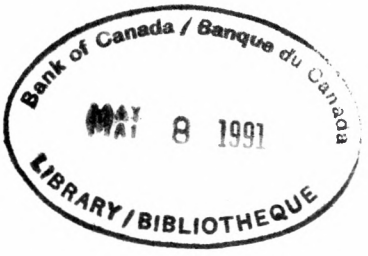

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John W. Crow
Governor of the Bank of Canada

at the
39th Annual Meeting of the
Trust Companies Association
Ottawa, Ontario
7 May 1991

Not for publication before 7 May 1991 at 8:00 p.m. eastern daylight saving time

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What does the term "trust company" convey?

Let me hasten to add that I am asking this in a broad sense. In other words, I am thinking not about how trust company legislation, federal or provincial, has defined, or ought to or will define, the particular characteristics of Canadian trust companies. Rather, I am asking what the words convey as a broad idea.

To my mind, they convey two basic elements: first, the fact that you have large amounts of funds entrusted to your stewardship; second, and equally importantly, that you are businesses. In other words, you aim to do well and to provide at least a competitive rate of return to your shareholders.

Let me also underline that at this level I am talking about the financial services business in general -- certainly the deposit-taking part. And at this generic level, banks, caisses populaires and credit unions at least are also trust companies.

Why should someone from the Bank of Canada feel entitled to talk about this territory? While the Bank is a member of the federal Financial Institutions Supervisory Committee, we are not in any direct sense a regulator or supervisor of any part of the financial industry. But we are the banker, even a "trustee", of much of the system. The Bank of Canada is both a lender of last resort and, relating crucially to

its powers and responsibility for carrying out monetary policy, at the heart of the Canadian system for settling payments. Those responsibilities are no doubt reflected in the points of view we bring to bear.

The points of view we bring to bear also reflect the fact that the deposit-taking part of the financial services industry is a very special kind of business.

The amounts of borrowed funds, other people's money, you have entrusted to you relative to the capital you supply yourselves are very large indeed. The size of this ratio is no doubt in part attributable to the public policy safety net within which you operate. Therefore, it is hardly surprising that you are regulated and supervised. And the issue, of course, is not at all whether you should be. The issue is to ensure that the rules under which you are going to operate do encourage, as efficiently as possible, appropriately prudent behaviour.

In that regard let me recall a point made in the Bank's latest annual report.

We noted with some satisfaction that Canadian financial institutions as a group do appear to be well equipped to withstand the pressures of the current, less favourable, environment after several very good years.

But we added that the current environment also helps to underline the value of a basic lesson regarding financial oversight. That lesson is that in assessing the usefulness of rules for the prudent conduct of financial institutions, the relevant yardstick is not the contribution such rules can make when the climate is benign. This is not what the standards are there for. The real test is the kind of contribution such rules

can make to ensuring that financial institutions can withstand the pressures that are bound to arise when conditions are more difficult.

This point was made because as we at the Bank observed the swirl of the debate -- thrust and parry -- with regard to federal financial services legislation, it seemed to us that the question of financial risk was not getting very much attention from those intervening in the debate.

This perhaps is not so surprising, since the central legislative issue for the private sector participants has clearly been the business powers to be permitted to different classes of financial institution. But the issue of prudent behaviour is crucially important because the risks are inherently great.

There is a dual need. On the one hand, it is important to have rules that promote the prudent stewardship of borrowed funds. On the other hand, the rules need to provide sufficient scope and initiative for a competitive, and therefore efficient, financial sector. This duality is inevitably the fundamental point of tension in any serious effort to modernize and improve financial services legislation.

The draft legislation for federal financial institutions that is now making its way into and through Parliament has had the benefit of very lengthy consideration -- first the green book in early 1985, then the blue book in late 1986, and now the current proposals. The drafters have aimed to cope in a constructive, that is forward-looking, way with the blending and overlapping of various financial sector activities that competition has produced and may produce in the future.

The drafters have had to try to do this against an awkward domestic background of overlapping federal-provincial, provincial-provincial jurisdictions. This awkward background has certainly not become any less awkward, while the world environment continues to change apace.

Indeed, when just over a year ago the Bank of Canada responded to the request of the Senate Committee on Banking for a submission on the matter of Canadian financial institutions in the context of the globalization of financial markets, one aspect of the situation seemed to us somewhat ironic. The Committee had highlighted the challenge posed by the fact that several provinces were, as the Committee put it, "well on the way toward re-regulating their own financial environment", and in pondering models for harmonizing the regulation of Canadian financial institutions across provinces, we found a potentially useful reference in principles that are now being applied across all the different countries in the European Community.

Looking back over the progress through the various phases of the planned federal financial services legislation, another element that is striking is that as time passed the drafters gave increased emphasis to questions of prudence and soundness. Initially, it was the measures perceived to enhance powers and therefore, it was hoped, competitiveness, that were both front and centre.

This particular emphasis perhaps reflected in part the widespread enthusiasm for the idea that the synergistic gains to be had from conglomeration and/or the financial supermarket were very large indeed. Bigger, or wider, should be better. Now, having seen these concepts tried in various places and in various ways, no-one can be so very sure.

The evolution in emphasis also reflected experience as to the problems that can face financial institutions, particularly deposit-taking institutions.

Canadian experience has of course been extremely relevant, but the large-scale hard knocks have been in the United States, especially in regard to the Savings and Loan industry.

A number of morals may be drawn from this affair. I shall only point to two.

One moral is that we in Canada have something to be thankful about. The protective controls through the application of Regulation Q interest rate ceilings sheltering the U.S. savings and loan industry and therefore, it was hoped, housing finance, were something that Canada was fortunate to avoid. Canada perhaps has the image of being generally more regulated than the United States. However, we have in our financial industry managed to avoid much of their regulation that essentially limits competition, instead of promoting the soundness of institutions. Prime examples from their experience are the restrictions on interstate banking and the attempt to subsidize, through broad restrictions on the private financial sector, certain kinds of activity such as housing.

The verdict has to be that these limitations have not worked. Indeed, not only have they not worked, but they have had effects that are strikingly perverse -- both for institutions themselves and for the very economy those institutions are supposed to serve.

The second moral from recent U.S. experience is that the combination of financial institutions running out of capital,

together with the guarantee entailed by generous deposit insurance, brings nothing but trouble. The institutions may still be attracting deposits that are insured, but with the disappearance of the owners' equity stake in the business, a built-in incentive for the owners to behave prudently goes out the window.

This danger can be mitigated in various ways. One way is to seek to strengthen capital ratios. Indeed, the Bank of Canada participated in one exercise in this area through the development of the multilateral accord on capital for international banks. This was put together under the auspices of the Bank for International Settlements. Another way is to keep looking hard at the deposit insurance arrangements themselves. The immediate purpose would be to ensure that the moral hazard to which particular aspects of deposit insurance arrangements give rise is kept down just about as far as it can possibly be. These ways are not necessarily substitutes, and of course the more fundamental issue is how to promote and achieve the prudent behaviour that makes use of the deposit insurance fund a rarity.

I noted earlier that the Bank has responsibilities that stem in part from the fact that we stand at the heart of the Canadian system for settling payments. Let me now make some brief comments especially directly on our interest in the clearing and settlement system.

The Bank recognized some years ago that it needed to make an active contribution to the way systems for clearing and settling financial transactions evolved in Canada. We have organized ourselves to do so. No doubt a number of you in this room have dealt with our officers in the various aspects of this highly complex, rapidly expanding, very important field.

We are interested in the technical arrangements for these systems, especially their precise relationship to Bank of Canada operations. But we are also of course concerned with the basic policy issues to which they clearly give rise. So we have been paying, and will continue to pay, close attention to such questions as: the extent of systemic risk involved in any particular type of arrangement; who might bear risk; who can reasonably have access to the systems; exactly how these systems might relate to each other; and how they can be effectively supervised. None of these evolving issues -- whether, for example, we are talking about systems that might be operated by the Canadian Depository for Securities, the proposed Large Value Transfer System for payments that is being considered by the Canadian Payments Association, or the possible netting of foreign exchange transactions -- has simple answers. But I can assure you that the Bank of Canada has been, and will continue to be, focussing hard upon them, and the solutions proposed by the players.

Let me conclude these remarks with a very brief, very general comment on monetary policy.

Besides speaking here in the nation's capital, my colleagues and I of course spend a lot of time meeting lots of people across the country. Not so long ago on one of these trips, it was put to me that being from Ottawa the best thing the Bank of Canada could do was to stop interfering with what people were wanting to do. In other words. "Get out of the way!" In response I noted that the Bank does not have a complicated, interventionist, monetary policy agenda. Indeed, in response to the many calls in the past for "regional" monetary policies the Bank spent a lot of time spelling out why, given the highly efficient financial markets across Canada that we enjoy, it is in any case possible only to have a monetary policy that is national

in scope. And the national goal of monetary policy, stripping away the veneer of money market technique, is to preserve the value of the nation's money -- no more, no less.

Well, is the value of money worth preserving? Of course it is. And the Bank has spelled out the crucial economic arguments on many occasions -- most recently in its annual report for 1990. I will not spell out those arguments again here, but just underline that this is far from being an academic point, or a matter of taste. It is an issue of practical importance that people are right to care about.

Thus in all the discussions and pronouncements on constitutional matters in recent months, it has been interesting to observe the emergence of a very real focus on what is required to maintain national monetary confidence. Let me just observe on this occasion that there's no deep mystery to it. One thing you certainly do is make a point of having a central monetary institution which has a responsibility for preserving the value of money, and which takes this responsibility seriously.