regulated securities markets while both levels of government have contributed to the regulation of insurance companies, trust and loan companies and cooperative institutions. This situation leads to the possibility of differences in the approach to regulatory questions both between the federal and provincial levels, and also among the provincial governments.

The focus of policy was initially influenced by the problems encountered by the financial system as it evolved. Failures of financial institutions in the formative years of the financial system kept policy focussed on ensuring solvency. Since then, a wider array of concerns has emerged, including competition and efficiency in financial intermediation, conflicts of interest implicit in particular combinations of financial activities, and the role of foreign institutions in a largely Canadian-dominated industry.

SOLVENCY OF FINANCIAL INSTITUTIONS AND DEPOSITOR PROTECTION

Government regulation of financial institutions started with the solvency question. At that time, financial institutions were small, often inadequately capitalized, and sometimes lacking in proper experience, expertise or adequate access to emergency sources of funds. Regulations dealt with these problems, often prescribing detailed operating procedures and strictly limiting borrowing and lending powers. In the last several decades, the solvency question has become relatively inconspicuous, testimony to the success of the regulations and to the growing sophistication and ability of the major institutions to cope with their problems.

Capital adequacy, liquidity, and prudent investment practices are the essential safeguards against insolvency. To ensure adequate liquidity, the traditional practices have been the maintenance of adequate reserves against deposits, although regulatory requirements vary for different types of institutions. To ensure that the capital base is adequate for the degree of risk in the institution's portfolio, limits to the degree of leverage and a variety of risk-limiting investment rules (including prescribed types of assets and asset ratios, prescribed loan-to-security ratios, limitations on acceptable security, and restrictions on holdings of higher-risk assets such as common stock) have been used. Again regulatory practice varies across types of institutions.

Over time, financial institutions have been able to move to lower levels of both capital and liquidity, reflecting an increased access to domestic and international money markets, and improved liability management as a consequence of more flexible financial instruments, institutional structures and management techniques. Restrictions on lending practices have also been eased over time as financial institutions have adapted to changing market conditions. However, liquidity and reserve requirements, debt-equity ratios and investment restrictions still vary widely among financial institutions. Meanwhile deposit insurance on Canadian-dollar deposits has clearly become the major form of protection for most depositors (the exception being those with large holdings), as all the major deposit-taking institutions are now covered directly or indirectly by some form of deposit insurance.

CONFLICTS OF INTEREST

Another long-standing concern of the government in framing legislation has been potential conflicts of interest. There are two general approaches to conflict of interest problems: detailed regulation and close supervision, or separation of function. In Canada, both approaches are followed.

For example, a financial intermediary which owns a significant share in a non-financial corporation to which it also lends can have an obvious conflict between its interests as a lender and custodian of its depositors' money and its interests through the non-financial corporation as a shareholder and borrower. Consequently, legislation has limited financial intermediaries' holdings in non-financial corporations, particularly in the case of banks and trust and loan companies.

Conflicts of interest also arise when a financial intermediary both lends to and underwrites the securities of a corporation, since the sale of the securities can reduce the risk to the intermediary of loans it may have extended to that corporation. The institutions most susceptible to this potential conflict of interest are chartered banks as a result of their dominant role as corporate lenders. Historically, banks' corporate-securities-related activity has been modest. Securities-related activity has been governed by provincial statutes and pertinent formal constraints did not exist in federal banking legislation prior to 1980, when the Bank Act revisions delineated the range of securities activities banks could undertake. Under the Bank Act, banks are permitted to underwrite and distribute government securities, but are prohibited from underwriting corporate securities, although they may participate as members of a selling group. As well, banks may advertise that they buy and sell securities, provided they do not promote the sale of securities they are not authorized to underwrite.

Another type of conflict of interest arises from the combination of commercial lending and fiduciary business. A trust company, as a financial intermediary, must consider the interests of its depositors and shareholders and, as a trustee, must consider the interests of its trust beneficiaries. Conflict could arise, for example, if the trust funds were invested by the company in its own low-yielding certificates in order to increase its pool of low-cost funds for the purposes of lending or investing. Alternatively, trust funds could be used to increase the price of new capital issues or to acquire debt of a non-financial corporation in difficulty in order to safeguard the trust company's loans to that corporation. As well, the bankruptcy of a client may be detrimental to trust funds invested in that client but nevertheless beneficial to the trust company as a financial intermediary. Similar types of conflict of interest situations arise when financial intermediaries are involved with "quasi trusts" such as mutual funds, the management of RRSPs and RHOSPs, real estate investment trusts (REITs) and mortgage investment companies (MICs), and activities such as portfolio management, investment counselling and securities advising. To deal with these concerns, governments have attempted to retain a separation of trusteeship and commercial lending and have made provision for supervision by courts and specified authorities, introduced arms-length regulations where necessary, and tried to limit the growth of the problem by restricting diversification of financial intermediaries into the trustee business.

Potential conflicts of interest also can arise from concentrated ownership of financial institutions. A majority owner of an institution could be in a position to influence the decisions of the institution to further private ends. In situations where the owner also has significant non-financial interests, the financial institutions' funds could be channeled preferentially to finance those interests to the possible detriment of other shareholders' interests and those of the general public whose funds the financial institution controls. In light of this potential conflict of interest, the Bank Act, for example, imposes a 10-per-cent ownership ceiling for individual holdings of bank equity.

COMPETITION AND EFFICIENCY

The 1964 Royal Commission on Banking and Finance helped place the focus of government financial institution policy on questions of efficiency and competition. There are essentially two aspects to the concept of efficiency in financial intermediation. First, the provision of as wide a range as possible of financial instruments with flexible combinations of risk, liquidity and yield, at as low a cost as possible, to a full range of customers. Second, the allocation of funds to those uses in the economy which promise the highest returns. Ideally, these goals should be met by a highly competitive system. Potential indicators of competitiveness in financial intermediation would be low spreads between lending and borrowing rates, low commissions and service charges where these apply, availability of "unbundled" products (i.e., absence of tied selling), an absence of major credit gaps, low degrees of concentration, and an ease of entry.

Prior to 1967, the only government policy directly concerned with competitiveness was a restriction on bank mergers. The 1967 Bank Act revisions, however, (i) placed limits on bank investments in trust companies out of concern for the danger of allowing further increases in the degree of concentration and the potential conflicts of interest involved; (ii) removed the 6-per-cent ceiling on bank loan rates and reduced the primary reserve requirements for banks, factors which had restricted the banks' ability to compete for term deposits; and (iii) allowed the banks to make conventional mortgage loans to increase competition in that market.

The 1967 revisions also prohibited interlocking directorates, and collusive behaviour in setting banks' lending and deposit rates. These provisions were aimed at increasing the degree of price competition among financial institutions. Up to then, banks had generally avoided price competition in favour of non-price competition such as increasing the number and convenience of branches to increase individual market shares. In 1976, financial intermediaries were also brought under the jurisdiction of the Combines Investigation Act.

Most recently, the 1980 Bank Act revisions have significantly eased the barriers to entry into the banking system. Where formerly special legislative action was required, entry is now possible through letters patent. As well, provincial governments were allowed to assist the establishment of a bank through equity participation, and the restriction on ownership of voting shares to 10 per cent of the total for newly established banks was relaxed. Finally, the revisions allowed foreign banks to establish wholly-owned Canadian subsidiaries. All of these measures were aimed at making entry into banking easier in order to promote the competitiveness of the financial system.

5. CONCLUSION

This paper has traced out some recent history of the Canadian financial system. It has been possible to identify a number of trends which have had a general importance in affecting the development of Canadian financial institutions and the way that the Canadian non-financial sector finances its activities. Perhaps the most important developments have been the following:

- the contraction of the bond market and the growth of the money market in its place;
- the rapid growth of deposit liabilities in the banks and near-banks and the decline in relative importance of contractual savings;
- the rapid growth of the mortgage and consumer loan markets and the increased importance of the chartered banks in these markets;
- the displacement of life insurance by pension funds as the most important form of contractual savings and source of long-term capital; and
- the increased reliance of non-financial corporations on the banking system for finance.

A major consequence of these changes has been the "blurring of distinctions" among financial institutions. As institutions have become more similar in their activities, questions have been raised about the appropriateness of a regulatory framework developed to supervise financial institutions which have been reasonably distinct in their activities. This paper has set out the basic policy concerns of governments in their approach to financial institutions policy in the past. To the extent that specific policy choices in the past have played a role in shaping the current structure of the financial system, it could well be that specific goals or regulations could be brought into question by this phenomenon. This paper has, therefore, attempted to establish a perspective from which individual issues can be viewed as regards their implications for government policy in the ongoing discussion of current issues that concern Canada's financial system and Canadian financial institutions.

APPENDIX: SOURCES AND NOTES

All data are drawn from three sources: Statistics Canada, Financial Flow Accounts (Cat. 13-001); Statistics Canada, Financial Institutions (Cat. 61-006); and the Bank of Canada Review.

The statistical framework used parallels closely that of the Financial Flow Accounts. Excluded from the calculations of asset holdings of the various institutions are: (i) non-financial assets; (ii) assets held for investment abroad; and (iii) assets which reflect offsetting contingent liabilities.

For the chartered banks and the trust and loan companies, the basic data source is the Bank of Canada Review. For all other institutions, the basic data source is the Financial Flow Accounts. The Financial Institutions data have been used to identify commercial loans for the non-bank financial institutions.

CANADIAN FINANCIAL INSTITUTIONS:
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CAPITAL MARKETS DIVISION
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Canadian financial institutions historically were, and to some extent still are, divided into reasonably distinct groups. This reflects the way the Canadian financial system and its regulatory structure developed. Companies were formed with specific activities in mind and legislation was framed accordingly. Each set of institutions thus came to have its own legislation and regulatory structure. In addition to helping preserve the soundness of institutions as was intended, this also had the effect of helping to establish and perpetuate their unique identities.

Thinking about the Canadian financial system followed the lines of institutional arrangements and, as a descriptive device, the concept of the "four pillars" was developed. This concept designated the banks, the trust companies, the life insurance companies and the investment dealers as the main bastions of the financial system. The "blurring of distinctions" phenomenon is the apparent erosion of this traditional arrangement.

The blurring of distinctions among financial institutions has raised the general issue of whether legislation should be structured along functional or institutional lines: that is, should we regulate banks or banking? Second, there is the set of issues raised by the possibility of growing concentration of the financial system, particularly as regards potential conflicts of interest when large, economically powerful firms engage in a wide array of financial activities. Associated with this issue is the question of the implications of sheer size of corporations for the efficiency of the financial system. Fourth, there is the matter of foreign ownership in the domestic financial system and the growing internationalization of financial activity. In this connection, questions are raised regarding the ultimate ability of domestic authorities to supervise properly the financial system when capital and financial services are free to move easily across national borders. Finally, there are the issues raised by the sharing of jurisdiction over financial activity by the federal and provincial governments, and the difficulties this may pose for co-ordination of policy.

At this time, a number of pieces of legislation which govern the activities of financial institutions are being considered for revision both by the provinces and by the federal government. Given the inter-relatedness of financial institutions, the need for a comprehensive framework for approaching financial legislation is urgent and, for that reason, a comprehensive view of the issues facing the financial industry is of prime importance. This paper seeks to identify and sketch out in preliminary fashion some of these issues.

Alternative Regulatory Regimes: "Banks or Banking?"

In Canada, the structure of the regulatory system has been designed with certain types of institutions in mind. Thus, financial institutions are regulated according to the basis of incorporation rather than according to, strictly speaking, the activities in which they engage. Thus, it is "banks" which are regulated rather than "banking". As the financial system evolves and institutions take on new roles and adopt new methodologies and techniques, some aspects of the regulatory system can, therefore, become perceived as being not in accord with the way the financial system actually functions. The issue of functional versus institutional bases for regulation tends to arise from time to time when such perceptions become widely held.

Logically, institutions which engage in similar types of activities might be expected to be subject to the same regulations. This would seem to be both equitable and conducive to greater competition among institutions. A functional basis for legislation and regulation has, therefore, received strong support in the past, particularly in cases where the institution-based regulatory structure contained important inequities in its treatment of different types of institutions. This issue is complicated by several factors: functions are not all that easy to define and moreover not all public policy goals are clearly function-oriented. Indeed, some of the most important policy goals, such as maintaining solvency, are very clearly institution-oriented.

There are two general questions which need to be addressed when consideration is given to modifying the basis of regulation of financial institutions: questions of design and of implementation. Designing an optimal regulatory structure would appear to involve finding a way to incorporate both functional and institutional elements in order to address the full range of public policy concerns. Implementing a new system of regulation would create other problems, notably of how to effect the transition from one regulatory regime to another.

Conflicts of Interest

Conflicts of interest arise from an institution playing two roles, or wearing two "hats", at one time. Since financial institutions perform a wide array of functions which place them in an intermediary or "middle man" role, they often act not only on their own behalf but also on behalf of borrowers or lenders in an agency role. Whenever they are forced to trade off their own or their shareholders' interests against those of a client on whose behalf they are acting, or to trade off the interests of a borrowing client against those of an investing client both of whom they represent, financial institutions find themselves in a conflict of interest.

There are two general ways in which conflicts of interest can generate undesirable economic effects. First, one characteristic of conflict of interest situations is that decisions which could otherwise be made at arms length in a market are internalized by an institution. To the extent that market solutions are considered optimal as regards questions of economic efficiency and equitable as regards questions of distribution of income, the conflicts of interest could lead to economic costs on both counts. Second, conflicts of interest could potentially lead to abuses which, given the large quantity of funds controlled by financial institutions, could lead to substantial costs.

There are, therefore, two main public policy concerns: first, to minimize the économic inefficiencies in the allocation of scarce funds to competing credit demands; and second, to maintain public confidence in the financial system by providing assurances that abuses will be prevented. In the latter regard, not only is it important that the system function fairly, it must also be perceived to function fairly.

There are essentially three ways to deal with a conflict of interest situation. One way is to enforce a strict separation of function and/or ownership to prevent any conflicts from arising in the first place. A second way is to allow activities to be combined, even though this might give rise to some conflicts of interest, but then through regulation and supervision to attempt to limit any abuses which could occur as a result. Specific regulations would include procedural guidelines, investment guidelines, and provision for disclosure to supervisory authorities who would then be in position to judge as to whether or not conflicts were being resolved appropriately. The third approach is to rely on self regulation and the industry's own long-run interest in maintaining public confidence by ensuring that conflicts were resolved in an objective way. In Canada, all three approaches are used.

Not all conflicts of interest are likely to be of equal severity or of equal concern to public policy makers. As noted, financial institutions are likely to find it in their own long-run interest to be perfectly scrupulous in their handling of such situations. Indeed, competitive forces impose such a discipline. Nevertheless, where the potential costs arising from even isolated abuses are high, there is a clear role for public policy. Important questions, then, are how important are the various conflicts of interest which can be identified, and what are the costs and benefits of the alternative ways of dealing with them?

Concentration of Economic Power

One of the chief concerns raised in the discussion of regulatory change in the Canadian financial system is the possibility that relaxing inter-industry barriers might increase competition only in the short run while ultimately leading to the demise or absorption of smaller institutions and thus to a more concentrated, less competitive system in the long run. The assessment of this issue is complicated by the fact that most financial institutions are involved in a number of markets or product lines. While some firms may be large in terms of total assets or revenues, these individual firms may not be dominant in any particular market. In this situation, it is possible to argue that since no market is dominated, there are no disadvantages to large size.

From an economic policy perspective, concern about the degree of concentration within an industry stems largely from the belief that the behaviour and performance of firms is in part determined by the structure of their industry; and, moreover, that non-competitive behaviour will be fostered in a highly concentrated market environment and that the efficiency of the industry will be impaired by the loss of competitive market discipline. As well, conflict of interest problems can be exacerbated in a highly concentrated market environment.

A highly concentrated market structure is not, of course, necessarily undesirable. For example, in some industries, economies of scale or scope might be sufficiently large that the most efficient market structure could be a monopoly, as in the case of utilities. Moreover, large size may confer competitive advantage in international markets.

A highly concentrated market structure also raises other, not purely economic, concerns. For example, when firms get very large the costs associated with their failure become so great that they cannot be allowed to fail. This is even more true in the case of large financial institutions than in the case of large non-financial institutions. There is also an additional set of issues arising from the potential for social and political power to derive from the concentration of economic power. These issues were examined by the Royal Commission on Corporate Concentration chaired by R.B. Bryce.

Foreign Ownership

Foreign ownership has generally not been a major issue with regard to Canada's financial system. Until the 1960s, there were no specific regulations governing foreign ownership of Canadian financial institutions. Following Citibank's takeover of the Mercantile Bank, restrictions were placed on transfers of shares of federally-incorporated financial institutions to non-residents. Also, restrictions were placed on the growth of assets of banks whose ownership was more than 25 per cent non-resident. Revisions to legislation governing other financial institutions, at both the federal and provincial levels, also included measures addressing foreign participation in the respective industries. For example, restrictions were placed on take-overs of domestic insurance companies although non-resident companies were allowed as before to establish Canadian subsidiaries. Another sign of government concern with foreign ownership of financial institutions was the extension of the jurisdiction of the Foreign Investment Review Act to cover financial institutions.

The 1980 Bank Act revision also addressed foreign ownership issues as it undertook to regulate the financial activity of foreign-owned firms which had become established during the 1970s under various statutes and which were conducting a "banking" business outside the bounds of federal banking legislation.

The concern about foreign ownership of domestic financial institutions has been tempered by the recognition that, particularly in banking, the foreign-owned firms can help meet Canada's financing needs and as well can bring a useful added measure of competition to the financial system. Another consideration is that restrictions on the activities of foreign-owned financial institutions in Canada raise the threat of reciprocal restrictions on the operations of Canadian financial institutions abroad.

Internationalization of Financial Services

The extent of foreign participation in Canada's financial system in the past has varied with the type of institution. In the banking system, foreign participation has been low. The recent incorporation of the schedule "B" banks has significantly increased foreign bank interests in Canada but, nevertheless, these institutions still account for only a small percentage of banking system assets. By contrast, in the life insurance business, foreign participation has been relatively heavy. One-fifth of the life insurance in force in Canada has been written by non-resident companies, mostly U.S.- and U.K.-based.

Canadian financial institutions in their turn have maintained relatively extensive operations abroad. Canadian banks have foreign-currency assets which constitute over 40 per cent of their consolidated balance sheet. Canadian life insurance firms are also active abroad and foreign contracts account for over one-quarter of their business. The investment houses, which are largely Canadian-owned, also operate a fairly large number of branches in foreign securities markets. Given the importance of foreign operations to Canadian firms, reciprocity of treatment of foreign-owned firms operating in Canada is an important issue.

From an economic perspective, several beneficial effects can result from greater internationalization of financial services. First, foreign companies operating in Canada, and Canadian companies operating abroad, can be conduits for new technology and innovative practices. While there are alternative channels for the inflow of new techniques, first-hand experience and familiarity with them are important factors in facilitating such transfers.

A second potentially beneficial effect is the possibility for improved access to foreign markets for Canadian exporters of non-financial products. Again the first-hand familiarity and intimate knowledge of foreign markets possessed by foreign institutions, and potentially by Canadian institutions operating abroad, can play an important role in facilitating entry for Canadian firms to those markets.

There are also a number of offsetting considerations. First, foreign-owned financial institutions may not have the long-term commitment to the Canadian market that domestic financial firms must necessarily have. Given the importance of the financial sector for the efficient operation of the rest of the economy, excessive reliance on foreign-owned firms may, therefore, entail certain risks. For example, in difficult times, foreign-owned firms may be disinclined to stay for the duration. Moreover, in a resource allocation context, a short-term perspective may result in the flow of capital being channelled into a less-than-optimal set of applications. Such considerations may become increasingly important as the "bricks and mortar" cost of establishing and running a financial operation decrease and short-term convenience may become an increasingly important consideration for managers of mobile international companies.

There is also a serious and more general question regarding the ability of the Canadian government, or indeed any national government, to supervise properly the activities of financial institutions when financial services flow easily across national borders. The rapid growth of international finance within a largely nation-based regulatory structure means that there has been effectively less control over financial institutions that have extensive international operations than over those that have confined their activities to primarily domestic markets. Given the importance of maintaining solvency, concerns about the effectiveness of international supervision are not trivial.

Federal-Provincial Jurisdictional Sharing

The division of jurisdiction over financial institutions among the federal and provincial governments raises numerous potential problems and issues which are often both complex and of a sensitive nature. Cooperation and coordination of policy among the various governments involved in regulating the financial system would seem to be an important requirement for a smoothly functioning system. Conversely, differences in regulatory philosophies on the part of the various regulatory authorities could lead to difficulties.

In Canada, the federal government has clear jurisdiction over banking and in practice this has meant jurisdiction over institutions which use the word "bank" in their corporate name. The Bank Act does provide examples of the activities banks may undertake but this does not constitute a definition of banking and, in point of fact, non-federally incorporated institutions carry on every important domestic banking activity. The federal government has also contributed to the regulation of a number of other types of financial institutions that are also in part regulated by the provinces. There are, therefore, numerous overlaps of jurisdiction of a federal-provincial nature.

For example, federally chartered trust and mortgage loan companies need, in most provinces, licences from provincial authorities to operate there. Moreover, their trust activities are largely governed by provincial legislation despite their federal charters. Conversely, federally chartered banks which are empowered by federal legislation to deal in securities observe provincial regulations in some aspects of their dealings in the provincially regulated securities markets.

Provincially chartered companies are not limited to operating in their provinces of incorporation as they can operate nationwide by simply registering in the other provinces. As a consequence, many firms are also subject to a number of different provincial regulatory authorities in their business dealings.

The sharing of jurisdiction has not proven to be an insurmountable handicap to extensive co-operation and co-ordination in the past. Over the years, federal-provincial and inter-provincial co-operation has been evident in a number of areas and has paved the way for some reduction of regulatory discrepancies. This has been particularly true with regard to trust companies as many provinces have modelled their own trust companies' acts after the federal Act. There have been other examples as well. With regard to deposit insurance, Ontario and Quebec developed their own programs prior to the federal government's deposit insurance legislation of 1967. Following the passage of the federal legislation, however, Ontario elected to come under the federal program while Quebec worked out an agreement with the federal government for dividing responsibility for coverage of the different types of institutions. Federal-provincial co-operation was also in evidence when the Canada Deposit Insurance Corporation was empowered to make emergency liquidity loans to credit union centrals. These are provincially incorporated and supervised institutions and operate largely within provincial boundaries. Through their membership in the federally incorporated Canadian Co-operative Credit Society, these institutions gained federal recognition and access to some federal help.

The general approach to financial system regulation being taken by some provinces differs from the approach taken in the past by the federal government with regard to its own areas of jurisdiction in the financial sector. The federal legislation is, of course, being reconsidered at this time and it is not clear what differences there may be between the underlying philosophy on these issues by the two levels of government. On the other hand, the speed with which some provinces are moving on their own programs does raise the possibility that if there are differences in thinking then there could also be differences in regulatory approaches.

POTENTIAL CONFLICTS OF INTEREST IN THE FINANCIAL SYSTEM

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A Working Paper for
Discussion and
Consultation

CAPITAL MARKETS DIVISION
DEPARTMENT OF FINANCE

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1. INTRODUCTION

Financial institutions function within a complex regulatory framework. This reflects two facts. First, being intermediaries in the flow of funds from savings to investment, financial institutions influence the allocation of resources in the economy; their decisions, therefore, have important consequences for the efficient functioning of the entire economy. Second, the amount of funds they borrow from, or handle on behalf of, the general public far exceeds the equity investment of their shareholders. They bear, therefore, a unique burden of trust. The public policy concerns which lie at the heart of financial institutions regulations can be grouped under three general headings: solvency, competition and efficiency, and conflicts of interest. This paper discusses the issue of conflicts of interest.

There are two important distinctions to be drawn at the outset. First, situations which give rise to conflicts of interest may also give rise to concerns about solvency and concentration of power. Insofar as it is possible to disentangle these various concerns, the discussion in this paper will be limited to the conflict of interest aspects. Second, the notion of conflict of interest must be kept clearly distinct from the abuses that might possibly occur as a result. Conflicts of interest are inherent in some situations; serious difficulties as to their resolution, however, might only arise in certain circumstances.

The nature of conflicts of interest and the policy concerns they generate are discussed in the next section of this paper. Section 3 then undertakes to list and classify some of the conflicts of interest to which certain combinations of financial activities could give rise. Section 4 discusses conflicts of interest which involve questions of ownership of financial institutions. Section 5 reviews and compares some public policy approaches to conflict of interest problems in Canada and other countries and poses a number of questions for discussion. Finally, section 6 attempts to summarize some of the key points touched on in the paper.

2. CONFLICTS OF INTEREST: AN OVERVIEW

As a general observation, conflicts of interest arise from an institution playing two roles, or wearing two "hats", at one time. Since financial institutions perform a wide array of functions which place them in an intermediary or "middle man" role, they often act not only on their own behalf but also on behalf of borrowers or lenders in an agency role. Whenever they are forced to trade off their own interests against those of a client on whose behalf they are acting, or to trade off the interests of a borrowing client against those of an investing client both of whom they represent, financial institutions find themselves in a conflict of interest.

There are two general ways in which conflicts of interest can generate undesirable economic effects. First, one characteristic of conflict of interest situations is that decisions which could otherwise be made at arms length in a market are internalized by an institution. Thus, for example, the price and quantity of funds involved in a transaction could be established internally by an institution rather than by an impartial market. To the extent that market solutions are considered optimal as regards questions of economic efficiency and equitable as regards questions of distribution of income, the conflicts of interest could lead to economic costs on both counts. Second, conflicts of interest could potentially lead to abuses which, given the large quantity of funds controlled by financial institutions, could lead to substantial costs.

There are, therefore, two main public policy concerns: first, to minimize the economic inefficiencies in the allocation of scarce funds to competing credit demands; and second, to maintain public confidence in the financial system by providing assurances that abuses will be prevented. In the latter regard, not only is it important that the system function fairly, it must also be perceived to function fairly.

In considering the various examples of conflict of interest outlined in this paper, it is important to bear in mind that it is very difficult to devise a regulatory structure which avoids all conceivable conflicts of interest. Indeed, some of the examples presented represent conflict of interest situations which currently exist in Canada or other countries.

In considering the seriousness of any particular conflict, there are two aspects of the situation which readers may wish to bear in mind. The first is the extent to which the various parties whose interests may be involved have access to information about how the conflict was resolved. It is, of course, also important that the interested parties have sufficient sophistication to evaluate this information and some genuine choice in the marketplace if they were dissatisfied with the way the conflict was handled.

A second important consideration is how much the individual or institution resolving the conflict could potentially gain or lose as a consequence of the decision taken. This would be an important element in determining the degree of "pressure" which surrounds a conflict of interest.

It is also important to focus on the nature of the various interests at stake in a particular conflict situation. Among the various examples of conflicts of interest discussed in the remainder of this paper, it is possible to identify three main types.

Agent-Agent Conflicts

One type of conflict of interest occurs when a financial institution acts as agent for two clients with conflicting interests. An example is the case of the institution which acts as underwriter on behalf of the borrowing client and as a trustee on behalf of a trust beneficiary whose funds are being invested.

Principal-Agent Conflicts

A second type of conflict occurs when a financial institution acts on its own behalf as a principal in either a borrowing or lending capacity and as an agent on behalf of a borrower or lender. For example, a financial institution could be a principal in the role of commercial lender while acting on behalf of investors as an agent or trustee.

Principal-Principal Conflicts

The third general type of conflict of interest situation typically involves questions of ownership of financial institutions. The owner of a financial institution may be in a position to lend to himself and could appear, therefore, as principal both on the borrowing side and on the lending side of a given transaction.

Although some situations involve more than one type of conflict, these categories may prove of some help in understanding policy concerns, and in considering the kinds of policy responses which would be most appropriate.

3. SOME POTENTIAL CONFLICTS OF INTEREST FOR FINANCIAL INSTITUTIONS

This section reviews a number of conflict of interest situations which could arise in a modern financial system and identifies some circumstances in which these conflicts could create severe difficulties of choice for the institution involved. This list is not meant to be exhaustive; in particular it is limited to situations in which particular combinations of financial activities give rise to conflicts. Conflicts of interest arising from ownership questions are dealt with in the following section.

Commercial Lending and Securities-Related Activity

As a commercial lender, a financial institution acts as a principal on its own behalf. As an underwriter, it acts as an agent of the borrowing corporation providing advice on the price, size and timing of a security issue. As a marketer of debt, it can act on behalf of the investing public, providing advice as to which securities to buy. A lending institution which underwrites and markets the securities of a corporation to which it also lends could, therefore, be in a potential conflict of interest.

The financial institution in that situation could face a particularly difficult choice if the corporate client were in financial difficulties, with the financial institution exposed either through outstanding loans or through securities underwritten but not sold. For example, the institution might be in a position to promote the corporation's debt securities to its investor clients thereby allowing the corporation to repay its outstanding loans.

Commercial Lending and the Management of Trusts

As a commercial lender, a financial institution acts on its own behalf as a principal. As a trustee, it acts as an agent of the trust beneficiary. A financial institution which is in a position to both lend to, and invest trust funds in, a corporation could, therefore, face potential conflicts of interest.

The most difficult situation for the financial institution would appear to be the case where it had loans to, and/or trust fund investments in, a non-financial corporation which was experiencing financial difficulties. For example, the financial institution could be faced with the problem of whether to make further trust fund investments to protect its outstanding loans, or to make further loans to protect its trust investments. In a variant of this scenario, the financial institution could be in a position to force bankruptcy, in which event it might be able to recover non-performing loans, to its advantage as a lender, while suffering losses on equity holdings in trust investments.

Securities-Related Activities and the Management of Trusts

In its capacity as underwriter, a financial institution acts on behalf of the client for which it is raising funds; as well, it has its own interest in securing underwriting contracts to increase fee income. In its capacity as trustee, it acts on behalf of its trust beneficiaries. If it were in a position to invest trust funds in securities which it was underwriting, the financial institution could face a potential conflict of interest.

One particular circumstance in which difficult choices could arise is when securities underwritten by the financial institution were not selling and trust funds could be used to remove those assets from its own account. In another circumstance, the financial institution could be in a position to use control over a pool of trust funds to win underwriting contracts.

Deposit-Taking and the Management of Trusts

As a deposit-taker, a financial institution acts on its own behalf as a borrower. As a manager of trust funds, it acts as an investor, but on behalf of its trust beneficiaries. If it were to invest trust funds in its own deposit instruments, it would face, therefore, a potential conflict of interest.

Serious conflicts could arise if the financial institution were facing liquidity problems with regard to its intermediary activities and could use trust funds to inject liquidity into its own balance sheet. The institution could also be in a position to place particular investments either directly in a trust account or, by channelling trust funds into its own deposit instruments, to create a pool of intermediated funds to finance the investment on its own account.

Underwriting and Securities Distribution

As an underwriter, a financial institution acts on behalf of the corporation for which it is raising funds. As a distributor, it plays an additional role acting on behalf of the investing public which it advises regarding investment opportunities. The financial institution which acts in both roles faces, therefore, potential conflicts of interest.

Difficult choices could arise if an underwritten security issue were not selling because of financial difficulties being experienced by the issuing corporation. In such a scenario, the financial institution would be faced with the problem of whether to promote the issue to its investor clients or to hold the issue on its own account.

4. POTENTIAL CONFLICTS OF INTEREST INVOLVING OWNERSHIP OF FINANCIAL INSTITUTIONS

The various conflicts of interest discussed so far have all involved particular combinations of financial activities. In addition to these, there is a set of conflicts of interest which involve the ownership of financial institutions. In these cases, a shareholder in a financial institution may have outside interests which conflict with his interests through the financial institution.

This type of conflict of interest situation is not limited to financial institutions or in fact only to shareholders. In the most general case, any director, officer, or shareholder of any type of corporation, financial or non-financial, may be in a position to benefit from the corporation's services and, moreover, to influence the corporation's decision on whether to provide the service. The potential for this type of conflict to arise would appear to be greater in the case of financial institutions, however, because of the nature of their products: financial institutions undertake a wide range of lending and investing activities and a number of scenarios can be postulated where the investments and loans could be of direct benefit to the other interests of a shareholder, director or officer. The possibility of difficult choices arising as a result of this type of conflict of interest may also be greater when the conflict involves the interests of a controlling shareholder because of the greater degree of influence which such a shareholder can exert over the business decisions of an institution.

Conflicts of interest of this type are most sharply drawn when a shareholder of a financial institution is a non-financial corporation whose credit needs match closely the type of credit supplied by the financial institution (or, conversely, when the financial institution is a shareholder in a non-financial corporation whose credit needs it is in a position to supply).

One specific example is the case where a financial institution making mortgage loans and real estate investments is owned by a real estate development company. Real estate developers have ongoing needs for funds. Many projects are highly levered and, moreover, subject to significant risk in the initial stages of development when funding is most urgently needed. A financial subsidiary would be in a position to provide ready access to mortgage funds or to make direct investments in projects sponsored by the developer. It would, thus, be in a conflict of interest situation regarding the quantity and terms of credit extended to its parent.

A second example where this type of conflict of interest could be of special significance would be the case of interlocking ownership between a non-financial corporation and a financial institution with commercial lending powers. The commercial lender would then face potential conflicts of interest regarding loans to its affiliated non-financial corporation.

The conflict of interest in this type of situation is more complicated, and potentially more serious, with respect to trustee functions. In the first place, a third party's interest - the trust beneficiary's - would be more significantly involved. As well, the administration of funds held under trust agreements is subject to much less supervision by regulators than intermediary business. Finally, unlike depositors, trust beneficiaries may be prevented by legal constraints from withdrawing their funds should they become concerned about the way the funds were being managed.

In situations where financial-non-financial ownership links create conflicts of interest, the greatest difficulties of choice would appear to arise if the non-financial corporation were experiencing cash flow problems and were in danger of suffering a business failure. In such a situation the pressure for an injection of funds from the affiliated financial institution could become particularly severe.

A second general type of ownership-related conflict of interest which could arise for a financial institution concerns the voting or disposition of shares under its control, including those held on its own account and those held in trustee or managed accounts. For example, a financial institution may have made significant investments both on its own account and on its trust and managed accounts in a corporation which was a "target" in a takeover battle. At the same time, the parent of the financial institution could be one of the corporations attempting the takeover. In such a case, the financial institution, in voting or disposing of the shares under its control, or in acquiring additional shares, could face conflicts between the interests of its parent and those of its trust beneficiaries.

It is also possible that a financial institution could be in a situation where the voting or disposition of shares under its control could have a significant impact on a takeover battle involving the financial institution itself or some other corporation with which it had ownership links.

The types of conflict outlined in this section relate mainly to ownership links between financial and non-financial corporations. The potential ownership-related conflicts of interest involving different types of financial institutions would seem to be significantly different. Most of these conflicts of interest would be essentially the same as those which arise from the combining of particular functions within the same financial institution. It is, however, possible that operating different functions within different corporate structures would provide a somewhat greater degree of separation amongst the functions and, thus, make it more likely that the conflicts of interest could be minimized, more easily resolved in an appropriate manner, or more readily controlled by regulation.

5. POLICY ISSUES AND QUESTIONS FOR DISCUSSION

There are essentially three ways to deal with a conflict of interest situation. One way is to enforce a strict separation of function and/or ownership to prevent any conflicts from arising in the first place. A second way is to allow activities to be combined, even though this might give rise to some conflicts of interest, but then to attempt to limit any abuses which could occur as a result. This involves the creation of a regulatory structure. Specific regulations would include procedural guidelines, investment guidelines, and provision for disclosure to supervisory authorities who would then be in position to judge as to whether or not conflicts were being resolved appropriately. The third approach is to rely on self regulation and the industry's own long-run interest in maintaining public confidence by ensuring that conflicts were resolved in an objective way. In Canada, all three types of approach are used; some examples are provided below.

First, there are several important separations of function in Canada between lending and securities-related activities. Chartered banks are the main commercial lenders and they are prohibited from underwriting corporate securities, although they are allowed to participate in a selling group. Banks are also prohibited from promoting specific corporate securities to their customers, although they are allowed to arrange securities transactions for their customers through brokers. Finally, chartered banks are prohibited from providing investment advice although they are allowed to provide accounts for investment purposes.

Ownership restrictions apply to the chartered banks and, conversely, chartered banks are limited in the extent to which they can invest in a particular non-financial corporation. Thus, the major commercial lending institutions are prevented from having strong ties with non-financial institutions.

Trust companies, meanwhile, which have some commercial lending powers but are not subject to ownership restrictions, are required to conform to a variety of regulations concerning their investments and loans. Moreover, individual trust contracts specify the extent of discretion available to the trustee in investment decision-making.

In contrast to these cases, Canadian financial institutions can perform both underwriting and securities distribution without special regulations for the conflicts of interest to which these two activities can give rise.

Interestingly, not all countries enforce the same separations of function. For example, Canada and the United States enforce a separation of function in the case of underwriting and commercial lending whereas Switzerland and Germany, among others, do not. On the other hand, Britain separates the functions of underwriting and securities distribution whereas neither Canada, the United States nor Germany do. Finally, as regards trusteeship and commercial lending, Britain enforces a separation of function, Canada regulates closely, while the United States invokes the "Chinese Wall".

A number of questions are prompted by the preceding discussion, particularly as regards the practical significance of many of these conflicts of interest and the feasibility and costs of different approaches to dealing with them.

Practical Significance of Conflicts of Interest

Not all conflicts of interest are likely to be of equal severity or of equal concern to public policy makers. As noted, financial institutions are likely to find it in their own long-run interest to be perfectly scrupulous in their handling of such situations. Indeed, competitive forces impose such a discipline. Nevertheless, where the potential costs arising from even isolated abuses are high, there is a clear role for public policy. One important question, then, is how important are many of the conflicts of interest which have been identified?

One aspect to the calculation of costs arising from conflicts of interest is the frequency of incidence and the potential cost in any individual incident. Small costs met with frequently might be less disturbing than high costs incurred in isolated incidents, even though the final tabulation of costs might come out the same in both cases. In considering the various conflicts of interest it is important therefore, to assess not only their significance in terms of frequency of occurrence but also in terms of potential costs in cases of abuse.

Comparative Importance of Particular Conflicts in Canada vs. Other Countries

As noted different countries have approached some of the more important conflict of interest problems in different ways. Does this reflect differences in the relative importance of such conflicts of interest in different countries, or different attitudes towards the problems and different perceptions as to the costs?

Alternative Policy Approaches to Conflict of Interest Problems

Are behavioural rules and separation of function feasible alternatives in all types of conflict of interest situations or is one approach better for particular types of situations than the other? For example, when an institution faces the problem of potentially serving two different clients, is it at all possible for rules to prevent conflicts of interest from leading to damage to one or the other's interests?

Relative Costs of Different Regulatory Approaches

Different regulatory approaches to conflict of interest problems have different costs. It is conceivable, for example, that gains from avoiding conflicts of interest made by enforcing separation of function might be more than offset by benefits lost. For example, potential economies of scale or economies resulting from integration of different financial services could be forgone as a consequence of separation of function in some cases. Similarly, the costs of generating and disseminating the information required to allow regulators to assess the conduct of financial institutions operating under behavioural rules may outweigh the benefits to be gained from such regulations. Is it the case that, where the cost of regulation is sufficiently high, straightforward separation of function or reliance on self-regulation and competitive forces are more appropriate approaches to conflict of interest problems?

6. CONCLUSION

The possibility of conflicts of interest is one of the reasons why financial institutions function under a considerable burden of regulation. It is important, therefore, to establish clearly the significance of the costs that such conflicts can lead to. This paper has attempted to identify some of the more important conflicts and has raised the question of their practical significance in comparison to the costs of either compliance with regulation or of separation of function.

In considering this question, it is important to bear in mind that the degree of concern arising from a conflict of interest situation will vary with the circumstances. In many cases, individuals or institutions may be able to perform functions with inherent conflicts of interest and discharge their responsibilities in wholly appropriate ways. However, when these same individuals or institutions are placed under a great deal of pressure, when for example the risks and benefits of resolving conflicting interests in one particular way are very large, then the difficulty in resolving these conflicts in an objective way becomes commensurately greater.

A further consideration in evaluating the relative costs of conflicts of interest, and the regulatory system erected to deal with them, is the value of public confidence generated in part by the system of regulation. Public confidence is the lubricant which allows a smooth functioning of the financial system; its value is not easily calculated. To what extent it depends on the general belief that conflicts of interest will not be permitted to lead to abuses is also not easily calculated. In considering the future evolution of the financial system, where more or fewer conflict of interest situations may be allowed to prevail, this is clearly one of the more important considerations.

REGULATORY CHANGE AND COMPETITION IN THE FINANCIAL SYSTEM: QUESTIONS OF CONCENTRATION AND INTERNATIONALIZATION

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1. INTRODUCTION

One of the chief concerns raised in the discussion of regulatory change in the Canadian financial system is the possibility of increased concentration emerging as a consequence of relaxing constraints on competition along inter-industry lines. This paper considers the economic and regulatory concerns that would be raised by increased concentration in the financial system and the possibility that relaxing inter-industry barriers might indeed increase competition only in the short run while ultimately leading to the demise or absorption of smaller institutions and thus to a more concentrated, less competitive system in the long run. In this discussion, it will be assumed that conflict of interest questions which arise out of concentration within the financial system are dealt with by regulation.

From an economic policy perspective, concern about the degree of concentration within an industry stems largely from the belief that the behaviour and performance of firms is in part determined by the structure of their industry, and, moreover, that non-competitive behaviour will be fostered in a highly concentrated market environment and that the efficiency of the industry will be impaired by the loss of competitive market discipline. A highly concentrated market structure is not, of course, necessarily undesirable. For example, in some industries, economies of scale or scope might be sufficiently large that the most efficient market structure could be a monopoly, as in the case of utilities.

However, a highly concentrated market structure raises other, not purely economic, concerns. For example, when firms get very large the costs associated with their failure become so great that they cannot be allowed to fail. This is even more true in the case of large financial institutions than in the case of large non-financial institutions. There is also an additional set of issues arising from the potential for social and political power to derive from the concentration of economic power. For example, concentration of economic activity in the hands of a few firms places the owners and chief executives of these firms in a position to exert influence over public policy and public opinion. Moreover, their decisions can have important impacts on output, prices and employment, discernible even at the macroeconomic level, and take on added significance, therefore, in the context of the political economy. These issues, which were examined by the Royal Commission on Corporate Concentration chaired by R.B. Bryce, are, however, beyond the scope of this paper.

The growth of domestic financial institutions can also be considerably enhanced by an increased presence in foreign markets. Growth abroad would not of course impact on concentration in domestic markets but in some ways a significant presence abroad could be a competitive advantage to the domestic operations of these firms. On the other hand, a greater presence abroad for Canadian financial institutions raises the issue of reciprocal treatment of foreign-owned institutions in Canada and potentially an increased foreign participation in domestic markets. While an increased foreign presence would increase the competitiveness of the domestic market, it would also raise issues regarding Canadian control of domestic financial affairs.

The economic and regulatory issues surrounding concentration of economic activity are discussed in the next section. Section three then considers the circumstances under which the financial system might become highly concentrated in the event of regulatory change and the likelihood of these circumstances arising. Section four considers the implications for domestic competition as well as for domestic control over financial activity of an increased foreign participation in the financial system. Section five outlines a number of issues and questions which emerge from this discussion. Finally, section six briefly summarizes some of the important points touched on in the paper.

2. CONCENTRATION OF ECONOMIC ACTIVITY AND PUBLIC POLICY CONCERNS

Economic theory suggests that the structure of an industry exerts an important influence on the conduct and performance of the firms that comprise it. The ideal market structure is generally considered to conform closely to the model of perfect competition. In this model firms are highly competitive but small relative to the size of the overall market and do not, therefore, exercise any individual influence over the price and volume of trades made within the market. Under certain conditions, such a market structure leads to an efficient allocation of resources and optimal price-quantity outcomes.

The highly concentrated market departs from this model in a number of important ways. First, some firms are sufficiently large to exercise market power, thereby affecting both the quantity and price of the goods and services made available in the market. In a financial markets context, such behaviour could manifest itself in the emergence of credit gaps, wider interest rate spreads, and higher service charges for financial services. The profitability of large financial institutions could also be enhanced under these conditions. However, for greater profitability to persist in the long run, entry to the market would have to be restricted by legislative barriers, high start-up costs or successful use of exclusionary practices by the established firms.

A variety of inefficiencies could also arise in a highly concentrated market. The avoidance of price competition through tacit or explicit collusion and an increase in potentially wasteful non-price competition, such as non-informational advertising, is one often-cited behavioural outcome in a highly concentrated market. Another hypothesis suggests that the reduction in competitiveness resulting from collusive behaviour could lead in turn to a relaxation of internal cost control by management. This "X-inefficiency" results in an increase in costs which, it is suggested, can erode any excess profits accruing to the firm from the exercise of market power. The absence of excess profits in a concentrated market situation is not, therefore, a certain sign of competitive behaviour of the firms involved, according to this hypothesis.

Finally, the reduction of competition could result in a lack of innovative behaviour. As a consequence, the range and quality of services which the industry is able to provide could be diminished and potential cost efficiencies could be forgone.

There are a number of offsetting considerations however. In some instances, economies of scale could be sufficiently large that the optimal size of a firm would be large relative to the size of the market and the perfectly competitive model would not be ideal. Moreover, it has been suggested that large firms have the resources to mount research and development efforts and are indeed an important source of innovation, contrary to some theoretical predictions. As well, large firms may be better able to meet the capitalization costs of adopting new technology. Also, a country such as Canada, whose economy is small relative to her main trading partners, may find it beneficial from a perspective of international competitiveness to have large firms, even though this may entail the toleration of high degrees of concentration in particular domestic markets. Finally, large firms with diversified activities may be able to weather business reverses that would lead to the failure of smaller firms. Moreover, conglomeration is often suggested to sharpen the competitiveness of component firms without raising market concentration by providing them with additional managerial resources and financial depth.

The concentration issue is even more complicated when the dynamic processes which actually produce or maintain concentrated market structures are considered. For example, highly competitive behaviour by efficient, aggressive firms could conceivably result in the emergence of a concentrated market structure. In this case, structure would be determined by conduct and performance, reversing the paradigm typically used. In these circumstances, a policy aimed at preventing an increase in concentration would be counter-productive, at least in the short term, as it would entail restricting the growth of the most efficient firms.

The latitude for firms to persist in non-competitive behaviour over the long run would depend significantly on the persistence of barriers to entry, legislative or other. As long as entry is possible, inefficient behaviour by existing firms would create the competitive opportunity for more aggressive firms to enter the market or to capture additional market share. Inefficient behaviour over the long run also raises the possibility of takeovers and the replacement of management teams. Even in the absence of a competitive market structure, therefore, some market forces could be brought to bear on a concentrated industry to minimize behavioural problems. The attempt to prevent a concentration of economic activity from occurring by restricting the growth of the most efficient firms could, therefore, be counter-productive both in the long run and the short run.

From an economic perspective, it is market concentration, or concentration within a particular activity, which is of concern. The definition of financial activities becomes, therefore, an important issue as well. For example, an increase in diversification of activities by financial institutions could result in a decline in the total number of firms within the system while increasing the number of firms engaged in particular activities. By some measures (e.g., share of financial system assets) concentration might then be seen to have increased while by other measures (e.g., share of the mortgage market or share of deposit liabilities) concentration might be seen to have decreased. Moreover, at a time when technological improvements are shrinking distances, the appropriate definition of the "market" in a geographical sense becomes an important consideration when measuring concentration. For example, some decline in the number of domestic financial institutions engaged in a particular activity might be more than offset by increased access to international markets for those services. Similarly, a decline in the number of regionally based firms might not indicate growing market concentration in any regional market.

From other, not purely economic perspectives, the cause for concern over concentration seems to be more clearly established. It is widely perceived, for example, that large corporations will not be allowed to fail because of the detrimental effects on the economy such failures might have. In effect, the government is seen to provide large corporations with a safety net not available to small business and private individuals. This concern is clearly well founded in the case of financial institutions since maintaining solvency is the most important goal of financial institutions policy. Thus, by allowing financial institutions to grow very large the government may accept an implicit commitment to sustain them in the event of business reverses. Moreover, from a regulatory perspective, a highly concentrated market structure increases the onus on authorities to ensure that the exercise of the market power generated by concentration does not lead to abuses. In a sense, regulatory discipline must replace market discipline in a highly concentrated environment.

The extent to which concentration of economic activity in a particular market in the hands of a few firms is a cause for concern on purely economic grounds is on balance not easy to establish. There are various off-setting arguments and the question appears ultimately to be an empirical one. High concentration does impose an additional burden on the regulatory authorities. Moreover, it can intensify any problems which arise with regard to potential conflicts of interest and raises a number of non-economic, social concerns. These issues should also be borne in mind when the economic issues are being considered.

3. REGULATORY CHANGE AND THE POSSIBILITY OF INCREASED CONCENTRATION IN THE FINANCIAL SYSTEM

The Canadian financial system has evolved within a regulatory structure which has divided financial institutions into reasonably well defined sub-groups with only limited possibilities for competition among these groups. Within these groups, the degree of concentration has been fairly high. The largest banks, insurance companies and investment dealers, for example, dominate a large number of smaller institutions within each of these fields. Removing barriers that separate the activities of the various institutional groups would, therefore, most likely reduce market concentration in the short run, even if the number of firms in each of the old industry groups were reduced as a consequence. The key question would concern the long-run outcome: would market concentration ultimately become higher than it is now?

There are three ways that greater concentration could emerge in the long run. First, inefficient firms, small or large, faced with sharper competition could fail. Second, increased competition for market share might lead less competitive firms which are losing market share to seek protective mergers; alternatively, aggressive, expanding firms might seek horizontal mergers to extend market shares or conglomerate-type mergers to expand their range of business. Third, the largest institutions might simply grow faster than their smaller rivals, gradually increasing the degree of concentration. There could, of course, be an increase in concentration resulting from all three types of trends occurring at once.

There are different implications to each of the above scenarios. If indeed a significant number of firms could be brought to the brink of failure by an injection of new competition into their traditional activities, there is a clear implication that significant inefficiencies have been fostered by the legislative barriers that still separate the various institutional groups. In this case, the argument for increasing competition would appear to be particularly compelling since an inefficient market structure already exists.

The possibility of an increase in concentration resulting from merger activity raises several questions. First, if the increase in concentration comes about through horizontal mergers, and persists in the long run, then in fact sheer size must confer some significant benefit on institutions engaged in particular activities. If scale economies are not a factor, however, and barriers to entry are not present, there is no reason to suppose that the market would in fact become significantly more concentrated, or, if there were an increase in concentration in the short run, that it would remain concentrated in the long run. Available evidence indicates that economies of scale are not an important factor with regard to many financial activities. However, if significant scale economies do exist, it is not clear that public policy should resist an increase in concentration since this would likely reflect a rationalization of the financial industry with the possibility of an attendant reduction in costs and improvement in services.

An increase in concentration resulting from conglomerate-type mergers raises a different set of issues. In the first place, an increase in conglomeration would not necessarily affect market concentration at all, although important questions of conflicts of interest and potential influence in non-economic spheres could emerge as a result. For market concentration to increase in the long run as a result of conglomeration, important economies would have to exist for conglomerates not available to more specialized firms. In this connection, the discussion regarding the future of the "financial supermarket" has not produced a consensus as to whether such benefits to diversification in financial activities indeed exist; or if they do exist, whether they are sufficiently large to drive specialized firms out of the market place.

An increase in concentration following the lowering of barriers which results from accelerated growth of the larger institutions would again imply economies resulting from increased scale or diversification. Canadian experience in the recent past is, to a certain extent, relevant here and provides some interesting contrasts. The largest institutions, the major chartered banks, have enjoyed very strong growth over the past decade and a half. However, the healthy growth of the credit union movement in direct competition with the banking system for personal sector business indicates that smaller institutions need not necessarily be driven out by larger competitors. More recently, the rapid growth of the foreign-owned banks' subsidiaries in the wholesale deposit and commercial lending field stands in contrast to the decline in business lending of the major chartered banks. In this case, the smaller institutions appear to have derived some competitive advantages from low overheads and specialization.

4. INCREASED INTERNATIONALIZATION OF FINANCIAL ACTIVITY: IMPLICATIONS FOR COMPETITION AND FOREIGN OWNERSHIP ISSUES

One very important factor to consider in assessing the degree of concentration and the competitiveness of a domestic industry in any relatively open economy is the extent of foreign participation. Greater internationalization of the financial services industry is indeed one way of ensuring that domestic institutions remain competitive even if the domestic industry structure becomes concentrated. Increased participation of foreign-owned financial institutions, however, would raise a number of other issues relating to domestic control over financial activity and resource allocation. To a certain extent, these questions concern the political economy of the financial system more so than the economics of financial activity, although there are a number of purely economic considerations as well.

The extent of foreign participation in Canada's financial system in the past has varied with the type of institution. In the banking system, foreign participation has been low. The recent incorporation of the schedule "B" banks has significantly increased foreign bank interests in Canada but, nevertheless, these institutions still account for only a small percentage of banking system assets. By contrast, in the life insurance business, foreign participation has been relatively heavy. One-fifth of the life insurance in force in Canada has been written by non-resident companies, mostly U.S.- and U.K.-based.

Canadian financial institutions in their turn have maintained relatively extensive operations abroad. Canadian banks have foreign-currency assets which constitute over 40 per cent of their consolidated balance sheets. Canadian life insurance firms are also active abroad and foreign contracts account for over one-quarter of their business. The investment houses, which are largely Canadian-owned, also operate a fairly large number of branches in foreign securities markets. Given the importance of foreign operations to Canadian firms, reciprocity of treatment of foreign-owned firms operating in Canada is an important issue.

From an economic perspective, several beneficial effects can flow from greater internationalization of financial services. First, foreign companies operating in Canada, and Canadian companies operating abroad, can be conduits for new technology and innovative practices. While there are alternative channels for the inflow of new techniques, first-hand experience and familiarity with them are important factors in facilitating such transfers.

A second potentially beneficial effect is the possibility for improved access to foreign markets for Canadian exporters of non-financial products. Again the first-hand familiarity and intimate knowledge of foreign markets possessed by foreign institutions, and potentially by Canadian institutions operating abroad, can play an important role in facilitating entry for Canadian firms to those markets.

There are also a number of offsetting considerations. First, foreign-owned financial institutions may not have the long-term commitment to the Canadian market that domestic financial firms must necessarily have. Given the importance of the financial sector for the efficient operation of the rest of the economy, excessive reliance on foreign-owned firms may, therefore, entail certain risks. For example, in difficult times, foreign-owned firms may be disinclined to stay for the duration. Moreover, in a resource allocation context, a short-term perspective may result in the flow of capital being channelled into a less-than-optimal set of applications. Such considerations may become increasingly important as the "bricks and mortar" cost of establishing and running a financial operation decreases and short-term convenience may become an increasingly important consideration for managers of mobile international companies.

There is also a serious and more general question regarding the ability of the Canadian government, or indeed any national government, to supervise properly the activities of financial institutions when financial services flow easily across national borders. The rapid growth of international finance within a largely nation-based regulatory structure means that there has been effectively less control over financial institutions that have extensive international operations than over those that have confined their activities to primarily domestic markets. Given the importance of maintaining solvency, concerns about the effectiveness of international supervision are not trivial.

5. QUESTIONS AND ISSUES FOR DISCUSSION

The fundamental question of what would happen as regards the evolution of the financial industry if institutional barriers were relaxed or removed is not answerable before the fact. Under some assumptions, the financial industry could come to be dominated by several giant firms, active in a wide range of activities. Under other assumptions, a wide distribution of firm sizes could obtain with smaller firms trading on their specialized knowledge to carve out and maintain niches in the system. The preceding discussion has raised, however, a number of questions both as regards the likelihood of various scenarios emerging in the future, and as regards the trade-off between increasing competition in the short run, and possibly in the long run as well, against the risk of a significant increase in concentration and eventually a less competitive system emerging. The potential role of foreign-owned institutions in enhancing competition in the domestic market also raises some important questions.

Market Power and Conglomerates

One scenario which has been suggested as possible is a growth in large financial conglomerates. Setting aside questions of conflict of interest and non-economic "power", would such a trend be a serious cause for concern for public policy? Market concentration might not be at all affected and competition in individual markets could even be stimulated as smaller firms gain in strength by becoming part of a conglomerate. Would there be a distinction in this regard if the component firms largely retained their corporate structure as opposed to the situation where the component firms would be integrated into some diversified company?

Eventual Domination by One Type of Institution

To a certain extent the concern which has been expressed over the implications of removing institutional barriers has not been focused on an increase in concentration *per se*, but rather on the possibility that one type of institutional group might come to dominate other types. This appears to reflect several considerations. First, certain types of activities might be considered to be better springboards to entry into others; for example, a movement from a banking business to a securities or insurance business might be perceived as being easier than a diversification in the opposite direction. Secondly, initially greater size might confer a competitive advantage on some types of institutions once institutional barriers were lowered. These concerns, if justified, would indicate that factors other than economies of scale and scope and barriers to entry might affect the long-run evolution of the financial system in a more relaxed regulatory environment.

Changing Technology and Shifting Competitive Advantage

The potential for a "natural" increase in concentration is largely determined by technical considerations. However, changes in technology can very quickly shift the competitive advantage from firms with large investments in an out-moded technology to smaller firms able to adapt themselves to new technology more easily. Technological change is an important factor shaping the financial services industry today. To what extent, therefore, is the current competitive situation a good guide to future trends given the shifting technological environment?

Past Trends in Concentration as a Guide to Future Trends

Many of the segments of the Canadian financial industry are characterized by a relatively high degree of concentration. Nevertheless, there has not been a clear trend to domination by one or two major firms in any of the segments, even considering the relatively small size of the Canadian market relative to the world markets in which many Canadian institutions also function. This situation seems to indicate that scale economies are relatively limited and that a "naturally" concentrated industry would not likely emerge if barriers were lowered. To what extent would the past be a guide to the future in this connection?

The Degree of Concentration that Triggers Serious Concern

Many sectors of the Canadian financial system are already concentrated to some degree. Yet this has not been a pressing concern for public policy in the recent past. This raises the question of how concentrated must an industry become for there to be cause for serious concern?

Costs and Benefits of Foreign Participation in the Canadian Financial System

Is there a trade-off between economic benefits and lessened control over domestic finances stemming from greater internationalization? Foreign-owned institutions, for example, can be brought under supervision as firmly as domestic institutions, as was done with the foreign-owned bank subsidiaries operating in Canada prior to the 1980 Bank Act revisions. However, concern has been expressed that foreign owned institutions will not be as responsive to Canadian public policy concerns as domestically owned institutions.

6. CONCLUSION

The potential for increased concentration of power has been one of the main concerns raised in discussions of any regulatory change which might have the effect of relaxing barriers that separate the activities of the major groups of financial institutions. This paper has provided an overview of the problems that high concentration could potentially cause. As well, it has considered some of the conditions that would have to obtain for the financial industry to become, in fact, seriously concentrated and the process through which such a concentration might evolve. The role of foreign-owned firms in enhancing competition in the domestic market was considered as well as some of the problems that increased foreign ownership could present. Conflict of interest considerations have not been dealt with here, although clearly these would become more important the higher the degree of concentration that emerged.

High concentration is not necessarily indicative of either inefficient production or non-competitive behaviour, although there is a strong presumption that firms with market power would exercise that power to some degree and, moreover, would be likely to recognize the potential mutual benefits of avoiding certain types of price competition and, therefore, to engage in non-competitive behaviour.

In the financial industry, the emergence of a significantly higher degree of concentration following a relaxation of constraints on competition could indicate a number of things, including the possibility that the current regulatory environment has fostered inefficient market structures, and the possible existence of significant returns to scale or scope which have as yet been unexploited. Such considerations raise the question of whether an increase in concentration should be resisted by public policy. This issue would turn on the relative costs and benefits which would result from a higher degree of concentration.

A significantly higher degree of concentration could also emerge from conglomerate-type mergers. In this case "global" concentration within the financial industry would increase while market concentration in the many types of financial activities would not necessarily be affected at all. The issues raised by the two types of concentration are different: market concentration concerns have been discussed in this paper; concerns over global concentration are more social and political in nature and are beyond the scope of the present discussion.

The most important question which has been raised is the following: given that a relatively high degree of market concentration already exists in many financial markets, how much greater would concentration have to become under a changed regulatory structure in order to create a serious public policy problem? If the degree of concentration which would generate serious concern were sufficiently high, then the risk that such a high degree of concentration could emerge under any plausible scenario would have to be weighed carefully against the advantages of increasing competition in the short run and possibly in the long run as well.

THE STRUCTURAL EVOLUTION OF FINANCIAL MARKETS AND INSTITUTIONS: THE IMPLICATIONS FOR REGULATION

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A Working Paper for
Discussion and
Consultation

CAPITAL MARKETS DIVISION
DEPARTMENT OF FINANCE

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1. INTRODUCTION

Markets, institutions, and regulations evolve in a mutually inter-dependent fashion: for financial institutions, regulations influence both the nature of, and the extent of involvement in, the activities they undertake; conversely, regulations must adapt over time to the changing nature of the activities and institutions with which they deal. In Canada, financial activities have been regulated through regulations imposed on the corporate entities that have engaged in those activities. To a large extent, this system has proven to be successful and Canada's financial institutions have been able to evolve without fundamentally eroding the rationales for the main structural lines of the regulatory system.

Diversification of activities has proceeded apace in the past decade and a half, however, and the basic structure of regulation has been brought into question. In 1976, the Economic Council questioned the reasonableness of continuing to maintain separate regulatory structures for the various kinds of deposit-taking institutions when it was becoming increasingly evident that their activities were becoming more and more similar. Since then, some attempts have been made to rationalize the regulation of deposit-taking institutions (through the formation of the Canadian Payments Association, for example; the federal Savings Bank legislation suggested by the Superintendent of Insurance also had the same intent).

More recently, other aspects of the structure of financial regulation have been brought into question as well: competition is emerging between insurance companies and deposit-taking institutions and between banks and investment dealers, while links have been created between the trust and insurance industries through holding companies. A further, significant diversification of activities of financial institutions along these lines could seriously strain the rationale for the current system of regulation.

This paper examines the changing nature of financial markets and institutions and attempts to set out some of the issues involved in assessing the extent to which the current structure of regulation could continue to retain its validity if the nature of the institutions which operate within it were to change to a significant degree. The next section of this paper examines how public policy issues are related in some respects to the functions performed by financial institutions and, in other respects, to the institutions themselves. Section three considers the questions of how and why financial institutions are changing along structural lines and attempts to provide a perspective on the implications these evolutionary trends have for the structure of regulation. Section four frames a number of issues which emerge from this discussion and poses a number of questions. Finally, section five summarizes a few of the main points which are raised in the paper.

2. THE ORIENTATION OF REGULATION: FUNCTIONS AND INSTITUTIONS

In Canada, the structure of the regulatory system has been designed with certain types of institutions in mind. Moreover, financial institutions are regulated according to the basis of incorporation rather than, strictly speaking, the activities in which they engage. Thus, as the financial system evolves and institutions take on new roles and adopt new methodologies and techniques, some aspects of the regulatory system can become perceived as being not in accord with the way the financial system actually functions. The issue of functional versus institutional bases for regulation tends to arise from time to time when such perceptions become widely held.

Logically, institutions which engage in similar types of activities might be expected to be subject to similar regulations. This would seem to be both equitable and conducive to greater competition among institutions. A functional basis for legislation and regulation has, therefore, received support in the past, particularly in cases where the institution-based regulatory structure was perceived to contain inequities in its treatment of different types of institutions.

However, it would be incorrect to conclude that, because the regulatory structure is based on institutional lines, there is no functional basis for regulation. Regulation has always been concerned with regulating activities. It has proven convenient, however, to impose the regulations on the corporate entities which engaged in those activities. This reflects a number of things. First, in some cases, certain functions were so closely associated with particular institutions that it was only natural to incorporate the functional regulations within the institutional legislation and regulatory framework. As well, functions are not always all that easy to define and, moreover, not all public policy goals are clearly function-oriented. Indeed, some of the most important policy goals, such as maintaining solvency, are very clearly institution-oriented.

The Definition of Functions

To a certain extent, current institutional lines also define very broadly the major functions of the financial system: banking, insurance, investment dealing and fiduciary services, for example. To move further towards a function-oriented system of regulation would therefore require a finer definition of functions than is implied by the institutional structure outlined above.

How functions are to be defined, however, is not immediately clear. It is possible, for example, to define functions on the asset side of financial institutions' balance sheets, or on the liability side. Alternatively, it is possible to define functions as intermediation of some sort (raising deposit funds from individuals and making mortgage loans, for example), or the provision of financial services (brokerage or fiduciary, for example). Thus, there is no simple principle which can be relied upon to generate appropriate definitions of functions. Moreover, whichever basis is adopted for the definition of functions, there is a range of possible definitions depending on the narrowness or broadness of one's perspective. An activity such as deposit-taking, for example, could be sub-divided into a number of more narrowly defined functions such as the offering of current accounts, money market accounts, personal term deposits or personal chequing deposits.

Ideally, a definition of functions should delineate intuitively sensible arrangements of activities which also correspond to natural divisions of expertise for financial institutions. Given this consideration, excessively narrow definitions of functions would seem undesirable since financial acumen can be applied in a variety of ways. Moreover, in an environment of rapidly evolving financial instruments, a definition of function should not be too closely identified with a specific form which an activity has assumed. For example, raising funds through short-term personal deferred annuities or through savings deposits are two particular examples of the more general function of raising relatively liquid short-term funds from the personal sector. The latter way of describing the activity may be the more useful in this context.

It is relatively easy to provide definitions which meet the criteria outlined above with respect to those functions which involve acting as an agent on behalf of a borrower or investor such as fiduciary, underwriting, and brokerage. It is more difficult to provide similarly satisfactory definitions for those functions which involve balance sheet activity. A finely drawn set of definitions of balance sheet activity could be made by distinguishing between methods of raising funds and ways of investing those funds. On the liability side, one major difference would appear to involve the contractual nature of some ways of raising funds, such as insurance premiums and pension savings, as compared to the non-contractual nature of other types of inflows such as deposits.

On the asset side of the balance sheet, it is possible to distinguish between types of markets, such as corporate and consumer lending, or between the types of security for loans. In the latter case, there would appear to be different skills involved in asset-based lending versus unsecured, line-of-credit type lending.

An alternative approach to defining balance sheet activities is to define certain intermediary functions. This approach has some intuitive appeal since institutions actually do take into account their contractual obligations on the liability side when making investments, and, from the reverse perspective, consider the nature of their intended investments when raising money to fund them. This approach also has some potential difficulties. In the first place, such definitions may tend to be either so general that they almost identify a type of institution rather than what might unambiguously be seen as function, or so narrow that any evolution of ways of doing business on either side of the balance sheet would leave the definitions outmoded. Secondly, it is not fully clear which criteria could be applied to distinguish between various types of intermediation.

Long-term lending and borrowing clearly involve a different focus than do short-term lending and borrowing: long-term interest rates, for example, move differently and for different reasons than do short-term rates. Nevertheless, it is not fully clear that the differences are sufficiently large to warrant making a conceptual distinction along these lines. Moreover, banks routinely make longer-term loans on the basis of short-term deposit inflows with floating interest rates sheltering them from interest rate exposure. This sort of term transformation is in fact a function in itself of financial intermediaries. Thus, there would not appear to be a sound enough basis, either in principle or in practice, for distinguishing between short- and long-term intermediation as two separate functions.

A market-based distinction between types of intermediation, on the other hand, while less attractive conceptually, may be quite practical. The suggested Savings Bank legislation, for example, would group a number of deposit-taking institutions under one institutional rubric in recognition of the similarity of their intermediary functions.

What is not clear in this example is whether it is a function or a type of institution which is being defined by the concept of a savings bank. Indeed, it would appear that, in this instance, the two concepts verge on one another.

Achieving Public Policy Goals: Functional/Institutional Issues

Public policy goals are not always solely related to either functions, however these are defined, or to institutions *per se*. In some cases, policy goals are best enunciated in terms of financial activities, and in other cases, in terms of the financial institutions that undertake them.

For example, one important policy goal is to promote competition. This may be taken to mean competition among those institutions which have a similar basis of incorporation. However, it may also be taken to mean competition in specific activities; in the latter case, competition can involve a variety of *types* of institutions. By and large, it is the latter sense in which competition policy is most logically framed. Thus, concentration is most meaningfully measured in terms of markets, rather than in terms of institutions. Competition and concentration as policy concerns are, therefore, more clearly function-oriented rather than institution-oriented.

Conflicts of interest, on the other hand, are more clearly perceived as institutional concerns, since they arise from the combination of several functions in one institution. Solvency is an institutional concern as well, since it is the financial health of an institution which is of interest here. However, the legislative structure and the degree of supervision deemed necessary to ensure soundness is clearly influenced by the nature and combination of activities which the institution undertakes. Thus, while the solvency issue concerns institutions, how it is dealt with is very closely related to the nature of their functions.

Meshing Functional and Institutional Approaches to Regulation

There are two general questions which need to be addressed when consideration is given to modifying the basis of regulation of financial institutions: questions of design and of implementation. Designing an optimal regulatory structure would appear to involve finding a way to incorporate both functional and institutional elements in order to address the full range of public policy concerns. Implementing a new system of regulation would create other problems, notably of how to effect the transition from one regulatory regime to another.

In an institution-based system of regulation, each group of institutions is subject to one regulator or supervisor who oversees all aspects of firms' operations. One problem this system poses is that of ensuring similar and equitable regulatory treatment to firms engaged in similar activities but incorporated under different Acts. Moreover, such a system of regulation can impede the efficiency of the overall financial system by inhibiting the free flow of capital, both financial and human, to optimal applications.

A function-based system would ensure that similar treatment would be afforded to all firms pursuing similar activities. This is an important consideration from the perspective of competition policy. In a sense, a function-based regulatory system would ensure a "level playing field" for all types of financial institutions, at least as far as regulatory treatment is concerned. Moreover, it would enhance the ease of adjustment of the range of activities undertaken by institutions in response to changing conditions.

A purely function-based system would, however, create a problem in that no particular regulator would be responsible for the overall soundness of firms. Moreover, inter-functional issues, such as product mix, allocation of funds among various activities, and conflicts of interest, would be beyond the pale of any individual regulatory authority.

A workable system of regulation would, therefore, appear to require a meshing of the two approaches to regulation. Under one extreme option, this could be achieved by having institutions operate under a different regulatory regime in each of their main activities as well as having a supervisor of institutions who would examine their overall structure and/or total balance sheets to ensure such things as capital adequacy, soundness of management practices and other institutional concerns. Alternatively, legislation could continue to be framed on an institutional basis, but care could be taken to ensure that, where activities were similar, the regulatory regimes would also be similar. In terms of modifying legislation, the latter approach would clearly involve co-ordinated, periodic reviews.

The Logistics of Change

Efficient regulation and supervision are to a large extent based on experience: knowing markets, knowing institutions and the persons who direct them, and knowing how markets and institutions interact. An abrupt shift of the basis of regulation or an alteration of the supervisory responsibilities could create dislocations and problems of proper supervision in the transition period.

In the past in Canada, regulatory change in the financial area has been undertaken on a gradual, incremental basis. This has given both institutions and regulatory authorities the time to adjust in an orderly fashion to new ground rules. In the current environment, however, the rapidity with which change is occurring may make it difficult to hold to a deliberate pace in making adjustments to the regulatory structure. Too slow a legislative response to changing conditions could lead to delays in the adjustment of the financial system to new market environments and/or waves of innovation expressly designed to circumvent existing regulatory obstacles.

A second important consideration is that, given Canada's constitutional setting, co-operation between the provincial and federal governments is essential to an orderly and coherent approach to regulatory adjustments. Too slow a response by one level of government, or lack of co-ordination between the levels of government, could create room for choice for institutions as regards the most convenient system of regulation under which to operate. This in turn could raise problems with regard to jurisdiction over particular types of activities or types of institutions if institutions attempted to take advantage of such a situation by seeking to change the basis of their incorporation to gain access to a less restrictive regulatory system.

3. THE STRUCTURAL EVOLUTION OF FINANCIAL INSTITUTIONS

Given the essentially institution-oriented structure of the regulatory system, an evolution of financial institutions along lines that cross traditional institutional boundaries raises questions of whether the structure of regulation should be modified to allow these trends to continue or whether existing regulatory barriers should be reinforced to prevent such trends from reaching fruition. These questions turn on considerations of why these changes are occurring and what are the likely implications for the attainment of public policy goals. To the extent that these trends lead to a more efficient system of providing financial services and better, more convenient products, then they clearly should be accommodated, unless there are clear risks of negative implications for the attainment of other public policy goals.

The current developments in the financial industry are commonly referred to as the "blurring of distinctions". This blurring has occurred because of a number of factors including inflation, shifting market opportunities and changes in legislation designed to increase competition. Another factor which has received some attention in discussions of this phenomenon is technological change. In some views, technological change is an important driving force behind the trends. In other views, however, it is identified only as a factor facilitating changes which are occurring for other, more fundamental reasons.

The direction of change in the financial industry is not certain. One model towards which financial institutions might evolve is some form of a "financial supermarket". Alternatively, the financial system might evolve towards large conglomerates comprised of individual financial institutions of the types which now exist, with greater or lesser degrees of co-ordination among the component firms. However, specialization may also have sufficient advantages that financial "boutiques" might be able to co-exist with larger integrated-services firms.

The "Blurring of Distinctions"[1]

The evolution of financial institutions has been influenced by a number of factors. Particularly important during the 1970s and so far during the 1980s have been the high levels and volatility of inflation, a development which has considerably increased uncertainty about future interest rate levels. Long-term financial markets have been particularly affected by this development and financial institutions have been crowded into short-term activity as one result.

Financial innovation has also been due to the competitive pressure on firms to find new ways to grow, in some cases because of declines in traditional markets. In other cases, this innovative activity has come from foreign institutions entering Canadian markets and bringing with them techniques more prevalent abroad (e.g., the growth of factoring in Canada was related to foreign-owned institutions entering the Canadian market). Other innovative activity has come from opportunities provided by the tax system (financial leasing, for example) or by ambiguities in the regulatory structure itself (for example, life insurance firms have been able to compete effectively for deposit funds through personal short-term deferred annuities even though deposit-taking is prohibited to them).

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1. For a more complete discussion of this phenomenon, see Chapter 3 of the background paper Canadian Financial Institutions: Trends and Policy Perspectives (Department of Finance, January 1984).

It is not, of course, clear that the trend towards diversification will continue or, if it does, will necessarily lead to a situation where the maximum degree of diversification becomes the norm for financial institutions. In the first place, certain separations of functions may have to be enforced out of public policy concerns regarding such things as concentration of power and conflicts of interest. As well there are costs to diversification in addition to potential benefits. For an existing financial institution to get involved in a new activity, it must acquire the skills and market knowledge required to function effectively and profitably in that activity. In cases where the institution's existing human and other resources lend themselves reasonably well to the new activity, the diversification may prove to be both easily effected and eventually profitable. In other cases, no clear advantages may accrue from particular combinations of activities and firms may become indifferent as to whether or not a diversification along such lines is undertaken or not. In still other cases, diversification may prove to be detrimental to the firm's own interests. For example, the attitudes and philosophies required to successfully manage an institution which engages in activity of a long-term nature could conceivably prove a handicap and lead to poor performance if applied in a short-term environment. It is also noteworthy in this respect that conglomeration in non-financial fields has not always proven to lead to higher earnings or to appreciably greater market success for component firms. The same could prove true for conglomerate movements among financial institutions.

The Role of Technological Change

While the various developments described above demonstrate that the financial system is both flexible and adaptive at all times, rapid technological change seems to have become in recent years an increasingly important factor in at least opening up new possibilities for financial innovation. The technological developments which have affected the financial industry have come with regard to the processing, transmitting and storing of information. Money, and financial products of all types, can be considered a form of information and the technological developments have, therefore directly affected the creation and manipulation of these products.

Aside from reducing the costs of storing and processing financial information, computerization allows an increased degree of sophistication and complexity of financial services. In some cases, this additional sophistication may have few if any implications for the structure of the financial industry. In other cases, however, there may be important implications for the range of services which institutions may be able to package and market profitably. While it is difficult to anticipate with any degree of accuracy what the impact of technological change will be, it is likely that experimentation will lead to the development of new financial products, new product mixes, and perhaps new delivery systems.

The development of new product delivery systems may have the farthest reaching consequences for the structure of the financial industry. For example, competitive opportunities could then arise for new types of arrangement to develop between the production and distribution phases of the financial industry's activities. Currently, most financial institutions distribute the products they "manufacture". The expertise involved in "manufacturing" financial products, however, is not necessarily closely linked to the expertise involved in delivering the products. Competitive forces, therefore, could conceivably drive a wedge between the production and distribution roles of the financial industry.

Alternative Forms of Industry Organization

Discussions of the changing nature of financial institutions have tended to focus on particular types of institutions that might eventually evolve as the end result of all the changes that are currently occurring. One model towards which financial institutions might tend is the generalized financial intermediary offering a full array of financial services to individuals and corporations. An alternative model which has been proposed is the financial conglomerate which would combine under one corporate structure various institutions which operate to some extent independently. A third model towards which financial institutions could turn would involve a separation of the "production" and "distribution" aspects of the financial industry. Of course, even if one or more of these models of a diversified financial institution were to prove viable, that would not preclude the possibility of smaller, specialized firms also prospering.

The Generalized Financial Intermediary

This type of financial institution would offer the full array of financial services and products available on the market. To a certain extent, this type of institution is close to reality today in Canada in the form of the deposit-taking institution. Most deposit-taking institutions offer a wide range of financial services and packages of services to their individual and corporate customers. Indeed, it would not require a great deal of further diversification by these institutions to create what many believe to be a financial "supermarket".

Alternative Versions of the "Supermarket" Concept

An evolution of deposit-taking institutions towards the supermarket concept along the lines described above, however, represents only one way in which supermarkets could develop. The modern non-financial supermarket sells not only a wide range of products but also competing brands of similar products. The possibility of separation of production and distribution in the financial system would raise the possibility of a similar type of supermarket emerging in the financial sphere. In this model, one distributor would market, for example, the deposit accounts of a number of banks, trust companies and other financial institutions. Precedents for such a system already exist in the financial system in the form of the independent insurance broker who markets the products of a number of insurance firms, and the mortgage broker who performs a similar function with regard to mortgages.

Even if some types of supermarket were to prove viable as financial institutions, it seems likely that other types of more specialized institutions would still thrive alongside them. Moreover, the eventual nature of the supermarket would also be shaped by the regulatory environment in which it would have to function. Thus, some explicit separations of functions may be desirable and there may be, therefore, practical limits to diversification.

Conglomerate Models

There are a variety of ways in which financial institutions might organize themselves in between the two extremes of the atomized one-product firm and the all-encompassing supermarket. For example, the ownership of financial institutions could provide links among individual financial companies involving varying degrees of integration of operations. The financial holding company, which is already a reality, combines a number of relatively independent financial institutions under one ownership structure. Co-operation among the individual financial institutions in the marketing of specific products in such an ownership structure could then provide the means of exploiting complementary features of certain products while leaving the basic nature of the existing institutions unchanged.

A second model of conglomeration could evolve through parent-subsidiary relationships. Under this system, existing financial institutions wishing to diversify could do so by acquiring subsidiaries operating in the area in which they were interested, or by starting up subsidiaries in these areas on a de novo basis. As in the case of the holding company, the degree of interaction and co-operation between parent and subsidiary could vary from virtually full integration to essentially complete independence.

These two models of conglomeration, the holding company and the subsidiary network, envisage financial institutions which are similar to those functioning today. Moreover, these models could evolve with little or no change in the regulatory framework since the component firms of the holding company and the subsidiaries of a parent financial institution would be subject to the regulations which already exist for those types of institutions.

4. QUESTIONS AND ISSUES

Attempting to assess appropriate regulatory responses to still-uncertain scenarios regarding changes in the financial system is subject to great difficulties. Some of the questions prompted by the preceding discussion are as follows.

Functional/Institutional Regulation

One way of achieving an appropriate meshing of functional/institutional approaches to financial regulation would be to co-ordinate legislative review of the various institutional Acts. Since the Acts would remain institutional in orientation, the institutional concerns would be covered. Meanwhile, co-ordination of legislation would help place the focus on ensuring that, where activities were similar, the regulatory changes would follow similar lines. To what extent, however, would such an approach prevent a re-formulation of the financial industry along lines that might be more efficient than those which currently exist and which would to a large extent still prevail in the future in this scenario?

The Definition of Functions

It is possible to define functions according to the asset or liability side of financial institutions' balance sheets or according to intermediary or agency roles. Where should the main notional lines be drawn to separate the various functions undertaken within the financial system? In this context, to what extent may the functional/institutional issue be primarily of concern with regard to deposit-taking institutions rather than with regard to other segments of the financial industry?

Technological Change and the Nature of the Financial "Product"

Aside from reducing the cost of handling information, technological change may permit an increased degree of complexity and sophistication of the financial services which can be offered. To what extent do these types of changes have implications for the nature of financial institutions and the range of products they are able to efficiently supply?

Human Capital as a Constraint on the Diversification of Institutions

While technological change may lay the basis for a more diversified financial system, the managerial requirements of such a system may be very difficult to meet. To what extent would the human capital embodied in financial management be the effective constraint to a significant, further diversification of financial institutions? What are the implications of such possible constraints for the solvency of institutions and their proper supervision?

Separation of Production and Distribution

One of the more interesting possible developments in terms of impacts on the future shape of the financial industry is the possibility that competitive advantages will accrue to firms that specialize rather than diversify their activities. One such scenario would involve the separation of production and distribution given that the skills involved in the two roles may not be closely linked. Under what circumstances would such an outcome be likely?

Financial Holding Companies

In a financial holding company or a subsidiary network, each component firm or subsidiary remains subject to its own legislation and operates within its own regulatory structure. This would at first glance obviate the need for additional regulation on the holding company itself, or on the parent-subsidiary system as a whole. Would this indeed be the case? Or, would the behaviour of the component firms be subject to influence because of their affiliations? In the latter case, separate legislation might be necessitated for such amalgamations.

5. CONCLUSION

The preceding discussion has raised a number of questions concerning the future evolution of the financial system. One important consideration for public policy that has flowed from this discussion is the need for flexibility and generality in dealing with financial institutions in the period in which they are making adjustments to new market conditions and new technical possibilities. Regulation should leave institutions as free as possible to make efficient adjustments. On the other hand, it is also important to ensure that public policy goals be met both during the interim adjustment period and in the financial system which ultimately emerges.

SOLVENCY OF FINANCIAL INSTITUTIONS AND THE PUBLIC INTEREST

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A Working Paper for
Discussion and
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CAPITAL MARKETS DIVISION
DEPARTMENT OF FINANCE

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1. INTRODUCTION

Developments in the financial services industry which have been occurring in recent years and changes in financial legislation which financial institutions have been seeking are related in large part to the structure of the financial industry. These developments and prospective changes, often referred to as "the blurring of distinctions", have particularly important implications for those public policy concerns that are closely linked to industry structure: namely, competition and concentration and conflicts of interest.

By contrast, solvency and solvency-related concerns do not bear directly on the internal structure of the financial industry. However, important parts of the regulatory structure are there for solvency reasons and, while they were developed to conform with a particular structure more so than to impose that structure, they do work to preserve its shape. Moreover, some of the current separations of functions within the financial system do have implications for the amount, the type and the combinations of risk that financial institutions can take on. In turn, this risk structure has implications for what constitutes prudent behaviour on the part of the institutions. Under alternative industry structures, institutions would face different solvency risks. Any change in the structure of the financial services industry, therefore, raises questions about how solvency-related goals are to be met.

The next section of this paper examines the public policy concerns that are associated with the solvency of financial institutions. It also considers alternative ways to achieve solvency-related goals and the limitations and costs of these alternative approaches. Section four then frames a number of issues and poses questions for discussion.

2. SOLVENCY AS A PUBLIC POLICY CONCERN

As a general observation, it is fair to say that governments are far more concerned about the health and well being of financial institutions than about their non-financial counterparts. This concern does not, of course, derive from any special consideration for the shareholders and owners of financial institutions or from any particular desire to extend the existence of specific corporate entities. Rather, it reflects the pursuit of a number of more fundamental goals which, however, tend to be closely intermeshed with the solvency of financial institutions. Solvency, as a public policy concern, is therefore best considered as a rubric for a range of other concerns.

Fundamentally, government involvement with financial institutions stems from the desire to facilitate the flow of funds in the economy from savers to borrowers in order to enhance the growth of the economy. If the risk of investing were too high, then individuals with surplus funds might either figuratively or literally stuff them into the mattress. It is difficult to assess the extent to which the financial industry, out of its own self interest, would have been forced to adopt some form of self-regulation in the absence of government involvement. However, it seems fair to postulate that government regulation and scrutiny of the activities of financial institutions has done much to facilitate the flow of funds in the economy and to make it easier for new firms to gain public confidence, thereby also adding some dynamism to the financial system.

In addition to facilitating the savings and investment process, financial institutions provide a wide range of financial services, including a large part of the payments system. Any major disruption to the financial system caused by failure of financial institutions would create problems in these other areas as well. It is because of the large and central role which financial institutions play in the economy that avoiding solvency-related disruptions to the functioning of financial markets is an important goal of public policy.

Confidence in the financial system, which helps ensure its continuing smooth operation, plays a central role in solvency and solvency-related issues. The failure of one financial institution could create doubt about the viability of other financial institutions, whose only connection with the failed company might be belonging to the same industry group, and thereby engender a spreading financial crisis. This stands in sharp contrast with other industries where the failure of one firm is often regarded as simply evidence of the market weeding out the inefficient.

In addition to the implications for the financial system as a whole, failure of an individual financial institution can have serious implications for those individuals who have placed their savings with that institution. Large numbers of people who know little, if anything, about financial institutions have their money invested in financial instruments through these companies. This contrasts with non-financial institutions where the number of creditors is much smaller and where the creditors are normally much more sophisticated financially and in a much better position to assess the risk of the investment they are making.

Protecting Against System Failure

There are a number of ways in which financial system crises could evolve out of institutional failures. One way, which is now probably largely prevented by deposit insurance, is the possibility that the failure of single deposit-taking institution would provoke a run by individual depositors on other similar financial institutions. This was one of the reasons for the failure of a large number of banks in the U.S. during the depression. A second way would be a money market flight to quality investments which could be sparked by a failure or even rumour of failure of a financial institution. A third way would be through the forced liquidation of financial system assets in the wake of a severe non-financial shock, such as the failure of a major debtor.

In the first two cases, the problem for financial institutions which are losing their deposits is one of liquidity, not of solvency. The solution to the problem in these instances is to supply emergency liquidity to avert the failure of firms which would otherwise be perfectly healthy.

The third case is potentially much more serious. The failure of a major debtor could have a large impact on the equity position of the financial institutions involved. The institutions, in this case, might still be capable of continuing operations on a going-concern basis and able to recover to a financially healthy position as retained earnings were built up and as new capital was injected. They would, however, be rendered insolvent if required to liquidate their assets under forced-sale conditions.

The problem in this case would be to prevent a large-scale liquidation of financial system assets which, by driving prices down below their warranted values, would bring more and more institutions into insolvency and which could in the end lead to the collapse of the entire system. In the event of a sufficiently massive shock, the only way to prevent such a chain reaction from getting under way might be for governments to extend guarantees, possibly even to fundamentally insolvent firms.

Protection for Savers and Investors

There are three ways of approaching the problem of providing some assurances to individuals who are investing or saving through the financial system. One way is to ensure that they have access to full information about the securities involved and about the institutions with which they are dealing. Investors are then in a position to assess the risks involved and to make informed choices about where and with whom to place their money. Such disclosure requirements play an important role in direct markets where underwriters must file detailed prospectuses with respect to the clients for whom they are raising funds.

A second way is to provide investors and savers with some guarantee on the securities involved, to the effect that all or part of their funds would be repaid should any difficulties with the institution arise. Deposit insurance provides an example of the second approach. The limitation of insurance in this case to $60,000 or less means that the smaller, probably less sophisticated savers receive full protection, whereas the larger investors, who might be expected to be more sophisticated financially, are only partially covered.

The third way is to provide some assurance to savers and investors that the institutions they deal with will be in a position to live up to their obligations by requiring them to observe standards of prudency. This is a commonly used approach as some degree of regulation or supervision applies to all of the major types of financial institutions. For contractual savings institutions, it is the only safeguard and therefore of particular importance in that case.

While the three approaches are to some extent substitutes for each other, it is clear that there are some differences in their usefulness for different types of instruments and with respect to different groups of savers and investors. For example, sophisticated individuals may be able to make sense of information provided through stringent disclosure requirements but it would clearly be a lot to ask of the average person to make sense of financial institutions' balance sheets, to evaluate the riskiness of their investment portfolios or to interpret actuarial reports. For the majority of individuals, therefore, disclosure would provide little effective protection.

Insurance, on the other hand, is effective, and particularly from the point of view of those with fully insured savings. It does, however, have its costs. In the case of deposit insurance, any losses arising from the failure of financial institutions must ultimately be made up in premiums from institutions issuing insured deposits. Moreover, there is also the possibility that the very existence of deposit insurance may make depositors less sensitive to the risks of loss and thus permit imprudently or inefficiently managed firms to grow more rapidly than could otherwise be possible. In one scenario, for example, firms suffering losses from poor investment policies might offer higher interest rates to attract funds in order to stay afloat. A rational person, facing no possibility of default risk, would then be led to place funds with those firms.

Regulation and supervision of financial institutions also has its limitations. For example, it does not provide the same degree of assurance as does a guarantee on an instrument: financial institutions do fail after all despite the plethora of regulations with which they must conform. As well, while it is possible that regulators may have a greater degree of risk aversion than financial executives (whose concerns regarding the solvency of their corporations are certainly no less although they are evaluated in the context of profit maximization), they are certainly no more prescient. In 1978, for example, sovereign loans to particular oil-producing countries undoubtedly seemed to be very safe investments to financial executives and regulators alike. In 1982, some of these perceptions were clearly reversed.

3. THE APPROPRIATE DEGREE OF REGULATION TO ENSURE SOLVENCY

Solvency concerns were most prominent in the early stage of the development of the financial system. At that time, institutions often had small capital bases, lacked essential experience in particular types of activity, and in some cases had inadequate support systems for liquidity. As a consequence, the number of institutional failures was high. The modern system has clearly evolved a long way since then. Institutions are more sophisticated and more experienced in various types of lending and investing. Moreover, important back-up systems have been put in place to provide support to otherwise sound firms facing short-run problems. However, the size of outstanding loans has also increased, debtors and financial institutions both tend to be more highly levered and, with increasing complexity of inter-locking financing arrangements, the exact exposure of institutions to risk has become more difficult to read. Whether or not the financial system is more or less liable to collapse for a given size of shock now as compared to fifty years ago is, therefore, perhaps not totally clear.

An effective and dynamic financial system must undoubtedly be highly levered and must incur risk. However, with every increase in the degree of risk, there is an increase in the degree of potential instability in the event of a shock. Put another way, the greater the degree of risk, the smaller the size of the shock needed to cause the system to unravel.

Given the fact that there are a number of ways in which solvency-related goals can be met, it is useful to consider whether or not the regulatory structure designed to achieve those goals continues to be efficient. The extent of regulation required to ensure that the financial system can withstand any shocks such as are likely to occur is, of course, difficult to determine. While the dangers of allowing the system to become too highly levered or to take on too much risk have been considered above, it is also important to bear in mind that regulation carries a number of costs. Some of these, like the benefits of regulation, may be hard to determine.

The most evident costs are those associated with maintaining the regulatory apparatus and, for firms, those associated with complying with reporting requirements and other aspects of the regulatory system. Regulation, however, also affects the flow of funds in the economy. Excessively restrictive regulation may, therefore, inhibit investment in desirable areas out of concern for the degree of risk being incurred. Moreover, as noted previously, regulation may play a part in sustaining inefficient firms by interfering with market forces and restraining the degree of competition in the system.

The usefulness of, and costs associated with, particular regulations are also affected by the presence or absence of other regulations. Deposit insurance, for example, has implications for the likelihood of deposit withdrawals in response to unsettling market news or rumours. Conceptually, therefore, it should be possible to maintain a more lenient policy regarding liquidity requirements for deposit-taking institutions in a system with deposit insurance than in a system without. In a similar vein, in the presence of risk-limiting regulations on institutions' investment behaviour, the cost of insurance should be lower than otherwise since the frequency of institutional failures should be reduced.

There are clearly tradeoffs involved in choosing the appropriate degree of regulatory restraint and hence the degree of riskiness of regulated financial institutions. A very rigid and conservative regulatory approach would probably minimize the risk of failure and ensure that virtually all the institutions in the system are in a position to withstand major shocks. On the other hand, such a conservative regulatory system may stifle innovation and make it difficult for worthwhile investment projects to obtain funds. This would be of particular concern if funds were not available for rapidly expanding firms or innovative entrepreneurs in light of the vital role these play in maintaining a healthy and growing economy.

At the other extreme, market forces could be relied upon to handle solvency and solvency-related concerns. It is possible that, in the absence of instrument insurance and supervisory authorities, the concern of savers and investors for the safety of their funds would place effective constraints on the degree of risk that financial institutions could undertake and still be able to raise funds. In that case, solvency-related concerns would be handled without a cumbersome regulatory apparatus.

However, it is also possible that normal market forces may not provide adequate control of risk. In one scenario, for example, rapid and uncontrolled growth of financial institutions could provide the credit to bid asset values up to excessive levels. Once such a situation started to unwind, financial institutions could be forced to contract credit and liquidate assets which would tend to induce a downward adjustment in asset prices. This situation could quickly develop into a vicious circle in which falling asset prices induce financial institution failures which in turn lead to further liquidation and further downward pressure on asset prices.

Moreover, it is also possible that relying upon market forces may, in a risk-averse world, lead to other, perhaps undesirable impacts on the structure and behaviour of the financial system. For example, a higher degree of concentration may be encouraged in an unregulated system if savers tend to assume that the largest financial institutions are the safest and avoid placing funds with newly founded companies. As well, the development of innovative practices might be hindered if aversion to risk creates a preference for tried and true instruments and practices.

4. ISSUES AND QUESTIONS FOR DISCUSSION

The modern financial system has developed tremendously by comparison with the system which existed at the turn of the century, or even during the 1930s, the periods during which the basic approach to financial regulation was shaped. It may be useful, therefore, to ask again several very fundamental questions:

Solvency Regulations and Efficiency

A competitive system rewards efficiency with profit and inefficiency with failure. The removal or sharp restriction of the possibility of failure takes away the most basic of market disciplines upon an industry. In principle, this should be avoided if at all possible. To the extent that system failure and protection of the individual are indeed the fundamental reasons for concern over the solvency of institutions, are the alternative ways to meet these goals, namely instrument insurance and disclosure, adequate to the task?

Size of Institutions

Large institutions, it would appear, tend to be protected from failure simply because of their size; this appears to be true whether they are financial or non-financial institutions. The failure of small institutions, on the other hand, tends to cause far less concern. Is solvency, therefore, a concern unique to financial institutions or is it merely the case that this concern has been more clearly enunciated with respect to financial institutions and with large financial institutions in mind? In this connection, would an increase in concentration magnify solvency concerns?

Deposit Insurance and Depositor Behaviour

It has been suggested that deposit insurance enhances the competitiveness of small, perhaps less well-known institutions because depositors have less cause for concern about the safety of their funds. One view suggests that this can aid the growth of poorly established and possibly failure-prone companies. An alternative view suggests that, in a properly regulated system, size and national prominence are not intrinsically related to the soundness of firms. Therefore, deposit insurance merely corrects for any misapprehension of this sort and does not diminish the overall soundness of the system by encouraging the growth of weak firms. Does deposit insurance, in fact, lead to less discriminatory behaviour on the part of depositors and enhance the growth of weaker institutions?

Deposit Insurance as an Alternative to Solvency Regulations

Given the costs involved, can deposit insurance be viable outside a context in which institutions are also regulated for solvency: i.e., is it to any extent a true alternative to regulation?

The Cost of Insurance

Is there a fair way to allocate the cost of deposit insurance?

The Role of Disclosure

Is disclosure a useful complement to regulations in the case of financial institutions? For example, would even a sophisticated investor be able to interpret insurance companies' actuarial calculations and evaluate banks' investments for risk?

REGULATION OF THE FINANCIAL SYSTEM:
FEDERAL-PROVINCIAL ISSUES

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CAPITAL MARKETS DIVISION
DEPARTMENT OF FINANCE

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1. INTRODUCTION

The division of jurisdiction over financial institutions and activities in Canada can arguably be said to have developed as much by chance as by design, and a number of types of institutions can operate under either federal or provincial legislation. It may be a useful exercise, therefore, to give some consideration as to what would be conceptually an appropriate split of jurisdiction between the two levels of government, given the nature of financial activities. Does the financial industry resemble health or education where some degree of national standardization is important but the actual day-to-day regulatory functions are as easily or more easily performed by the provinces? Or is it more like the airlines industry, for example, where regulation and control at the national level seem most appropriate? The split in jurisdiction between the two levels of government could be made almost anywhere, as the current situation indicates, regardless of the conceptual appropriateness. If co-ordination of regulation can be achieved then in practice it may not matter very much which level of government regulates which activities or which institutions.

This paper examines the issues raised by a sharing of jurisdiction over financial activity between the two levels of government against the background of how that sharing of jurisdiction has actually affected overall public policy towards the financial sector in Canada. The next section of the paper provides a brief overview of the history of federal-provincial aspects of regulatory and legislative developments. Section three addresses some of the conceptual problems raised by a split jurisdiction. Section four then considers some of the recent developments in Ontario and Quebec, the two provinces with the largest number of financial institutions incorporated within their jurisdictions. Finally, section five frames a number of issues and poses a number of questions for the purposes of discussion. The appendix to this note provides brief summaries of several papers and decisions dealing with financial institutions regulation in Ontario and Quebec.

2. GENERAL BACKGROUND

Jurisdiction over financial intermediation in Canada has been divided between the federal and provincial governments in a rather "mixed" and "confused" fashion, to quote the Porter Royal Commission on this issue. The federal government has clear jurisdiction over banking and in practice this has meant jurisdiction over institutions that use the word "bank" in their corporate name. The Bank Act does provide examples of the activities banks may undertake but this does not constitute a definition of banking and, in point of fact, non-federally incorporated institutions carry on every important domestic banking activity. The federal government has also contributed to the regulation of a number of other types of financial institutions which are also in part regulated by the provinces. There are, therefore, numerous overlaps of jurisdiction of a federal-provincial nature.

For example, federally chartered trust and mortgage loan companies need, in most provinces, licences from provincial authorities to operate there. Moreover, their trust activities are largely governed by provincial legislation despite their federal charters. Conversely, federally chartered banks which are empowered by federal legislation to deal in securities observe provincial regulations in some aspects of their dealings in the provincially regulated securities markets.

Provincially chartered companies are not limited to operating in their provinces of incorporation as they can operate nationwide by simply registering in the other provinces. As a consequence, many firms are also subject to a number of different provincial regulatory authorities in their business dealings.

The credit unions and caisses populaires provide a useful example concerning the ambiguities relating to jurisdictional claims and the rather accidental fashion in which the existing regulatory system gained its shape. The range of activities of the cooperative institutions overlaps to a substantial extent the activities of the chartered banks. Early in its history the cooperative movement sought federal charter. A lack of response by the federal government led the movement to then seek provincial charter and recognition. For this reason cooperatives now operate largely under provincial rather than federal jurisdiction.

The sharing of jurisdiction has not proven to be an insurmountable handicap to extensive co-operation and co-ordination. Over the years, federal-provincial and inter-provincial co-operation has been evident in a number of areas and has paved the way for some reduction of regulatory discrepancies. This has been particularly true with regard to trust companies as many provinces have modelled their own trust companies' acts after the federal Act. There have been other examples as well. With regard to deposit insurance, Ontario and Quebec developed their own programs prior to the federal government's deposit insurance legislation of 1967. Following the passage of the federal legislation, however, Ontario elected to come under the federal program while Quebec worked out an agreement with the federal government for dividing responsibility for coverage of the different types of institutions. Federal-provincial co-operation was also in evidence when the Canada Deposit Insurance Corporation was empowered to make emergency liquidity loans to credit union centrals. These are provincially incorporated and supervised institutions and operate largely within provincial boundaries.[1] Through their membership in the federally incorporated Canadian Co-operative Credit Society, these institutions gained federal recognition and access to some federal help.

3. CONCEPTUAL ISSUES RAISED BY A DIVIDED JURISDICTION

At first glance, it would appear that the bulk of financial activity has more of a national than local character. Money flows easily across provincial borders and thus many financial institutions operate on a national scale. Moreover, money flows across national borders, and with much more ease than do other goods and services. This also provides a rationale for regulation at the national level because of the implications for international economic relations.

Another factor suggesting national policies on financial activity is the role played by the financial system in transferring funds among the regions from net saving regions to net borrowers. In principle, this is an important aspect of an economic federation.

The examples of the national aspects of financial activity can perhaps be countered with some examples of more local activity. Smaller financial institutions may be quite specialized on a regional basis and confine the bulk of their activities to one province. The locals of the credit unions and caisses populaires movement provide one example of this. Nevertheless, to the extent that the local organizations compete with or engage in activities similar to those institutions that are regulated at the national level or by some other provinces, concerns about the uniformity of treatment could arise.

If it is not possible to achieve national policy objectives by co-ordinating policy among the provinces and between the two levels of government, then it may matter very much how jurisdiction is split. It is possible that provincial authorities will adopt conflicting regulations or even engage in competitive deregulation, seeking to attract financial institutions to locate their head offices and main operations within their respective provinces. In evaluating the probability of this scenario one must bear in mind (i) the constitutional difficulties noted above; (ii) the already apparent differences in approach to financial regulation adopted by Ontario and Quebec; and (iii) the example provided by the U.S. where some competitive deregulation with regard to insurance company regulation has been engaged in by some states.

In considering the importance of potential conflicts in regulatory approach, one must attempt to assess what the cost of such conflicts are likely to be. It certainly does raise the possibility for competitive advantages and disadvantages being placed upon individual financial institutions which happen by accidents of history to be regulated by different jurisdictions. Conflicts of regulation also raise the possibility of considerable administrative and legal problems for institutions operating on a national scale and yet subject to a variety of different and potentially conflicting regulatory regimes.

How concerned one should be about competitive deregulation depends on one's view regarding the appropriate degree of regulation required for the financial industry. If regulators tend to be too conservative and restrictive, then a competitive situation among regulators may drive them to an optimal minimum of restrictions. On the other hand, if regulators have established an appropriate degree of control over the industry then competition among regulators may permit a substantial increase in the risk taken on by the financial industry and by its clients. In the extreme, competitive deregulation could lead to a regulatory haven similar to a tax haven.

4. DEVELOPMENTS IN FINANCIAL INSTITUTIONS POLICY IN ONTARIO AND QUEBEC

The provinces with the largest number of financial institutions under their jurisdiction are Ontario and Quebec. The regulatory philosophies of the governments of these two provinces play an important role, therefore, in shaping overall public policy regarding financial services. The Ontario government, on the whole, seems to be adhering to traditional views on regulation and the separation of functions for financial institutions. The Quebec government, on the other hand, seems to be prepared to follow the course of action proposed in the Parizeau Report of 1969. The basic philosophy underlying this report is that the existing barriers which separate financial institutions should be removed and competition increased by allowing financial institutions to expand into other financial services. While not proposing major changes to the basic legislation governing each type of financial activity, the Quebec government appears to be willing to allow a single financial enterprise to be active in all the main financial services.

A fundamental difference of this type in the philosophical approach to regulation by the two provinces could, of course, have significant implications for the evolution of the financial system in Canada. To date the main area in which the differences in regulatory philosophy have actually been manifest is securities dealing, and more particularly as regards the role of financial institutions in this activity. The Quebec Securities Commission (QSC) has decided to relax constraints on registration of financial institutions as securities brokers and on diversification of brokerage houses into other financial activities. The QSC believes that its measures will stimulate competition and let firms add to their equity base and diversify their range of permitted activities. These expanded powers, it believes, will improve brokerage firms' abilities to compete in the rapidly evolving financial system. The Ontario Securities Commission, on the other hand, has decided that investment by financial institutions in brokerage houses should be restricted and that securities dealers, in turn, should not be permitted to diversify their financial activities.

Quebec is also taking some major departures in insurance company legislation from positions taken in federal legislation and in that of the other provinces. Of these changes, the most significant for the structure of the financial system are with regard to the capacity of insurance companies to invest in downstream holding companies and for mutual insurance companies to finance subsidiary companies with funds raised in the market.

Another area in which important differences might surface in the imminent future is trust and loan company regulation. The approach recommended in the Ontario White Paper represents an attempt to strengthen and up-date the existing regulatory structure. To the extent that the anticipated Quebec trust legislation follows in the vein of the Parizeau Report recommendations, then it is possible that differences with the Ontario approach may emerge.

The general approach to financial system regulation being taken by Quebec differs from the approach which has been taken in the past by the federal government with regard to its own areas of jurisdiction in the financial sector. The federal legislation is, of course, being reconsidered at this time and it is not clear what differences there may be between the underlying philosophy on these issues by the two levels of government. On the other hand, the speed with which Quebec is moving on its own program does raise the possibility that if there are differences in thinking then there could also be differences in regulatory approaches.

5. QUESTIONS AND ISSUES FOR DISCUSSION

The division of jurisdiction over financial institutions among the federal and provincial governments raises numerous potential problems and issues which are often both complex and of a sensitive nature. Cooperation and coordination of policy among the various governments involved in regulating the financial system would seem to be an important requirement for a smoothly functioning system. Conversely, differences in regulatory philosophies on the part of the various regulatory authorities could lead to difficulties. The following are several of the questions and issues raised by the sharing of jurisdiction over financial institutions in Canada.

Jurisdictional Sharing and the Nature of Financial Activity

Are there conceptual grounds for any particular way of dividing jurisdiction over financial activity between the levels of government? More particularly, in which financial activities does a division of jurisdiction and a multiplicity of regulators pose difficulties for financial institutions?

Nation-wide Companies and Provincial Regulation

To what extent is it a problem for financial institutions which operate on a nation-wide basis to function under different regulatory regimes in each of the different provinces with respect to activities regulated by the provinces?

Competitive De-Regulation

If the advantages of operating from a province with a relaxed regulatory regime were of sufficient significance, and if some provinces favoured such relaxation of regulatory control, the possibility would be raised of corporate relocations and an ensuing de-regulatory competition among provinces. Would such a development lead to a serious weakening of regulatory safeguards or would it tend to result in a leaner, more streamlined and efficient regulatory structure?

APPENDIX: RECENT DEVELOPMENTS IN FINANCIAL INSTITUTIONS POLICY IN ONTARIO AND QUEBEC

There have been several notable reports written and decisions made regarding the regulation of financial institutions in Ontario and Quebec which it may be worthwhile to review briefly. Summaries are provided below of the content of the following papers:

(i) The Report of the Study Committee on Financial Institutions (Parizeau Report) of 1969 which is apparently shaping the regulatory philosophy of the Quebec Government;

(ii) The Quebec Securities Commission Decision on Ownership and Diversification;

(iii) The Ontario White Paper on Loan and Trust Companies;

(iv) The Ontario Securities Commission Report on Institutional Ownership of Securities Dealers and the Diversification into Other Businesses by Security Dealers;

(v) The Ontario Securities Commission Report on the Implication for Canadian Capital Markets of the Provision by Financial Institutions of Access to Discount Brokerage Services.

The Parizeau Report

The Parizeau Report takes the position that the present system of regulation of financial institutions has the twin disadvantage of not always affording savers sufficient protection, while at the same time erecting artificial barriers to the development of certain institutions. According to the Report, the present system of regulation makes two implicit assumptions. First, that specialization is less risky than complete freedom to diversify. Second, that public authorities are in a better position than management to appraise investment and lending risks.

The Report makes three fundamental criticisms of the present system of regulation. The first criticism is that restrictions applying to borrowing and investment vary arbitrarily, being more severe for some institutions than for others. The second objection is that this regulatory discrimination among institutions inevitably leads to discrimination among borrowers. These discriminatory restrictions then needlessly affect the flow of savings, and without necessarily improving investor security. The third criticism is that the present system is somewhat inconsistent in its implicit appraisal of investments made by financial institutions.

The Report believes that strengthening the existing system of regulation would only accentuate the differences between types of institutions and perpetuate troublesome rigidity. As an alternative, the Report proposes regulation by function rather than by type of institution. In this vein it identifies three categories of operations carried on by financial institutions, namely:

(a) borrowing and investment operations;
(b) insurance operations; and
(c) trusteeship.

To accommodate these operations, the Report recommends that financial legislation be consolidated into a single act that would specify the powers and responsibilities of financial institutions. Every financial concern constituted under the act would be automatically licenced for borrowing and investment. Additional special licences would also be required for the other activities. Four types of financial institution could then exist:

(a) loan and investment companies;
(b) loan, investment and insurance companies;
(c) loan, investment and trust companies; and
(d) loan, investment, insurance and trust companies.

The current system of specific, rigid regulation would be replaced by continuous and sustained qualitative surveillance of financial statements and operations by public sector supervisors. A number of general and what would appear to be essentially traditional rules would guide supervisors. The first rule would specify limits on the percentage of total assets that a company could put into a single enterprise. (However, this figure would not preclude the financial institution from purchasing a majority interest or even the entire capital stock of another financial enterprise.) A second rule would concern lending restrictions similar in nature to current eligibility criteria for insurance and trust company investments. A third rule would establish asset-capital ratios. The fourth rule would be related to liquidity requirements.

As a result of the sharing of jurisdiction over certain institutions, the Report states that companies operating throughout Canada, wherever chartered, would be faced with two choices if its recommendation were implemented.

(a) They could retain their present charters, but would then have to conform to the most restrictive of the regulatory regimes to which they would be subject. Since the Report's recommendations are in many respects more liberal than comparable legislation in other jurisdictions, any resultant Quebec legislation would then give Canada-wide companies powers in Quebec that they would not be able to exercise.

(b) If Quebec law were to offer sufficiently broad advantages, national corporations could create Quebec-chartered subsidiaries.

Financial Institutions and Securities Dealing in Quebec

One area where the philosophy of the Parizeau Report appears to have found application in Quebec is securities regulation. The decision by the Quebec Securities Commission (QSC) on the ownership and diversification of brokerage firms was in line with this philosophy when it rejected the need for maintaining existing barriers, or erecting any new ones, around the securities industry.

The Quebec Securities Act specifies brokerage registration conditions and any firm which meets these conditions can register with the QSC. In the past, financial institutions were granted a limited registration, but the QSC now favours relaxing these constraints in the interests of competition. The QSC is also of the opinion that brokerage firms should not be arbitrarily prevented from providing other financial services or purchasing shares in other financial institutions. To implement its decision QSC has directed the Montreal Stock Exchange to repeal by-laws that restrict the ownership of member firms.

The principal method of protecting the public interest from excessive concentration of the securities industry would be to prohibit mergers of financial institutions and brokerage firms. While this approach may seem to be contrary to the views expressed regarding ownership, it appears to be based on the view that it is easier to monitor a number of separate subsidiaries, each of which would be subject to its own governing legislation, than to supervise one large institution.

The minority report followed more along the lines of views expressed by the Ontario Securities Commission and strongly disagreed with the views endorsed by the majority of the QSC panel. The recommendations of the minority were:

(1) to allow financial institutions, including foreign financial institutions, to own up to 10 per cent of a brokerage firm;

(2) to restrict any brokerage-sector activities of financial institutions to ancillary functions; and

(3) to allow brokerage firms to own up to 10 per cent of a financial institution, but not to involve themselves in other financial activities directly.

Financial Institutions and Securities Dealing in Ontario

The Ontario Securities Commission (OSC) is of the belief that each of the types of financial institutions in the Canadian financial system has a "core" function and undertakes as well certain other permitted, ancillary activities which might impinge on the "core" activities of other institutions. This system has several advantages, in the OSC's view, in that it minimizes the potential for conflicts of interest and assures investors of regulatory protection. This led the OSC to the conclusion that investment by financial institutions in securities dealers should be restricted and similarly that securities dealers should not be permitted to diversify into other financial activities.

The OSC was unable to reach a unanimous conclusion on the extent of the restriction. The majority view was that any such investment be prohibited. The minority view was that a 10-per-cent limit was acceptable.

While objecting to the diversification of securities dealers into other financial businesses due to possible dilution of management and diminution of available capital, the OSC concluded that it had no objections to diversification into non-restricted businesses (i.e., businesses other than banking, trusteeship and insurance) by the owners of a securities firm through a holding company providing there were no cross-guarantees, cross-liabilities, or cross-assurances.

The OSC has also considered the implications for the securities industry of financial institutions offering access services to discount brokers. In its decision it again relied heavily on the "core" function concept and accepted the view that the financial industry should remain segmented. The OSC is of the opinion that discount brokerage services, whether offered by independent brokers or by brokers associated with financial institutions, would not materially affect the ability of full-service brokers to perform their "core" function which the OSC defined as underwriting. To ensure the health and effectiveness of the underwriting business, the OSC believes that this function should remain the exclusive domain of the brokerage industry. To ensure this, the OSC has taken the position that it will allow discount access services to be offered by financial institutions, but only under controlled conditions. Moreover, participating financial institutions would be severely limited as regards room for expansion of securities-related services.

Trust and Loan Company Regulation in Ontario

The direction taken by the Ontario Government with regard to trust and loan company regulation is more or less traditional and the recommendations tend to buttress and strengthen the existing system of regulation. This contrasts sharply, of course, with the philosophy of the Parizeau Report in this regard.

Important provisions in the Ontario White Paper on loan and trust corporations concern restrictions on transfers of major blocs of shares of trust and loan companies, and the necessity for regulatory approval of mergers and amalgamations. Tighter controls are also proposed on ownership of subsidiaries and on transactions with corporations in which the company has a significant interest. The thrust of these provisions would be to maintain a fairly clear line of demarcation between the trust companies and other segments of the financial industry.

As regards business powers, the White Paper proposes to retain the guaranteed trust concept for the deposit business of trust companies, to adopt better rules concerning the valuation of real estate as security for mortgage loans, to limit real estate investments to 10 per cent of assets and to permit commercial lending only to companies that have demonstrated their management ability and, further, to limit commercial loans to a maximum of 15 per cent of a company's total assets. Investment rules would be simplified and broader powers granted as a company proved its capability.

Financial standards would be generally at the discretion of the regulatory authority. Leverage would be limited through the use of a "borrowing base" and "borrowing multiple". A maximum of 25 times is suggested for the latter. Financial reports would be more frequent and more carefully analyzed.