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Notes for a Luncheon Address by
John W. Crow
Governor of the Bank of Canada
at the 71st Annual Meeting of the
Investment Dealers Association of Canada
Ottawa, Ontario
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I appreciate the privilege of addressing you today on the occasion of the first Annual Meeting that you have held here in Ottawa.

The Bank of Canada and the members of the Investment Dealers Association go back a long way together. In its role as debt manager for the federal Government, the Bank for about fifty years has had regular close contact with many investment dealers in this country. And in exercising its responsibility for monetary policy, the Bank deals directly in the money market with quite a few of the firms represented here today.

The Bank also benefits tremendously from the dialogue and flow of information that it maintains with the investment dealer community. In keeping with this long-standing interchange, I think that this is a good time for me to share with you some observations about the financial sector in Canada.

The financial system in Canada, as elsewhere, has entered a period of profound, and in some cases wrenching, change. No part of it is facing more challenges than the securities industry. Changes to the financial sector in Canada have been subject to wide-ranging debate. And there is bound to be a good deal more discussion.

I expect some of you will be disappointed that my remarks today do not specifically address the role and concerns of investment dealers. This is not because we at the Bank of Canada do not recognize the crucial importance of the market intermediation function. Rather, it reflects the discretion of a central banker about venturing into a situation already in considerable ferment unless he has a direct role to play.

Instead, what I want to do today is to look in a general way at public policy questions that are basic to the issue of financial system restructuring.

From whatever angle we approach this process of financial system restructuring in Canada, and however important any particular aspect might be to our business, those of us involved in the financial industry can undoubtedly subscribe to a common goal. We need to ensure the development of a Canadian financial industry capable of meeting Canadian needs and able to prosper in an increasingly global financial marketplace.

Like any other industry, the financial sector must be efficient to do well. But to a far greater degree than most other industries, it must also maintain the trust and confidence of its users. Mistakes are likely to be very costly to undo.

So when we look at any proposed change to our financial system, we have to weigh two fundamental questions. Will the change improve the industry's capacity to develop and deliver its services at least cost? Secondly, what are the implications of any change for the soundness of the system and the confidence users have in it?

Where changes improve both the efficiency and the soundness of the financial system, they are easy to adopt. Others, however, may involve a trade-off between the two. The focus of my remarks today is on that trade-off and, in particular, on how vital it is to maintain stability and confidence in financial institutions.

The cost and availability of financing for industry, government and the consumer depend importantly on how efficiently the financial system performs its day-to-day tasks. This is why for many years public policy has aimed to spur the performance of financial markets, mainly by opening them up gradually to increased competition.

Let me give some examples.

As a result of the last two Bank Act revisions, the ceiling on bank lending rates was eliminated, collusion in the setting of interest rates was prohibited, restrictions hampering the ability of chartered banks to make mortgage loans were removed, and foreign banks were allowed to enter into direct, though limited, competition in the Canadian market. Similarly, legislation and regulations governing non-bank financial institutions have been modified over the years to allow these institutions to broaden their range of activities and make more intensive use of their capital. The shift from fixed to negotiated stock commissions in 1983 was another move towards increased competition. The desire to promote efficiency has been a motivating factor behind recent federal Government proposals to facilitate the movement of each of the so-called "pillars" of the financial industry into what had previously been the preserve of the others.

But as you well know, an efficient and thriving financial industry must do more than just provide traditional services at least cost. Financial intermediaries must also respond quickly and flexibly to the changing requirements of customers and must anticipate future needs. And the financial industry, in Canada as elsewhere, has demonstrated an impressive capacity for innovation.

I would cite, for example, the "bought deal", the increasing use of interest rate and foreign currency swaps, various forms of securitization, daily-interest accounts, lines of credit for households and floating-rate mortgages. The list goes on and on. Looking ahead, one might anticipate wider use of debit cards, the development of a large-value transfer system, the implementation by the Canadian Depository for Securities of a book-entry system for securities and even greater use of auctions in marketing Government debt.

The increasingly international character of financial markets and institutions has already been felt in Canada. Many Canadian users of capital markets have become accustomed to alternatives beyond those offered by the domestic market. In recent years, foreign investors have shown keen interest in Canadian securities. The servicing of these activities will be a challenge in the years ahead -- one which I am sure your industry will meet.

But in contemplating recent and proposed changes -- the kinds of changes needed to keep the Canadian financial industry efficient and flexible enough to compete in an ever more global arena -- it is just as important to maintain jealously the confidence of users of the financial system in its integrity.

The basic reason is so obvious that it often seems to be taken for granted. It shouldn't be. The reason is that financial firms use other people's money -- lots of it -- to carry out the overwhelming part of their activity. With high leverage ratios and a considerable part of their liabilities at relatively short terms, such firms are very dependent on the confidence of their creditors. The fact of the matter is that these firms also have a public trust.

Loss of confidence in a financial business can be expensive both for the industry and for the public in general. Such disruptions are traumatic for those directly connected with the financial firm. And in the highly interconnected world we live in, bad news travels fast. As we have seen recently in the case of two small banks in Western Canada, failure can spill over into a loss of confidence in other institutions, and confidence is not quickly restored. This is by no means a strictly Canadian phenomenon. In the

United States, for example, there have also been several recent episodes in which the failure of one institution had a rapid contagious effect on others.

Because of this special vulnerability of the financial industry, and because of the central importance of a well-functioning financial system, governments around the world have accepted overall responsibility for fostering the soundness and stability of their financial sectors.

Carrying out this responsibility has involved the establishment of deposit insurance, as well as supervision and regulation aimed at preventing financial institutions from engaging in excessively risky activities to the detriment of the rest of society. Clearly, however, the institutions themselves must bear considerable responsibility for ensuring public confidence in their operations. The investment dealer community and the IDA itself have been strong leaders in upholding their industry's reputation for soundness.

As the financial industry has become more international, so have supervision and regulation -- presenting tricky problems of cross-jurisdictional responsibility and coordination. But supervisory authorities of the major countries have arranged among themselves that no branch or subsidiary of the banks headquartered in their countries goes unchecked. They have been working together recently on common international standards for such matters as capital adequacy. It is increasingly evident that in today's global markets the securities business too will have to come under some kind of joint international scrutiny.

But of course, regulation and supervision, whether domestic or international, are only part of the answer. The issue of preserving and enhancing the soundness of financial institutions extends directly into the very ownership core of such institutions. Of particular note in this regard has been the controversy over linkages between commercial and financial businesses. This question has rightly been a major preoccupation of Canadian policymakers over the years and has recently become a topic of debate in other countries, including the United States. The issues posed by the potential for self-dealing and conflicts of interest can in principle be tackled in a number of ways. However, a crucial question is whether a set of regulations can realistically be expected to cope with the potentially solvency-threatening nature of non-arm's-length transactions between a commercial parent and its closely-held financial subsidiary. In my view, to put one's faith solely in regulatory walls to restrict the scope for related-party transactions, without a reinforcing buttress of restrictions on ownership links, would not be prudent. That is why I welcome the emphasis on concerns about ownership in the federal Government's December 1986 policy statements on the financial sector.

There is another aspect to this. Maintaining public confidence goes beyond narrowing the chances that financial institutions will run into solvency or liquidity problems and ensuring that any problems do not spread. Users of financial services must also have confidence in the fairness, the impartiality, of financial institutions. The string of insider trading charges in the United States serves to remind us that one of the major sources of corporate financing in our financial system -- the stock market -- will not fulfill the role expected of it if investors come to perceive that the dice are loaded against them. Likewise, financial institutions must also be seen to be acting impartially in their decisions in extending loans. In fact, such concerns are a further reason for having reservations about the mixing of commercial and financial interests within a single firm.

In conclusion, let me summarize. The legislative and regulatory changes to the structure of the Canadian financial system over the past two decades have mostly had the objective of promoting efficiency. More recently, considerable interest in Canada and worldwide has focussed on the need to maintain confidence in the soundness, stability and impartiality of the system and its institutions. I think such a rebalancing of emphasis is appropriate and fully consistent with achieving further development of an efficient, dynamic, internationally competitive financial system for Canada. Sustained, efficient operation of our financial system will not be assured without the confidence that comes from a strong commitment to soundness. Any legislative or regulatory changes have to be judged on the basis of this fundamental consideration.