au courant

Economic Council of Canada Volume 7, No. 3, 1987

- Reforming the financial sector
- A new look at government enterprise

PUBLICATIONS

New Council Statement

Competition and Solvency: A Framework for Financial Regulation (EC22-134/1986E; $4.95 in Canada, $5.95 elsewhere).

In this statement, the Council puts forward a new framework for financial legislation, on the grounds that the existing regulatory system has not kept pace with changes in the marketplace. The statement also looks at such issues as ownership; conflict of interest; consumer protection; various institutional practices; and the need to harmonize financial regulation among provinces and different regulatory agencies and between the federal and provincial governments. (The recommendations in this statement are based on the findings of a research report to be released shortly by the Council.)

New Council Report

Minding the Public's Business (EC22-135/1986E; $10.95 in Canada, $13.15 elsewhere).

The Council looks at the role of government enterprise in this report. It develops a general framework for the evaluation of public enterprise and applies it in the examination of a number of federal, provincial, and municipal corporations. The case studies lead to some important recommendations. At a more general level, the report puts forward suggestions for improving the management and control of public corporations, and provides guidelines for determining under what circumstances they are the most appropriate policy instrument.

Reprint

The following Council publication has been reprinted and can be ordered in accordance with the information below:

Workable Futures: Notes on Emerging Technologies, by *Words Associated* and *Keith Newton* (EC22-132/1986E; $5.95 in Canada, $7.15 elsewhere).

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No. 314 "Marginal effective tax rates for the oil industry in Alberta, 1965-84," by *Mireille Ethier* and *Dominique Simard*.

No. 315 "Structural change and regulatory reform in rail transport: Opportunities for separating the ownership of track and carriage," by *Adil Cubukgil*.

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Minding the Public's Business

Air Canada and Petro-Canada should be privatized as part of a plan to revamp the role of government enterprise in Canada, the Economic Council of Canada recommends.

The two Crown corporations are among a number of government institutions that the Council examines in its recently published report, *Minding the Public's Business*. The Council finds that in some sectors of the economy public corporations are not the most appropriate policy instrument. In certain cases there is a need for "a general strategy of reform designed to reduce government protection and increase the role of market forces." While privatization is one component of that strategy, the Council says there is also "considerable scope for institutional reform and for improvements to ... the control of public corporations."

Public enterprise has played a unique and important role in Canada's development. Even prior to Confederation, public corporations were involved in building canals and operating ports and harbours. Over the years governments have used these instruments for such diverse purposes as nation-building, responding to crises, and promoting economic and cultural development.

In terms of size, Canadian public enterprises run the gamut from multibillion-dollar Ontario Hydro to Canadian Patents and Developments Ltd., with assets of less than $1.5 million. In 1983 government-owned and -controlled enterprises accounted for about 26 per cent of net fixed assets in the economy and for just under 5 per cent of total employment. Some enterprises are heavily dependent on public subsidies, while others, such as Saskatchewan Minerals, are profitable ventures. Likewise, some public institutions, such as the provincial hydro utilities, are regulated monopolies, while many others operate in highly competitive markets.

Today, the federal government is the largest single investor in Canadian industry. All the provinces and many municipalities have major commercial holdings as well. Government involvement in commercial activities has become a matter of growing public concern, the Council notes. Many people are alarmed over the substantial losses incurred by several large federal enterprises. Others fear that the government-enterprise sector has grown beyond government's ability to control it, that public corporations may be unduly privileged (provincial corporations are not required to pay corporate taxes, for example), or that public-enterprise debt – which at the federal level amounted to almost $15 billion in the last fiscal year – places undue financial strain on governments.

While these concerns merit attention, the Council points out that government institutions are as much public-policy instruments as they are commercial entities; hence their noncommercial objectives must be considered in any assessment of their performance. The Council poses certain basic questions in this regard. Why has the government intervened, and does the rationale for intervention remain appropriate under present circumstances? Has the appropriate policy instrument been selected? (Is the use of a public corporation likely to be less costly than, for example, regulation or subsidization?) Has the corporation been managed and controlled so as to realize the potential benefits from intervention?

This study enters new territory for the Council, since its primary focus is on individual firms rather than on particular sectors of the economy as a whole. The Council says it is important "to examine the relevance of individual enterprises in the context of this country's social and economic needs." It notes that there are clear cases where public production is the best choice. One example is the provision of water purification facilities, where it is impossible to introduce competition. There are other cases, however, where private companies could fulfil government economic and social policy just as well as, or better than, public corporations. The Council says it is important that governments have "a realistic view of the possibilities, as well as the limitations, of government enterprises."

Case studies

In its examination of specific public enterprises, the Council finds that some Crown corporations no longer serve the purposes for which they were intended, while in other cases they are not the most appropriate policy instrument. In such cases, the Council believes, a thorough examination of the enterprise's objectives is required.

Electric utilities

Most of the electricity we use is provided by large provincial enterprises, such as Hydro-Québec, Ontario Hydro, and B.C. Hydro. The Council finds that, in general, public enterprises are no less efficient than a system that involves the regulation of private firms. Moreover, governments can more readily influence, for public-policy purposes, the investments of public rather than private firms. But the Council does question some of the objectives for which electric utilities have been used.

For example, provincial electric utilities have set prices at levels below those which would encourage efficient use of electricity. This has led to both overproduction and overconsumption – and to significant economic losses.

The Council did not find evidence suggesting that the public electric utilities are "out of control" in any absolute sense, as some have argued. But it did find the kind of control problems that can occur when government doesn't monitor a corporation closely enough. To help solve these problems, the Council recommends monitoring by independent commissions that would regulate prices and advise governments on the utilities' capital expenditure plans.

Telecommunications

Public telephone companies, such as Edmonton Telephone, Alberta Government Telephones, Saskatchewan Telecommunications, and the Manitoba Telephone System, were established as government monopolies on the Prairies in response to widespread mistrust of the private monopolist, Bell Canada. But in the Council's view, recent developments such as major technological changes in the industry and increased competition from the United States "have placed in doubt the continued desirability or inevitability of monopoly in many aspects of telecommunications."

The Council is particularly concerned that the heavily regulated public Prairie systems have failed to adopt new technologies and to offer new services to the extent that other Canadian systems have. It suggests that the governments of Manitoba, Saskatchewan, and Alberta reduce regulations that limit competition in telecommunications, in order to reduce the current disparity between those provinces and jurisdictions subject to federal regulation.

The Council is also concerned that none of the provincial boards has sought to foster competition. It believes that competition would increase if provincial boards were to make more of an effort to identify the costs of particular services of public telephone companies, to ensure that their monopolistic activities were not subsidizing their competitive ones.

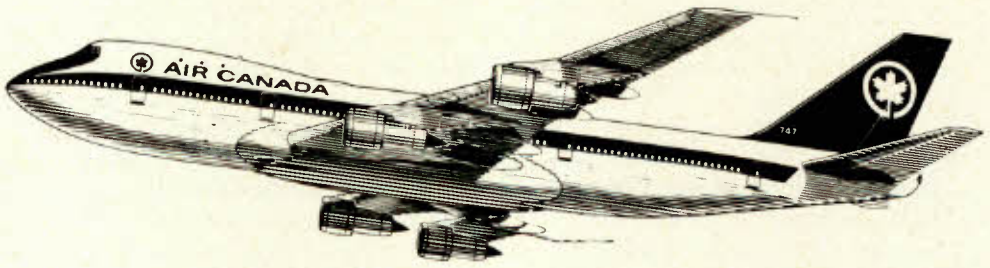
Public transit

In all large Canadian cities, urban transit service is generally provided at a loss by municipal governments.

The use of competitive tendering, or contracting, has continued in smaller centres. Noting that many Canadian and U.S. studies have shown that contractual systems cost less, the Council recommends that provincial and municipal governments actively explore the use of private contracting for urban transit, and that provincial governments redesign transit subsidy programs that discourage contractual arrangements.

Transportation

Some of the report's most dramatic and far-reaching recommendations are in the area of air and rail transportation. As the Council notes, both transportation markets and government-policy orientations have changed greatly since the creation of such public transportation enterprises as Air Canada and Canadian National Railways. The result is that "existing organizational arrangements are no longer consistent with government policy requirements, and major reforms are now called for."



In 1937, the federal government established Air Canada (then known as Trans-Canada Airlines) to do a job that other Canadian airlines couldn't, or wouldn't, do: provide transcontinental and international air service. But today's airline industry is far different than that of 50 years ago. Many new players have entered the field; regulation has been loosened; and Air Canada has come to play an increasingly commercial role, while losing many of its earlier social responsibilities, such as the provision of air service to remote northern regions.

With airline deregulation an established fact in the United States and imminent here, Canadian airlines are in for some major changes. The Council questions whether maximum gains can be realized from deregulating an industry whose major player is publicly owned. The Council believes Air Canada should be privatized as soon as the National Transportation Act has been amended to allow for deregulation of the domestic air

industry. The Council also believes that share offerings should be made initially only to Canadians.

As for rail freight, the Council feels that the industry would be more efficient and more productive if competition within the industry were increased. It notes that the provision of rail-freight services does not require heavy capital investment and is inherently competitive; therefore these services should be open to anyone (including shippers) willing and able to provide them. As such, the Council proposes that new firms be allowed entry into the rail-freight carriage business and that they be provided with liberal access to the existing roadbed.

To help increase rail-freight competition, the Council suggests the establishment of a public track authority based on the CN infrastructure. All potential carriers would apply to this new authority to provide a specified service on the "public track." The authority would be concerned only with maintaining and managing the track; all other activities would remain with CN, which would not necessarily have to remain a public company.

Passenger rail

While VIA Rail was created largely because of public concern over rising passenger-rail subsidies, its own operating losses have continued to mount. Of particular concern to the Council are VIA's lack of a proper legislative mandate and the arrangements governing its purchase of passenger-rail services from CN and CP (payments to the two railways account for two-thirds of VIA's operating expenses).

Current arrangements allow the railways essentially to pass on their costs to VIA, without giving them any incentive to improve their efficiency.

Legislation had been introduced in the last session of Parliament to provide VIA with a mandate; to allow more generally for clarification of the government's passenger-rail-policy objectives; and to give VIA more leverage in its dealings with CN and CP. The Council supports this legislation but would increase the authority of VIA's board of directors. It also believes that VIA should seriously consider competitive tendering to help it reduce its current dependence on the railways.

Air Canada should be sold through a broad share offering made initially only to Canadians.

Industrial policy

Canadian governments have frequently used government enterprise as part of their overall industrial-policy strategy. In some cases, a public enterprise was established to help correct perceived capital-market inadequacies. In other cases, the aim was to establish a Canadian presence in a given sector (usually a high-tech one). And still other government enterprises were set up – usually in high-unemployment regions – to prevent the closure of a private firm and thus maintain employment.

Although there have been exceptions, the Council finds the performance of all three types of public enterprise generally quite disappointing. For example, the Canada Development Corporation, created in response to a perceived lack of capital for homegrown Canadian enterprise, has had a poor record as finder and developer of profitable Canadian businesses; indeed, it has earned a far lower rate of return over the past decade than has the average Canadian industrial firm.

While government enterprise may be unavoidable in the case of a "bail-out" of the failing private firm, the Council believes it should be viewed as an instrument of last resort. As the experience of enterprises like Cape Breton Development Corporation illustrates, political pressure may make it very difficult for government to withdraw support from such enterprises, no matter how costly they may have become. To reduce the costs associated with government enterprise in these cases, the Council suggests that it be accompanied by appropriate adjustment measures, such as worker retraining and relocation programs, and industrial restructuring.

Mixed enterprises – in which both private and public interests own equity – play a limited role at best, the Council says, because the government's public-policy aims may clash with the interests of private shareholders.

Nonrenewable resources

Canadian governments have become involved in the nonrenewable resource sector for a variety of reasons: to keep more of the proceeds from such resources within a particular jurisdiction, to ensure adequate energy supplies, and to promote economic development. The Council finds that while public enterprise has sometimes been a useful way to achieve those objectives, many public resource enterprises were the product of particular historical or political circumstances that no longer apply. "In general," the Council suggests, "(such) objectives are more appropriately pursued through alternative instruments."

In the case of Petro-Canada, the Council says there are significant costs to maintaining a major commercial enterprise within the public sector. For example, since Petro-Canada's equity is not publicly traded, the impact of its purchase of Petrofina could not be reflected by investor reaction to that purchase. As well, government resources are better devoted to carrying out public-policy objectives than to administering commercial activities. The Council believes that Petro-Canada's objective of developing nonconventional energy sources and its concern with security of supply could be addressed more effectively through other policy instruments. Hence it recommends that Petro-Canada be privatized and that share offerings be made initially only to Canadians.

Controlling government enterprise

Many Crown corporations are difficult to manage because corporate objectives are unclear and because managers lack sufficient freedom of action.

In order to make these firms properly accountable, governments should give them "real authority and responsibility," along with a clear statement of objectives, the Council maintains. The problems of controlling government enterprise have received considerable attention lately, as a growing number of reports and inquiries disclose the dismal state of financial management control in many Crown corporations. While significant reforms have been introduced in recent years, many problems remain.

Among the principal difficulties in controlling public enterprise, the Council finds that governments often lack the information necessary to do a proper job. In particular, governments may rely on available financial data that tend not to be very meaningful, partly because these corporations have noncommercial obligations that are difficult to assess in financial terms. In many cases the most serious problem is the lack of precise corporate objectives against which to measure the company's performance. Moreover, the ministers and government officials to whom corporate managers report may not be effectively accountable for actions that influence the decisions of these managers.

Needed reforms

In response to these problems, the Council suggests a number of reforms. A major requirement, it says, is for a "more rational division of responsibilities" between governments and the boards of public corporations. It therefore proposes that, for each corporation, governments be required to table in the legislature a statement of objectives (and/or any changes to it), which would clearly identify all imposed public obligations and make them a matter of public record. The statement would serve as a guide to management and as a basis for assessing corporate performance. It would also help to resolve any conflicts between the company's commercial and noncommercial activities. Each statement would be reviewed periodically and would undergo a major re-evaluation every three to five years.

Corporate boards

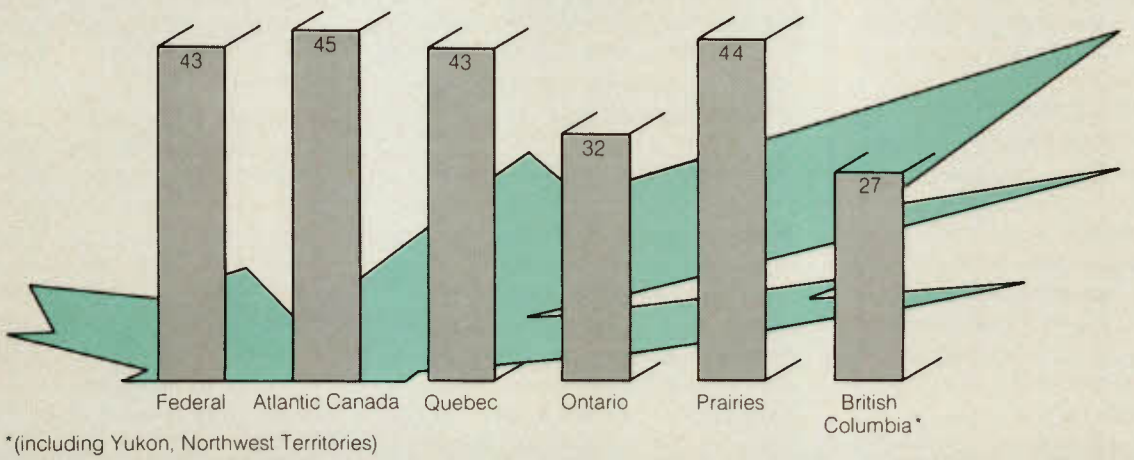
While ministers must provide the required policy direction, responsibility for the administration of corporate activities "should properly fall to the board of directors," the Council insists. To strengthen the position of the board, it proposes that directors be appointed from among candidates nominated by an independent commission, that ministers or public servants from the parent government be excluded as members, and that final authority over the hiring and compensation of senior management belong to it. To attract skilled and experienced board candidates, directors' fees should be brought more in line with private-sector rates. Finally, public corporations should be subject to the same legal responsibilities as private firms under the Canada Business Corporations Act, and these responsibilities should be linked to the statement of objectives.

Investment decisions

As a further measure to minimize ministerial involvement in corporate decision making, the Council would require a separate agency of government to assess and approve all commercial investment decisions by public corporations. Within government this would help to avoid situations where the individuals involved in the initial investment decision have subsequent monitoring responsibility. The Council believes that noncom-

Sizing up government enterprise

Number of wholly owned Crown corporations, federal and provincial, 1985



*(including Yukon, Northwest Territories)

mercial investments, on the other hand, warrant increased attention by policy makers.

Monitoring and evaluation

The Council recommends that a thorough evaluation be undertaken prior to the creation of a public corporation or the establishing of a new objective for an existing one, with particular attention to the costs involved (including such hidden costs as a below-market return on capital investments). The evaluation would attempt to weigh the competing claims on the government's budget and consider alternative instruments for achieving the desired objectives.

Measures are needed, the Council says, to make sure corporate officials appropriately represent the public interest. Where possible, for example, the corporation's performance should be assessed against that of a private company engaged in the same activity. Since the corporation's financial performance may at times be an inadequate monitoring tool, a detailed examination of its corporate activities may be necessary, the Council points out. Finally, since rewards and penalties can pressure management to perform better, corporate boards should be allowed the flexibility to tailor employee compensation packages to meet their specific needs.

Holding corporations

While holding companies may serve a useful purpose in some situations, generally they do not increase corporate accountability or improve governments' control over public enterprise, the Council finds. Since they are set up to control other enterprises, in fact, holding companies encroach on the role of directors of these enterprises. The Council would rather see stronger boards within each corporation.

Legislative committees

Federal and provincial legislatures have an important function in the control process in overseeing the activities of government enterprise. To improve legislative surveillance, the Council suggests greater use of specialized legislative committees. (The 28 standing committees recently established at the federal level would be well suited for this task, the Council notes.) Committee members should be appointed for the life of the legislature so they can develop knowledge and expertise in a particular subject area. The committees themselves must have sufficient budgets to hire competent professional staff. They should also be given complete access to available information and should be able to summon government and corporate officials during investigations. (When sensitive information is to be discussed, these investigations should be held "in camera.")

The role of auditors

Federal and provincial auditors are helpful in monitoring government enterprise, but their methods and the criteria used in comprehensive auditing should be open to criticism and debate, the Council says. Moreover, auditors' findings should be interpreted in the light of management explanations and in relation to the alternative evidence gathered by the relevant government or legislative committee.

Mixed enterprises

In the coming years governments may turn increasingly to the use of "mixed enterprises" – wherein they share ownership with private investors – as a convenient halfway house on the road to privatization. In these instances, governments should not have powers greater than those of other shareholders under federal or provincial corporate law. The Council does suggest, however, that a special group within government be set up to monitor the performance of mixed enterprises.

Subsidiaries

Many public corporations have authority under their enabling legislation to establish subsidiaries, or at least they are not precluded from doing so. In some cases the subsidiary is free from the reporting requirements of its parent and may have greater powers as well. In the Council's view, however, corporations should not be allowed to create or acquire a subsidiary without explicit Cabinet approval. (New federal legislation makes this stipulation.) As well, the mandate and powers of the subsidiary should not be greater than those of its parent, and control mechanisms should apply equally to both.

As for government-enterprise monopolies such as the provincial hydro utilities, the Council proposes that regulatory commissions be assigned a major responsibility for monitoring and controlling them.

Significant costs will be incurred unless the process of privatization is handled carefully.

Legal status

Most federal and provincial government enterprises have special privileges and immunities, such as exemption from criminal prosecution and other laws. The majority of provincial government enterprises do not pay corporate income tax either. The Council questions the granting of special immunities and privileges, since it is contrary to the principle of equality before the law. It suggests that governments, as a start, accept in principle "the desirability of removing current immunities limiting the taxation of public corporations."

Privatization

Public enterprise will remain an important policy instrument in Canada despite the growing debate over privatization, the Council concludes. But as governments increasingly consider selling some of their holdings, the Council warns that significant costs will be incurred unless the process of privatization is handled carefully. For example, attaching conditions to the sale – such as the requirement to undertake research and development – may severely reduce the earnings, and thus the market value, of the corporation. It also notes that where shares are to be broadly distributed, the government should initially issue a small offering, in order to gauge investor reaction and establish some basis for setting the share price in subsequent offerings.

The environment revisited

Governments are becoming less credible in their role as environmental watchdogs.

One reason is that persistent reassurances about environmental safety – proffered in response to the growing spate of recent environmental disasters – are "beginning to wear thin," says Peter H. Pearse of the University of British Columbia, a Canadian authority on the environment and chairman of the recent Inquiry on Federal Water Policy. Public anxiety about the safety of the environment continues to swell over the unknown effects of such incidents as the Chernobyl nuclear accident and the discovery of chemical pollution at the bottom of Ontario's St. Clair River.

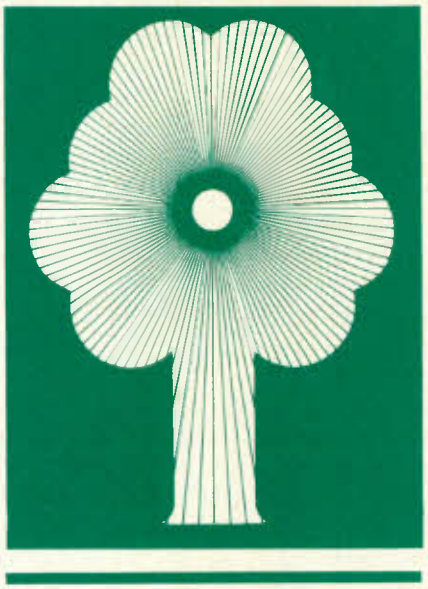
"The public is beginning to realize that we don't live in a risk-free environment," Pearse says. "But risk is always a matter of degree."

Because Canadians are becoming steadily more conscious of their environment, public policy will be influenced "more and more by the need to minimize risks to the environment and human health," he explains.

Pearse was responding to questions by *Au Courant* in a follow-up to its coverage of the Economic Council's Colloquium on the Environment, held in Toronto just over a year ago. The Colloquium brought together more than 100 experts to discuss some of the major environmental problems facing Canada and other countries. (The papers presented at the Colloquium have been published by the Council under the title, *Managing the Legacy: Proceedings of a Colloquium on the Environment*.)

Asked to identify what he believes to be Canada's most pressing environmental concern, Pearse cited the growing use and presence of persistent toxic substances – those which resist biological or chemical transformation. "The fact that we don't know how to dispose of a growing number of toxic substances is very worrisome to say the least," he says. "We are pressing on the limits of our scientific knowledge."

While biotechnology offers some hope of solving the toxic-waste problem – by developing bacteria to consume these wastes, for example – the appearance of toxic substances in the environment is growing at an alarming rate, Pearse notes. Although not all chemicals are toxic, about 32,000 are being used in Canada today. As many as 800 toxic organic substances have been found in the waters of the Great Lakes, according to the latest studies. In Ontario alone, about half



a million tons of hazardous industrial wastes are being disposed of improperly each year. Often these include many of the most toxic and difficult-to-treat substances. Nowhere in Canada, in fact, does there exist an approved treatment facility for such poisonous pollutants as PCB compounds, which are becoming increasingly detectable in virtually every form of life. (Ontario recently approved the technology for the province's first mobile PCB destruction unit.)

Canadians are demanding more effective control of these pollutants, Pearse says, as evidenced in part by their growing preference for such commodities as bottled water and by their concern over the use of pesticides in food production and forestry. (In a recent poll, in fact, many Canadians indicated their willingness to forgo economic development in order to protect the environment.) At the moment, however, legislation fails to provide sufficient means of coping with the toxic-waste problem, Pearse maintains.

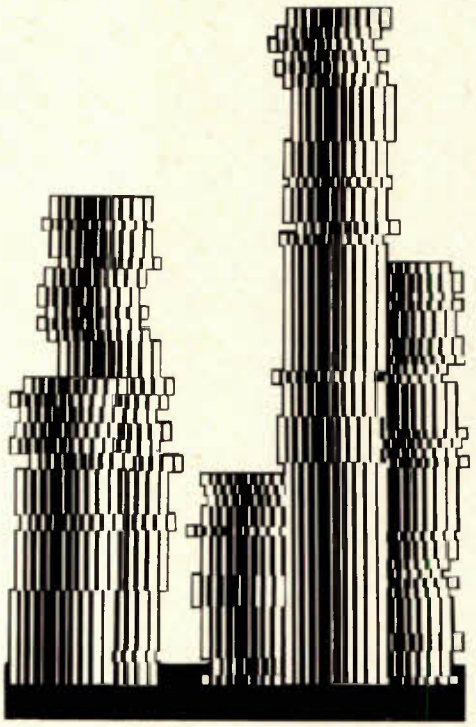
What is needed, he suggests, is a "cradle-to-grave" approach that would ensure that toxic substances are registered and approved before being allowed on the market. (Ottawa is adopting the idea in its new Environmental Protection Act.) Their use should also be strictly regulated, possibly by a toxic-control commission modeled on the lines of the Atomic Energy Control Board, he says.

But the major impediments to effective pollution control are the problems created by the division of powers between Ottawa and the provinces. Many of the activities that threaten the water system, for example – including mining, forestry, and municipal works – come under provincial jurisdiction. But the federal government administers the Fisheries Act and its environmental safety provisions. Environmental legislation at both levels is weakened by the absence of cooperative arrangements for controlling pollution that crosses provincial or international boundaries. A major breakthrough in this regard came last fall when federal and provincial environment ministers agreed to new water-quality guidelines.

Meanwhile, most governments' economic portfolios continue to operate apart from their environmental agencies, which are usually accorded "junior status," Pearse says. At the same time, an emerging view is developing that "sustainable economic development is clearly dependent on a healthy environment," he points out.

If Canada has failed to make significant progress on some pollution fronts, however, it has made impressive headway in tackling more traditional pollution problems, Pearse acknowledges. Because of stricter regulation, for example, wastes discharged by the pulp and paper industry have in some instances been cut in half since the late 1960s.

Competition and Solvency



Canada needs sweeping changes to its financial system in order to boost competition and enhance solvency in that sector, says the Economic Council of Canada.

In a new statement containing 31 recommendations, the Council says that weaknesses in the existing regulatory framework are "so severe that fundamental reform has become imperative." (These recommendations are based on the findings of a research report soon to be published by the Council.) Many of the problems in this area stem from the breakdown in the traditional division of functions among chartered banks, trust companies, insurance companies, and securities firms. Today it is possible to buy stocks from a bank; to open a demand deposit account (a classic banking function) with an investment dealer; to purchase short-term deferred annuities from a life insurance company; and so on. Yet, despite the growing overlap in many of their products and services, regulation (of each of the pillars) of the financial system has not adapted to the new realities.

In its new statement, *Competition and Solvency: A Framework for Financial Regulation*, the Council concludes that regulators have either had inadequate power or have not used the existing powers to deal with the recent onslaught of financial-sector difficulties. The turbulence of the past few years – most notably the failure of 22 financial institutions between 1980 and 1985, the instances of abuses, and the quest for diversification – has also raised some important questions. Is it prudent to combine banking and insurance, or commercial lending and securities underwriting, for example? Is it wise to combine financial and nonfinancial companies under one corporate umbrella? What is the impact on competition of increased concentration of ownership in the financial sector? Is there an increased potential for abuses? The growing complexity and globalization of financial markets are creating additional competitive pressures, while an antiquated domestic regulatory framework sometimes makes it harder for Canadian firms to meet the international competition head on.

The Council points out that the regulatory system does not provide a "level playing field" in its application of the rules to the various financial players. Banks, for example, are the only deposit-taking institution required to hold non-interest-bearing reserves against deposits. In addition, the overlap in regulation creates confusion and has become an increasingly serious administrative burden. Deposit-taking, for example, is subject to regulation by the federal Inspector General of Banks, the federal Department of Insurance, the Canada Deposit Insurance Corporation, and various provincial regulatory bodies.

The lack of harmonization in provincial policies and practices also impedes the efficiency of the financial system, the Council points out. In some cases it would appear that provinces compete against one another in order to attract financial business. Access to financial services in many communities is quite limited, and there are barriers to competition, in the form of heavy start-up costs in retail banking and capitalization requirements, various incorporation and licensing requirements, and so on.

There is now a broad consensus on the need for reform, the Council says, since a sound and efficient financial system is of vital importance to the Canadian economy. The Council favours adopting a new regulatory framework that would "give full play to competition and at the same time buttress the solvency of institutions." The proposed framework would result in better service to Canadians at lower cost. The changes would require governments to harmonize legislation – and some institutions to undergo internal adaptation – "but they are not radical," the Council insists.

"We believe the proposed adjustments are worthwhile ... in the context of a system that would be better able to finance Canada's economic growth, to build world-class financial institutions that can compete on international markets, and to safeguard the soundness and solvency of institutions upon which Canadians rely," the Council concludes.

A framework for reform

In the Council's view, the basic thrust of reform should be to strike the best balance between increased competition, enhanced solvency, and adequate consumer protection and accessibility. Reform should also be forward-looking, in order to keep pace with the accelerating changes in the marketplace. As well, the cost of regulation should be minimized, in terms of both its administration and its impact on the normal course of financial business. (Nonetheless, regulators should be given sufficient resources to do the job properly, the Council adds.)

A new framework

With that in mind, the Council recommends a "regulation-by-function" approach to the reform of the Canadian financial system. This would provide for a "level playing field." Because solvency is an institutional matter, under the Council's new framework, each institution would be restricted to engaging in one major financial "function" – banking or insurance, for example. An institution could also diversify into other financial functions by creating a holding company authorized to acquire other types of financial institutions. A separate regulatory authority would be responsible for each function. Regulators would determine the range of permissible activities under each function, based on what they, and the companies involved, considered prudent. For example, commercial lending might not be an appropriate activity for securities dealers who underwrite new stock issues, given the potential for conflict of interest.

Whether or not it is part of a holding group, each institution could engage in such activities as "networking" and "cross-selling" – promoting and selling another institution's products – provided those arrangements do not make combined purchases compulsory. Members of a financial holding group could, within limits set by the relevant regulator, sell assets and lend funds to one another without prior regulatory approval, provided the members are not in any financial difficulty. Each institution would have to maintain a separate capital base to ensure greater solvency. The Council also suggests monitoring the financial health of holding groups and including a requirement for global financial statements on a quarterly basis.

Banking definition

Each financial function would have to be well defined, the Council asserts, in order to have effective regulation by function and to ensure that each function is supported by a separate capital base. One of the most difficult tasks in this regard would be to reach agreement on a definition of banking, since so many financial institutions are engaged in banking activities. The Council proposes that any institution be considered a bank if it is involved in providing "means of payment" – such as deposits that can be withdrawn on demand or transferred by cheque.

Canadian Bankers Association

Banking activities would be defined

This new definition would bring under federal control the deposit-taking activities of some institutions that are now provincially regulated. But it would not centralize the regulatory apparatus to any significant degree. Through the creation of a new category of cooperative bank that recognizes the special local nature of provincially regulated financial cooperatives - credit unions and caisses populaires - only the central organizations of these cooperatives would fall under the Bank Act. Federally incorporated trust and loan companies already account for 80 per cent of the total assets of these businesses, the Council points out. Also, the federal government could delegate to a province supervisory responsibility over institutions that operate within that province only, it suggests.

Costs and benefits

Financial cooperatives and trust companies would be affected the most by the proposed changes, and particularly by their new obligation to hold non-interest-bearing reserves against deposits. (This cost would be lower if interest were paid on reserves.) Life insurance companies and other institutions that offer depositlike instruments (short-term deferred annuities, for example) would either have to modify those instruments or spin off a banking subsidiary to deliver them from within a holding group. The separation of banking and trust services would occur at the production level only, so that trust companies could continue to use their existing retail networks to deliver any number of services. The deposit-taking side of the trust business would gain by acquiring the powers of a bank.

Notwithstanding the costs, the primary advantage of the new system is its simplicity, the Council says. It would eliminate the current regulatory overlap and the lack of clarity in the sharing of responsibilities between Ottawa and the provinces. Regulators would be able to do a better job, because they would be responsible for only one major function. Institutions, for their part, would have "great flexibility in meeting the various financial requirements of their clients," by using the holding-company route to diversify into other financial functions. Firms would not be tied to the holding-group structure in order to diversify at the retail level, however, since any institution could enter networking agreements. The new system also recognizes the special nature of financial cooperatives. Finally, the system is forward-looking, since the definition of a financial function can be changed over time.

Urgency of reform

The Council realizes that sufficient time is needed for institutions and governments to adapt to, and implement, the new system. But because of the urgency of reform, governments should proceed "as expeditiously as possible" to amend all financial legislation, the Council maintains.

The legislative review should be carried out simultaneously, since changes in one law can affect institutions other than the one under consideration. A full legislative review should be undertaken periodically as well, so that changes in the marketplace do not force regulators to become legislators (by having to regulate or leave unregulated new financial practices that are not covered under existing legislation, for example). The Council suggests including "sunset clauses" in financial legislation for that purpose.

To strengthen regulatory capacity, the Council would grant regulators more power to monitor and enforce legal provisions; to establish a better early-warning system, so that preventive measures to ensure solvency could be undertaken at an early stage; and to require that regulatory authorities alert one another to any problems encountered by member institutions of financial holding groups. Finally, the Council urges provincial governments to implement mechanisms that would ensure interprovincial uniformity of financial regulation.

The new look financial system

Current System	Council Proposal
1. Banking function performed by banks, trust companies, loan companies, credit unions, caisses populaires, etc.	1. Separate institutions — banks, insurance companies, securities dealers, etc. — for each function.
2. Institutions are attempting to enter new fields of activity.	2. Institutions allowed to diversify through holding groups.
3. A variety of federal and provincial regulators for each function, particularly banking.	3. One regulator responsible for one function only, making regulation simpler, more efficient.
4. Networking arrangements — for example, a bank selling life insurance — prohibited under some laws.	4. Local branches of any institution allowed to participate in networking arrangements.

Toward a healthier system

New conflict-of-interest rules, well-defined ownership limits, better corporate governance, and greater consumer protection would make for a healthier financial system, the Council maintains.

Measures in these areas are key to preventing "harmful transactions that endanger the solvency of institutions or the fair treatment of customers," it says. In particular, the Council recognizes that allowing financial institutions to diversify through holding groups increases the potential for harmful "non-arm's-length" transactions (where related parties do business). On the other hand, some non-arm's-length transactions can be beneficial, since they give holding groups increased flexibility – to reallocate funds in order to take advantage of the most profitable opportunities, for example.

Preventing abuses

To help distinguish between harmful and appropriate non-arm's-length transactions, the Council would require financial institutions to establish a special committee of their board of directors to review all major non-arm's-length activity. The committee would be composed mostly of outsiders to the firm and would have the authority to reject or reverse a decision not deemed to be in the interests of minority shareholders, depositors, or other customers. Financial institutions would also be required to disclose to their customers any major conflict-of-interest situations in which they might find themselves. The relevant regulators would monitor such disclosures.

As a further precaution against harmful non-arm's-length transactions, the Council would ban loans to company directors and managers, or to any shareholder owning more than 10 per cent of the company's outstanding voting shares.

The Council is concerned about the possibility of financial institutions straining their finances by bailing out associated nonfinancial companies. So it would prohibit financial holding groups from acquiring nonfinancial subsidiaries (unless those firms are providing related services, such as data processing).

To prevent an excessive concentration of ownership in the financial sector, the Council would limit any one company or individual from owning more than 10 per cent of the capital stock of an independent financial institution or a group of related institutions with more than $10 billion in domestic assets. (The $10-billion cutoff is designed to balance the benefits of hands-on management for smaller firms against the higher costs of abuses for larger firms. Owners of institutions with more than $10 billion in assets at the time the rules are implemented would not have to divest but would be required to dilute their holdings as the firm grows.) Individual firms whose combined assets exceed the $10-billion mark could not be owned by any one company or individual either. In any event, the purchase of more than 10 per cent of the capital stock of a financial institution would be subject to prior regulatory approval.

The limits on ownership, the Council explains, would be applied at the highest level, so that individual firms within a holding group could be "closely held" – owned by a small number of individuals – provided the holding group met the ownership requirements. The Council recommends, in fact, that institutions linked through a holding group be wholly owned by the holding company, unless at least 35 per cent of their voting shares are widely held by other investors. Minority shareholders would be better protected as a result, the Council says.

As for foreign companies, they would be allowed to enter all financial sectors gradually, provided Canadian firms are given the same rights in their home countries. In Canada, foreign firms would be subject to the same regulations as domestic firms.

Royal Bank of Canada

Protecting consumers' interests.

Institutional practices

The Council's investigation also indicates that certain institutional and management practices need reforming. Under existing legislation, for example, auditors' obligations are "vague and incomplete," it finds. Their role should be clarified, requiring them (and actuaries, where applicable) to report to regulators any material wrongdoing they uncover or any serious concerns they might have about the solvency of the companies they audit. Internal audit committees should be strengthened as well. Since auditors need management's full co-operation to do a proper job, the latter should be liable for the quality of information provided auditors.

The rules governing how financial institutions invest their funds are too restrictive and should be revised in consultation with the institutions themselves, the Council says. To ensure solvency, however, each institution would have to maintain a separate capital base. In calculating the size of its capital base, each firm would have to deduct any holding of more than 10 per cent of the common stock or subordinated debt that it has acquired in another financial institution. (Regulators use the size of an institution's capital base to determine, among other things, how much it can lend.)

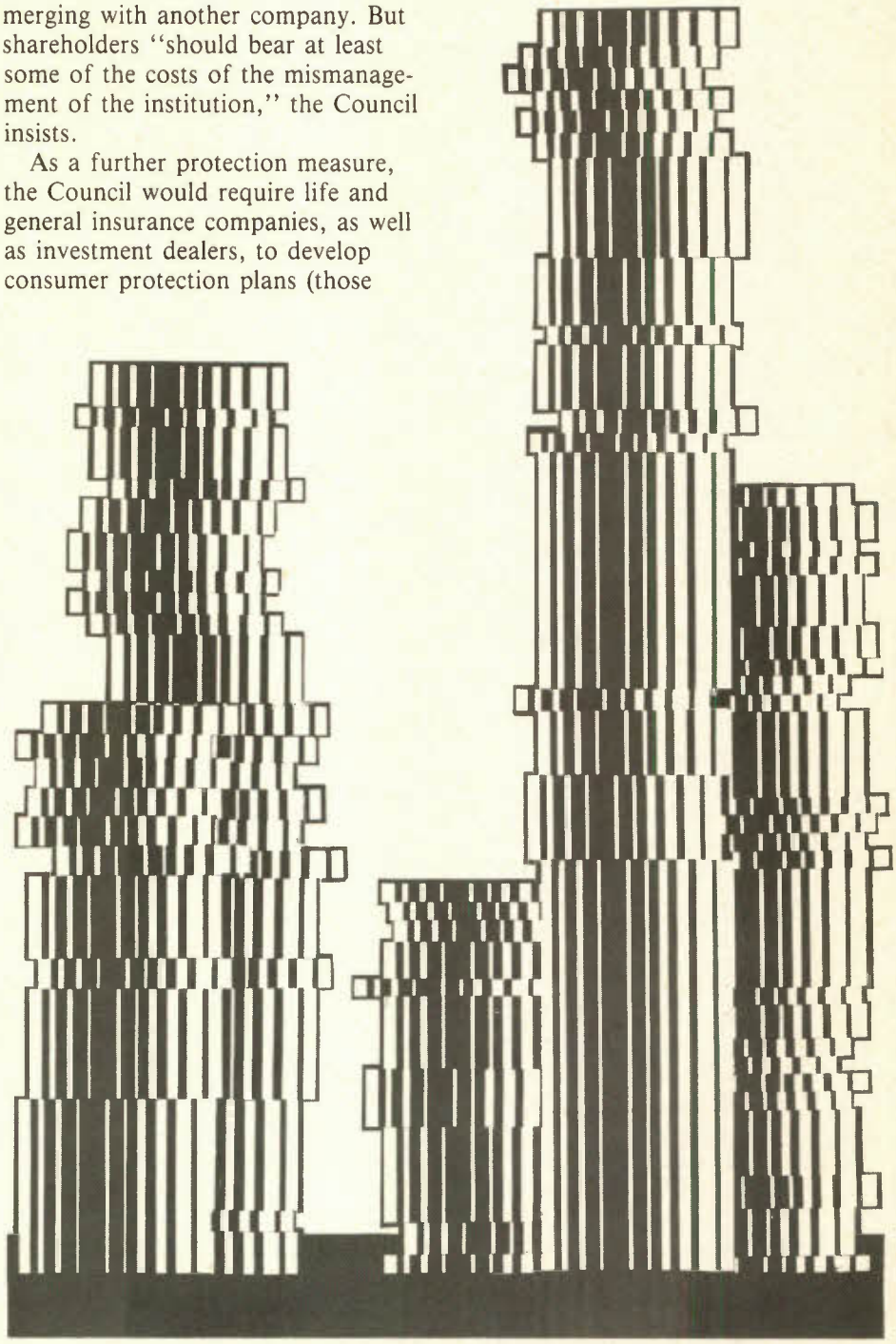
Consumer protection

In the context of a fast-changing financial world, public confidence in the financial system and consumer protection are of "paramount importance," the Council says. The existing insurance coverage on deposits of up to $60,000 should be maintained by the Canada Deposit Insurance Corporation (CDIC), it concludes. But more generous limits should apply to deposits that form part of a registered retirement savings plan. Since the CDIC ultimately pays when financial failures occur, it should share supervisory power with the federal regulator of banks. It should also have the power to set insurance premiums, the Council says.

As a general rule, the Council believes that governments should not provide a guarantee to uninsured depositors. When financial disaster looms, governments might consider a takeover or assistance to the firm in merging with another company. But shareholders "should bear at least some of the costs of the mismanagement of the institution," the Council insists.

As a further protection measure, the Council would require life and general insurance companies, as well as investment dealers, to develop consumer protection plans (those already in place should be strengthened and well publicized). Financial planners and investment counsellors, together with lawyers handling estate and trust accounts, would also have to meet minimum standards under a licensing agreement. Finally, any institution delivering in one transaction two products that originated in separate institutions would be obliged to inform customers of their option to buy the second product from other distributors. This would reinforce consumers' awareness of their sovereignty in the marketplace, the Council says.

Public confidence in the financial system and consumer protection are of paramount importance.

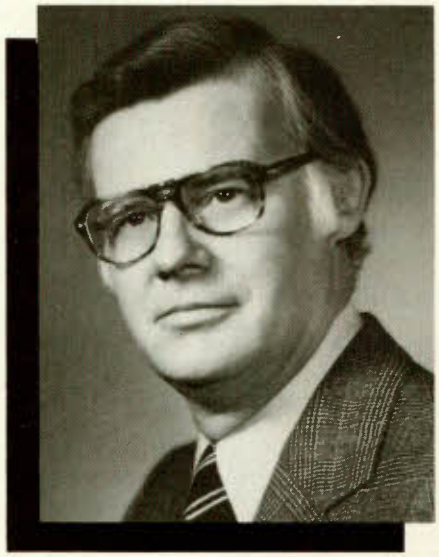


New members appointed to the Economic Council

Chester Johnson is chairman of the B.C. Hydro and Power Authority in Vancouver, as well as director of a number of companies, including B.C. Place Ltd., the Prudential Assurance Co. Ltd., and Scott Paper. He is also a member of the Faculty of Commerce and Business Administration Advisory Council at the University of British Columbia.

Chaviva Hosek is a research partner with Gordon Capital Corporation in Toronto and president of Pension-fund Immunization Inc. A former professor of English at the University of Toronto (Victoria College), she is also past-president of the National Action Committee on the Status of Women.

Steve Atanas Stavro is the president and owner of Knob Hill Farms Ltd. and of Sevendon Holdings Ltd. The founder of the Steve Atanas Charitable Foundation, he is also a member of the board of directors of the Better Business Bureau of Metropolitan Toronto and of Maple Leaf Gardens Ltd.



Graham Wilson, of Hamilton, Ontario, is vice-president and corporate secretary of Dofasco Inc. He is also president and chairman of the Board of Management of the Hamilton Art Gallery, and director of the National Ballet of Toronto.

WORKING TO IMPROVE
CANADA'S POLICY PERFORMANCE

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The Council pursues its goal of improving Canada's economic performance in three ways:

Consultation

Members of the Council, representing a wide cross-section of Canadian society, meet regularly with governments and groups to study, analyse, and make recommendations on significant economic issues.

Research

An expert staff originates research and provides background information on a variety of topics, with particular stress on the medium- and longer-term problems of the Canadian economy.

Information

The need for better information on economic issues has led the Council to place strong emphasis on its contact with the public, through the use of topical publications, speeches, conferences, workshops and media relations.

Economic Council of Canada

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