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BANK OF CANADA

Introductory Statement by John W. Crow Governor of the Bank of Canada

before the

Standing Senate Committee on Banking, Trade and Commerce
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John W. Crow
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The regulation of Canadian financial institutions has already been the subject of much study and debate. However, as your Committee has recognized, the globalization of financial markets has become a more significant development than it was when the examination of regulatory arrangements for Canadian institutions was started in the early 1980s, and it is appropriate to look again at these regulatory issues with this development in mind.

In this opening statement I would like to comment on some of the financial regulation issues abstracting from globalization, and then on some of the implications of globalization. But first I thought it would be useful to indicate the role of the Bank of Canada in the Canadian financial system.

<u>The Bank and the Financial System</u>

The Bank of Canada's main responsibility is to formulate and implement monetary policy. Also, the Bank acts as a lender of last resort to deposit-taking institutions, a role common to central banks around the world. Unlike some other central banks, the Bank is not a regulator or supervisor of financial institutions; nevertheless, we keep a very close eye on the financial system. One reason is because monetary policy is most effectively transmitted to the economy if the financial sector is healthy and efficient. Furthermore, as the ultimate provider of liquidity to the financial system, the Bank necessarily takes a keen interest in the actual condition of financial institutions and in the supervisory and regulatory framework under which they operate.

The Bank therefore plays an advisory role in developing legislation to regulate and supervise financial institutions. We also have a number of more direct responsibilities. As Governor, I am a member of the Financial Institutions Supervisory Committee that was established by legislation in 1987 to facilitate the exchange of views and information among federal agencies on the supervision and prudential regulation of financial institutions. I am also an ex officio member of the board of the Canada Deposit Insurance Corporation, and an officer of the Bank chairs the Canadian Payments Association. The Bank, in its capacity as fiscal agent for the federal government, has also been actively involved with the Canadian Depository for Securities in its efforts to create a book-based clearing and settlement system for debt securities. At the international level, the Bank participates in the work of the Bank for International

Settlements. The BIS has been responsible for bringing about a convergence of the national treatment of the definition and standards of capital adequacy for international banks. The BIS also makes important contributions to other aspects of the regulation and supervision of financial institutions and to the analysis of risks associated with payments systems and other clearing and settlement arrangements, including what might be done to mitigate those risks.

The Need for Regulation of the Financial System

For Canadian consumers of financial services to be well served, there needs to be competition within the financial system. But at the same time a high degree of confidence is required in the soundness of the system. The challenge is to provide a regulatory environment that promotes both efficiency and soundness.

The reason for this emphasis on confidence is obvious. Financial institutions are special in that they are entrusted with or handle huge sums of money from others. Much of the funds placed with financial institutions are available on demand or after very short terms so that depositors can have ready access to them. These features, together with the high capital leverage ratio at which financial institutions have traditionally operated, give rise to the possibility of large and rapid losses.

Financial problems at an individual financial institution have the potential not only to cause a rapid exodus of funds and a liquidity shortage at that institution but, if confidence is undermined in other similar institutions, could also lead to more widespread financial disruption. It is to help to preserve confidence by protecting depositors that government has established comprehensive supervisory systems for individual financial institutions operating in Canada. In addition, deposit insurance plans and other types of consumer protection arrangements have been created. Central bank liquidity support is also available for deposit-taking institutions.

With such a safety net in place to protect and reassure savers, regulatory constraints clearly need reinforcement to ensure that financial institutions are not tempted by the situation to take excessive risks.

Prudential regulation of financial institutions must cover a number of crucial areas. These include the definition and enforcement of minimum levels of capital, limitations on the involvement of financial institutions in certain risky types of business, and limitations on the risk that transactions between a financial institution and its owner (including the owner's related companies) will not be in the interests of the institution or the savers who have entrusted their funds to it.

I want to place some emphasis on this last area. Self-dealing can be a serious threat to the solvency of individual institutions and more generally to the stability of the financial system. The causes of the failure of financial institutions are by no means identical across the board. Adverse economic circumstances are important in quite a few, but one cannot help but be struck by the number of instances where the problems of failed financial institutions were related in part to transactions with the other business interests of the owners.

Two responses have been proposed to these risks of abusive self-dealing. One is to require widely-held ownership of financial institutions; the other is to restrict non-arms-length transactions by closely-held financial institutions. Widely-held ownership has worked well for the banking system and should be continued and encouraged. We have less experience with the operation of broad restrictions on non-arms-length transactions by closely-held institutions and their owners, but I believe that for such a mechanism to be effective, the ban must be as absolute and as stringently applied as possible.

In framing rules in this area, it is advisable to bear in mind that the more relevant context for assessing their usefulness is not how they work when the climate is benign but how they work when it is not.

Competing in More Globalized Financial Markets

The term "globalization of financial markets" has been used to describe a number of developments in financial markets. There has been an increasing willingness of investors and borrowers to shift among different national markets for very small increases in expected returns. In addition, there has been a large increase in the volume of international transactions by financial institutions and the establishment of a large number of foreign offices by domestic institutions. More recently, financial innovations have been spreading rapidly from one domestic market to another. In any event what all this means is that financial markets are now linked around the world to an extent and in ways that are without precedent.

In the light of this, two main sets of issues for public policy can be noted here. The first has to do with concerns that national financial services regulation that is weighted towards the promotion of sound financial practices could unduly inhibit the ability of national institutions to compete effectively at home and abroad against foreign institutions. The second is also concerned with competitive equity, but more from the viewpoint of the fairness of the conditions under which each country's financial institutions may enter other countries to provide financial services. This is the so-called reciprocity issue regarding market access and national treatment for foreign financial institutions.

With respect to the first issue, the point I want to underline is that efforts in Canada to emphasize sound practices have been paralleled at the international level by efforts to encourage the improvement and international convergence of national financial regulations. Thus, agreements have been reached under the auspices of the BIS to co-ordinate the supervision of international banks and to establish high common standards for required levels of capital for banks. More recently, there have been international initiatives to bring about improved and more standardized rules of operation in major national securities markets and to work towards greater co-ordination in the regulatory oversight of securities firms. Reactions to these efforts have been very positive, not only from national authorities but also from individual financial institutions. The actions of international banks to augment their capital in advance of the BIS timetable and to ensure adequate provisions for potential losses on loans to developing countries are rather significant examples of the emphasis individual institutions are placing on their financial reputations.

As regards the reciprocity issue, it is of course a matter for international negotiation among countries to ensure that domestic institutions get access to, and adequate treatment in, other countries. However, I should note that here again increasing convergence of national regulation of financial institutions is helpful. For example, a broadly similar trend is evident in most countries towards permitting financial institutions to offer a broader range of financial services and products to their customers. To the extent that the range of business powers permitted to national financial institutions, as well as the prudential aspects referred to earlier, become increasingly similar across countries, agreement to liberalize trade in financial services and market access for foreign institutions should be more readily achieved.

Differences in Regulation by the Provinces and at the Federal Level

The only comment I wish to make on the regulatory differences we have among the different jurisdictions inside Canada is to point again to the example of recent international developments. If it is important to achieve some convergence of regulatory standards internationally, that must surely also apply even more strongly within Canada. The model from Europe 1992 suggests that it is not necessary to have complete harmonization of regulation. The procedure there is to establish a set of minimum prudential standards that are implemented by all member countries. Each country must then be willing to accept the adequacy of the remaining regulatory and supervisory arrangements in other member countries and to permit financial institutions with head offices in those other countries to operate in its domestic market. These minimum standards guard against any competition in laxity among member countries to attract new institutions or to enhance the competitiveness of existing domestic institutions by reducing prudential standards. The arrangement also foresees the likelihood that some member countries will establish prudential standards in excess of the minimum. In the long run, financial systems that establish good reputations stand a better chance of flourishing than those that do not.

These developments in Europe provide one possible example of how we might deal with the split jurisdiction over non-bank financial institutions we have within Canada while maintaining the high standards of prudential regulation and supervision needed to ensure continued consumer confidence in our financial institutions. It is not my intention here to suggest that the European way is the only way open to Canada, or even necessarily the best way, but only to note that, as one looks at what is going on around the world, the European model is clearly worth bearing in mind.