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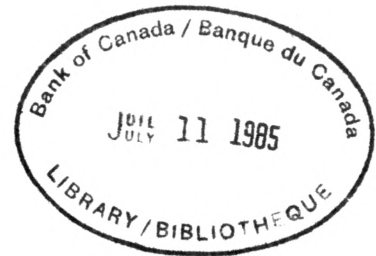

Introductory Statement by

Gerald K. Bouey

Governor of the Bank of Canada

in an appearance before the

House of Commons Standing Committee

on Finance, Trade and Economic Affairs

Tuesday, July 9, 1985

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Mr. Chairman, the range of topics that your Committee is examining is very broad indeed. The issues involved have, however, been identified and discussed in detail in the Green Paper on the regulation of financial institutions and in the Wyman Committee Report on deposit insurance. In this introductory statement I propose to highlight a few of those issues that from my vantage point seem particularly important.

Before going further it might be helpful if I clarify for you the Bank of Canada's role in these matters. The Bank has no formal responsibility in the area of financial legislation, and neither the Green Paper nor the Wyman Report have any very direct or immediate implications for our main responsibility, the operation of monetary policy. However, the Bank has a vital interest in efficient financial markets for the effective transmission of monetary policy and has traditionally played an advisory role in legislative revisions. Moreover, as a member of the board of directors of the Canada Deposit Insurance Corporation (CDIC) I have a special interest in and bear a responsibility for its operations.

The issues being raised are complex and the solutions are unlikely to be straightforward or simple. The Green Paper and the Wyman Report provide a set of proposals for discussion, and the next important step will be to hear from the financial institutions and the users of financial services -- those who will be the most affected by changes in regulation.

In my view the most important issue that we face, and one that must be dealt with urgently, is the risk from self-dealing for the financial viability of closely-held financial institutions and the possible implications for confidence in the system as a whole. The potential for financial institution failures because of self-dealing is evidently also a major concern for our deposit insurance arrangements. While the primary cause of the difficulties encountered by financial institutions over the past few years has been the adverse economic conditions we have been through, one cannot help but be concerned about the number of instances where the financial problems of the individual institutions which have failed were related to transactions with the other business interests of the owners.

With the growth of large financial conglomerates owned by those with substantial interests in non-financial businesses, the potential risks to the financial system from self-dealing have become much larger. I do not wish for a moment to imply that most owners of financial institutions would be likely to engage in transactions that would knowingly place excessively risky assets in their financial firm in order to benefit their other business interests. However, there have been some unscrupulous operators in the financial industry, and even apart from them, there may be circumstances when the temptation for an owner to take improper advantage of access to funds from

the financial institution may be overwhelming. Those are risks we cannot take. The results, as we have seen, can be losses for individual depositors, a severe drain on the Deposit Insurance Corporation and some weakening of confidence in the stability of our financial system.

My preferred solution is widely-held ownership, with no single owner of a sufficient size to dominate a financial institution and be in a position to use it in his own interests. Widely-held ownership has worked well in the banking system, and I am anxious to see it preserved for Schedule A banks. Some years ago it might have been possible to impose the same requirement on most of the rest of the financial system, but it would be extremely difficult now. The trend to closely-held ownership has gone too far for it to be practical to reverse.

The approach proposed in the Green Paper is a virtual ban on non-arm's-length transactions. This is not an ideal solution because such a ban will not be easy to monitor and enforce, but it can be accompanied by penalties which could provide a powerful deterrent. And no one has, to my knowledge, come up with any workable alternative. To make the ban effective it will probably have to be virtually absolute. Making determinations of good versus bad non-arm's-length transactions puts too great a burden on matters of judgement; it would enmesh the financial industry in extensive bureaucratic regulation; and it would increase the risk that unscrupulous operators would avoid detection. Far better to set some simple rules about non-arm's-length transactions in advance, and if some harmless transactions are banned, that is a price we will have to pay to protect the stability of the financial system and retain the confidence of depositors.

If it turns out that the restrictions on non-arm's-length transactions are found to be rather onerous by some institutions, the option will always be open to them to diversify their ownership so that the restrictions would no longer apply.

Another set of issues discussed in the Green Paper on which I would like to comment result from the recent tendency for each group of institutions to move increasingly into the traditional business of other types of financial institutions. That tendency raises concerns with respect to equity and conflict of interest.

It is difficult to define what constitutes equitable regulations and requirements when institutions in competition with one another in one area of the financial market are quite different in other aspects of their business. And as the Green Paper comments, equitable regulation for differing institutions does not necessarily require a similar sets of rules. However, when institutions move into one another's business to the extent that they become very much alike, it is clear that they should be treated in the same way. One area of particular concern to me is the statutory requirement that banks hold cash reserves against their deposits. This requirement exists to provide the Bank of Canada with a reliable fulcrum for the operation of monetary policy. Yet other financial institutions which have been moving increasingly into what was the traditional business of banking are not subject to that requirement. I am thinking here particularly of trust companies whose deposits have become much more like banks in that their chequing account and savings deposit business have expanded and which are now moving increasingly

into the business lending area. Except for their estate, trust and agency business, trust companies are coming to look very much like banks but they are not subject to reserve requirements.

Another implication of this tendency for institutions to move into one another's traditional business, especially when taken in conjunction with the growth of conglomerates, is an increase in the potential for problems of conflict of interest. While the structure of our financial system may not have been set up expressly for the purpose of limiting conflicts of interest, the separation of commercial lending by banks from the trustee business of trust companies and from the underwriting business of investment dealers did have that beneficial feature.

The proposals in the Green Paper to maintain, and even strengthen, the traditional partition of financial business in separate companies but permit ownership links among banks, trust companies, insurance companies, etc., addresses both the equity and the conflict of interest problems, while still responding to the desire of many financial institutions to diversify. Trust companies and insurance companies could then move further into business lending by setting up Schedule C banks, subject to all the same rules and requirements as other banks. Moreover, the maintenance of trust and commercial banking business in separate corporate structures under a holding company should make it more straightforward to erect a "chinese wall" to prevent the passage of client information which could cause conflict of interest problems. Finally, the continuation of traditional separations between the different types of institutions should facilitate supervision.

This is a consideration which is clearly very important if substantial additional demands are going to be placed on supervisory agencies to enforce self-dealing rules.

The financial holding company concept in the Green Paper will permit the growth of financial supermarkets in this country if that is what customers want, but the proposals are not meant to force such a development. In my view there will remain plenty of room for independent financial institutions specializing in a more narrow range of financial services.

I would like to turn now to comment on some of the issues regarding the operation of deposit insurance in Canada. I do not propose to deal specifically with all the various proposals made in the Wyman Committee Report. I look forward to the testimony of Mr. Wyman later this week and to the responses you receive from the various groups of financial institutions to help us assess fully all the implications of the proposals. Most of the points I want to make today are of a more general character.

I would like to say first of all that deposit insurance is an integral part of the financial system in Canada. For 15 years following its establishment in 1967, deposit insurance operated effectively but in the background. It is only in the last few years, as financial institutions have come under severe strain, that its operations have been given prominence. In assessing the appropriateness of our deposit insurance arrangements, it is important not to lose sight of the fact that these recent strains on financial institutions in general have been extraordinary.

None of us will soon forget the difficult economic times we have been through -- the serious inflation, the severe recession and the way inflation was fought with high interest rates in most industrial countries because of insufficient fiscal restraint. Financial institutions were bound to be shaken by these almost unprecedented economic events. Some institutions have not survived and others have needed assistance. In both cases there have been payouts of deposit insurance funds.

There have also been other less widely publicized instances where the maintenance of confidence was aided by the existence of deposit insurance. I have in mind the temporary threats to confidence such as those encountered by banks because of the international debt burdens of developing countries and the financial difficulties of some large domestic borrowers, particularly in the energy field. Moreover, one should remember that, even when no deposit insurance payouts are involved, loan losses still have to be paid for by someone. The costs of the unusually large provisions for loan losses which banks have had to make for various reasons in recent years have been passed on to customers mainly in the form of wider interest rate spreads between loans and deposits.

Despite the support for financial institutions provided by deposit insurance during the past several years, there is some tendency to attribute a lessening of market discipline on financial institutions to the form of our present deposit insurance arrangements. While I believe that this argument has been overstated, there is nevertheless room for improvement in the

operation of deposit insurance. However, striking an appropriate balance between encouraging market discipline for deposit-taking institutions and avoiding instability in the financial system is not easy.

The judgement in the Wyman Report is that the balance needs to shift to providing more market discipline, and it proposes that insurance should be limited to 90 per cent of deposits but with a higher maximum amount of insurance. While I would not dispute the value of greater market discipline, I would agree with the Minister of State for Finance that this is not the approriate time to implement such a proposal. The present emphasis should be on strengthening the confidence in our financial institutions.

But even if confidence were not a concern, proposals to increase market discipline are not likely to be sufficient checks on financial institutions by themselves. They typically rely on the ability of depositors to obtain information on the condition of financial institutions and to act in a way which will bring pressure for change at institutions taking excessive risks but without leading to panic withdrawals of deposits. That is demanding a great deal from small and medium-sized depositors. While it should be possible some day to incorporate increased market discipline in our insurance arrangements, I believe that much of the discipline will still have to come from regulation and supervision.

There are other proposals in the Wyman Report that should be given more immediate consideration. Certainly we need to get on with raising the deposit insurance premium to start reducing the CDIC deficit. The Wyman Committee has suggested a premium increase from 1/30 of one per cent to

1/10 of one per cent of insurable deposits in two stages. You have already heard that the board of directors of CDIC favours such an increase to take place immediately. On the Wyman proposal to eliminate the deficit more rapidly with a preferred share issue, I am less certain. While the Wyman Committee recommends that the Government should not participate directly in refinancing CDIC, the proposal nevertheless involves an increase in the Government's tax expenditures because of the tax-free nature of these preferred share dividends. The view that member institutions and not the Government should refinance CDIC is one which I fully support. The payouts made by CDIC have all been based on the objective of minimizing the cost to the members of the deposit insurance system and cannot be attributed to political considerations.

The last point I want to make concerns the Wyman recommendations on the role of CDIC in the prudential supervision of financial institutions. In the light of the changes occurring in the financial industry and the responses in the Green Paper which significantly increase the need for supervision, a thorough review is needed of the present organization of supervisory agencies. I agree with the view expressed by the Wyman Committee that CDIC should receive more information on its member institutions and should have greater influence over their behaviour. However, I think we must seek arrangements which would strengthen the position of CDIC without the extensive duplication of the activities of the present supervisors proposed in the Wyman Report.