Adjusting to Globalization: Challenges for the Canadian Banking System[1]

Edward P. Neufeld

Introduction

The forces of "globalization" are transforming virtually every industrial sector in Canada including financial services retail distribution. Observers who downplay its significance tend to take a short-run view of the matter, pointing to what has not yet been affected greatly by globalization rather than to how a continuation of current developments will change the economy and its sectors over the next decade.[2] Because of the mobility of capital, financial services sectors have already been heavily affected by globalization.

How well is the Canadian financial system including its regulatory regime, positioned to deal with globalization? This paper addresses that question, and mainly as it relates to the Canadian banking system, by: (i) referring to past evolution of the system and how current challenges differ from past ones; (ii) identifying the challenges that the current environment has generated — in part by examining the stresses and strains revealed by the Asian financial crisis and its lessons for achieving stable and efficient financial systems; (iii) appraising the extent to which the Canadian banking system and its regulatory framework, as well as current Canadian financial services policy, is in tune

[1] Some of the analysis included here is taken from Neufeld (2000).

[2] For an effective portrayal of current and prospect changes driven by globalization see Friedman (1999).

with addressing those challenges; and (iv) drawing some conclusions of relevance to the Canadian banking system from this perspective on globalization.

The Evolution of the Canadian Banking System

The need to adapt to changing circumstances and opportunities is nothing new for the Canadian banking system. Over its history of almost two centuries the growth and development of the system has involved: geographic expansion; industry consolidation; expansion in the range of financial services offered; and innovation in the delivery of services. The process was greatly assisted early on by innovations in transportation technology — transcontinental trains; and in communications technology — telegraph and telephone. By the end of the 1920s domestic geographic expansion and industry consolidation had gone a very long way. However, product and product delivery innovations were minimal until after the Second World War.

Currently, with the domestic market relatively mature, both in terms of geographic coverage and product offerings, the only significant frontier left for the system is that of international financial services. The most important question now is whether the Canadian legislative framework and the ingenuity of the banks will be such as to see the system survive strongly in Canada and abroad in the face of the forces of global competition that have become a permanent feature of the system and are likely to increase in intensity.

It is useful to examine these evolutionary forces in somewhat more detail.

The Period before World War II

The chartered banks first typically emerged in the larger urban centres, with smaller urban and rural communities being served by local private bankers and money lenders, including the activities of accountancy and law offices. The banks then began to extend their reach into the hinterlands — which saw the emergence of the historically important innovation of the branch system and its effective administration — the latter involving not just new accounting and control procedures and practices but new human resource policies as well, as personnel that were required to move around far-flung branch systems.

This experience and new regional opportunities combined to enable the banks to extend their reach beyond their own hinterland to neighbouring provinces and, simply following trade, to the Caribbean region. As they did so it became evident that structural changes to the banking system were necessary in order to take advantage of the inviting presence of banking opportunities in the widely dispersed regions, and to serve their communities efficiently. These structural changes took two major forms: the disappearance of local private bankers and money lenders as the more efficient bank branches began to serve local communities, and major consolidation among the banks through mergers and acquisitions as they sought to meet the new dimensions of "optimum size" dictated by a greatly expanded market.

The structural changes that emerged were quite dramatic. It would appear that in the 1890s there were close to 200 private banking offices in Canada most of which had disappeared by the 1920s; on the other hand, while in 1890 there were 426 bank branches, in 1920 there were 4,676.[3] Whereas in 1890 there were about 11,300 Canadians per branch this had declined to below 3,000 by the 1920s and represented long-term density maturity. At the same time the number of chartered banks diminished dramatically. In 1870 there were 30 active chartered banks while by 1930 these had been reduced to ten. Mergers played a very significant role in enabling the emergence of institutions of a size appropriate to the breadth of the Canadian market and to the then demands of international business.[4]

In Canada, in contrast to the United States, government policy did not impede these major structural changes that led to the development of national branch systems and consolidation among the banks, to the substantial benefit of the Canadian economy with its relatively small population and large territorial expanse.

While the Canadian chartered banks were highly successful in growing their institutions by increasing their geographical reach within Canada and by mergers and acquisitions, they were much less imaginative in doing so through expanding the range of their products, as indicated by the relatively static character of their liability instruments and assets over many decades

[3]See Neufeld (1972) for a full analysis of the development of the Canadian banking system.

[4]A significant example of this was the emergence of the Royal Bank of Canada. It began operations as a small chartered bank in 1871. From 1910 to 1925 it effected five strategically important mergers. Consequently, whereas it accounted for under 4 per cent of bank assets in 1910, by 1930 it had 27 per cent,

making it the largest chartered bank in Canada. See McDowall (1993, ch. 4) and Neufeld (1972, p. 99).

prior to the Second World War, and the relative absence of non-intermediation services. On the sources of funds (i.e., liabilities) side of their activities they did begin to develop actively the simple savings deposit in the late 1860s, in addition to their chequing account business, and this turned out to be highly significant for their future growth, but no further important liability instrument innovations appeared until after the Second World War.

As for their lending activities, they saw themselves essentially as providers of short-term business loans, with peripheral activity in areas such as federal, provincial, municipal and corporate securities remaining relatively small. One bank in the 1930s found a way of circumventing the interest rate ceiling in order to develop consumer instalment credit, but the business remained small and its lead was not followed by the other banks. Not until well after World War II did they take consumer lending seriously and they waited long before starting to lobby for mortgage-lending powers.

In the meantime, their intermediary competitors moved ahead and their share of the financial intermediary business declined steadily — from 73 per cent in 1870 to 40 per cent in 1940. Their mortgage loan, trust and insurance company competitors pioneered mortgage lending, both industrial and residential, the small loan companies and money lenders developed consumer credit; while that wonderful savings instrument — the automatic periodic payment — was for long largely the preserve of the life insurance companies, it was also adopted by the mutual fund companies which emerged in the 1930s. Trust companies in the 1920s succeeded in achieving legislative changes that enabled them to enter the historic preserve of the banks — the deposit business — as did the credit unions and caisses populaires.

This lethargy on the part of the banks in product development cannot be explained by legislative constraints even though such constraints did exist. Over decades, the banks had been relatively successful in achieving desired changes in the *Bank Act* during the decennial reviews. The overriding perception among the banks themselves was that they should confine themselves to gathering demand and savings deposits and this, it was felt, dictated that they confine themselves essentially to providing short-term, self-liquidating business credit.

The Period after World War II

Geographic expansion and increasing branch density had been largely exhausted as a way of growing the banking system prior to World War II. But growth through expansion of the product range had great potential. It emerged slowly and in the two very important cases of consumer credit and mortgage lending, it came as much through the desire of the government as through the lobbying of the banks. The 1937 *Home Improvement Loans Guarantee Act*, which protected the banks against losses up to 15 per cent, was followed in 1954 by the *National Housing Act*, under which the banks began to offer government-guaranteed residential mortgage loans. Not until 1962 did the banks begin to argue for broad mortgage lending powers and these emerged in the next *Bank Act*, the one of 1967.

Similarly so with consumer credit. The step taken by the Canadian Bank of Commerce in 1936 to offer consumer instalment loans under accounting that enabled them to charge more than the maximum legal interest rate, a step tolerated benignly by the government, was not followed by the other banks. The 1954 *Bank Act* permitted the banks to take chattel mortgages as security but not until 1958, when the Bank of Nova Scotia entered the consumer credit field aggressively did the rest follow.

Innovation in instruments for raising funds also came slowly. In 1959 the Canadian Bankers' Association appointed a committee of three, two bankers and one outsider (the writer) to examine the feasibility of forming an active short-term money market with emphasis on bankers' acceptances. But only gradually did a full array of term notes, debentures, bankers' acceptances and a variety of savings plans appear. In the 1960s all the chartered banks became associated with mutual fund companies and in time this evolved into a major area of activity. There then emerged a virtual explosion of innovation in how services were delivered with the move into credit cards, beginning with CHARGEX, then VISA and MASTERCARD, and some years later individual bank cards and automated teller machines (ATM), then debit cards, telephone banking and finally Internet banking.

Of great significance for achieving growth through widening the range of services offered was the permission granted to banks in 1987 to acquire investment dealers and in 1992 to acquire trust companies. This, together with their burgeoning mutual fund business paved the way for them to become major players in wealth management and related services. The acquisition of dealers was also important for their lending activities in that it enabled them to provide the full range of corporate financing services, not simply demand and term bank loans as they had done over much of their history. Special departments for loans to small and medium-sized businesses as well as separate venture capital arrangements were also developed by the banks individually.

As a result of this broadening of the range of services offered, the banks succeeded in achieving a rate of growth that maintained their relative position in financial intermediation in Canada and increased somewhat their share in the provision of non-intermediary services such as wealth management. But by the end of the twentieth century the potential for further growth in Canada through broadening even further the range of services appeared to have been largely exhausted — apart from branch distribution of life insurance and car leasing, both of which they were prohibited from entering by federal government legislation. In short, just as geographic reach and branch density had been essentially exhausted prior to the Second World War, by the end of the twentieth century the potential for growth through expansion of product range in Canada had also been largely exhausted.

The challenge for future growth and development that this has posed for the Canadian banks is clear. They can be content with serving the very mature Canadian market and accept the low rate of growth that this implies or they can begin to extend their reach seriously beyond Canada's borders just as in the late nineteenth century they had begun to extend their reach beyond their local communities and home province into Canada as a whole.

However, either is easier said than done because of a new development that exploded in the 1990s, namely globalization and global competition. On the one hand, this phenomenon has the potential for challenging the banks in their own domestic market — a new development that will reduce further the opportunities for growth in the already mature domestic market; and on the other hand it has imposed new prerequisites for banks wishing to become respectable players outside their home market. Domestically, the banks must be as efficient as possible in terms of the cost and quality of service or their market share will be eroded by international institutions; while being effective international players requires them to have a size that enables them to capture the economies of scale enjoyed by their much larger international competitors.

The issue that emerges is whether the Canadian banking system and the legislation governing it are poised to meet the challenges of globalization over the next ten years.

Implications of Globalization for the Canadian Financial System

Globalization is a permanent, non-reversible phenomenon. Canadian financial services policies based on the assumption that domestic financial systems are heavily protected from external influences, as was the case over past decades, will be ineffective and, indeed, counterproductive. They risk undermining rather than strengthening the domestic financial system. A recent book on the subject of globalization has noted that:

> the globalization system, unlike the Cold War system, is not static, but a dynamic ongoing process: globalization involves the inexorable integration of markets, nation-states and technologies to a degree never witnessed before — in a way that is enabling individuals, corporations and nation-states to reach around the world farther, faster, deeper and cheaper than ever before, and in a way that is also producing a powerful backlash from those brutalized or left behind by this new system. (Friedman, 1999, pp. 7-8)

There are a number of important implications for the Canadian financial system of this worldwide trend. How Canadian policy deals with some of them will determine whether the Canadian financial system will be "brutalized" or "left behind", its place to a significant degree taken by external players.

Increased Foreign Competition within Canada

Canada's domestic market will be challenged by non-Canadian institutions much more so in the future than in the past. Telecommunication innovations and the decline in telecommunication costs — microchips, satellites, fibre optics, the Internet — are breaking down regional, international and institutional barriers that had previously protected institutions from external forces. The nineteenth century equivalent of this was the massive improvement in transportation and decline in transportation costs, as well as the improvement in communications through the telephone and telegraph which were prerequisites for breaking down regional barriers to nation-wide banking and financial services generally. The break-down of international boundaries by rapidly developing information and communication technologies will naturally lead to an increase in the share of the Canadian financial services market going to non-Canadian financial institutions.

Increased Importance of International Competitiveness

The ability of Canadian institutions to withstand increasing foreign competition will depend on their economic efficiency relative to that of the encroaching competitors. In the past when the threat of foreign competition was unimportant it did not much matter for Canadian financial institutions if government policy impeded the move to a more efficient system, the only ones suffering being the users of financial services. But now non-Canadian institutions with greater scale advantages can use rapidly emerging technology to deliver highly reliable and competitive financial services to the home or office. Canadian clients are likely to be quite receptive to such services since they are among world leaders in the adoption of Internet services, including banking services. Therefore, it is simply a matter of time before most of them will routinely use the Internet for accessing banking and other financial services.

Not only does this mean that new non-Canadian institutions have much easier access to the Canadian market than previously, but Canadians will become increasingly indifferent as to whether they are dealing with Canadian or non-Canadian institutions. Such new competition in itself is beneficial to Canadians, but if the edge is given to non-Canadian institutions because of costly legislative constraints imposed on domestic institutions then the outcome is undesirable both for the long-term prospects of the domestic financial system and for the efficiency of resource allocation within the financial services sector. The challenge for Canadian policy is to remove such constraints, some of which, as noted later, are currently of concern.

Obsolescence of Past Measures of "Optimum Size"

The forces that have facilitated globalization of financial services have also made obsolete past measures of economies of scale and of the "optimum" size of financial institutions, and past guidelines concerning excessive domestic market concentration are no longer reliable. Month after month cases emerge in a large number of countries of already large financial institutions increasing their market reach and reducing their operating costs through mergers with other large institutions. That is, the technological revolution is changing the parameters concerning the relationship between size and efficiency so that data relating to past size/efficiency experiences are no longer a reliable guide for the future. At the same time the concern in earlier years that this would lead to problems of inadequate domestic competition are increasingly irrelevant. They are being made irrelevant because financial services clients increasingly can source a wide variety of financial services from abroad as well as from a growing range of foreign and domestic institutions within domestic markets.

Recent Canadian policy of, in effect, preventing mergers between the larger banks stands out as an exception to what is happening in most of the industrialized countries. There are already disturbing indications that the Canadian banks do not have the size to support certain large international and domestic financial activities. For example, they have all exited the payroll business and, all but one, the custodial trust business, their places taken by foreign institutions. Also in March 2001, the Royal Bank of Canada announced that it would be selling RT Capital Management, its equity management arm, the most likely buyers being foreign fund managers.[5]

System Growth Dependent on Competitiveness at Home and Abroad

For Canadian financial institutions to experience solid growth in the future will require them to be internationally competitive at home and abroad. Not only, as noted earlier, is the Canadian financial services market a very mature one but it will be increasingly challenged by non-Canadian institutions. Therefore the future growth of Canadian financial institutions will depend on them expanding their international activities, especially in the United States. But in order to do this successfully they will need both to be internationally competitive in their home market and to have a size that enables them to compete aggressively abroad.

The Canadian banks have already slipped a long way down the list of important international financial institutions as measured by the size of their assets and of their capital bases; and current government policy impediments to mergers among the big banks means in my view that non-interest costs are 10–20 per cent higher than they would be if mergers were permitted. The result is that current attempts by the large banks to establish a stronger presence in the United States while entirely appropriate, and indeed very necessary, are limited both by domestic operations that are more costly than they could be and by capital bases that are smaller than they need to be.

[5]The Canadian institutions had been inhibited in building up their foreign equity management teams because of the prolonged Canadian restrictions on the foreign content of Canadian pension plans — an example of regulative restrictions causing permanent damage to the Canadian financial system.

Inevitability of Increased Foreign Ownership

The forces of globalization will generate a persistent tendency towards increased foreign ownership of Canadian financial institutions as has already begun to happen, and to an increase in non-Canadian executives running them. International institutional and other investors seeking long-term profit maximization through balancing their investments over a wide spectrum, are increasingly indifferent to the national origin of the investments. This alone will lead to an increase in foreign ownership of Canadian companies. Furthermore, as Canadian institutions acquire foreign institutions through share exchanges in order to grow their business, as in a recent case,[6] the degree of foreign ownership will increase. Also in order to be internationally competitive it will be necessary for Canadian institutions to seek executive talent where they can find it. Since Canada's own supply is much smaller than the international pool, this will inevitably mean more non-Canadians running Canadian institutions. Boards of directors will have a growing number of non-Canadian members as business activities are globalized.[7]

Neither of these developments are ones that Canadian policy can or should combat. But they increase the urgency for Canadian policy to be in harmony with enabling domestic financial institutions to be as competitive domestically and internationally as possible and to avoid actually hastening the trend towards foreign ownership and control by weakening the relative position of Canadian institutions.

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[6]On January 26, 2001, the Royal Bank announced that it intended to acquire Centura Banks Inc. of North Carolina for $3.5 billion through an exchange of shares.

[7]The number of U.S. residents who are directors of Canadian companies increased from 10 per cent in 1995 to 15 per cent in 1999. See *National Post*, February 5, 2001, p. C1.

Weaknesses of Financial Systems Revealed by Globalization

The Asian Financial Crisis Experience

How well, over-all, is the Canadian financial system placed to survive financial globalization? A useful way to address this question is to examine how the Canadian system stands up against the weaknesses in certain financial systems revealed by the Asian financial crisis — a crisis that was largely triggered by the forces inherent in financial globalization. For domestic financial systems to survive globalization will involve correcting or avoiding such weaknesses.

Many of the weaknesses revealed by the Asian financial crisis had existed within the various financial systems for many years. What brought them to the fore was first the easy access of official and private institutions to short-term capital brought about by the globalization of financial markets and then the shock imposed on domestic financial systems of the sudden flight of that capital at the first signs of economic difficulties. Stabilization of conditions in those systems involved not just the historically well-known adjustment to cyclical distortions but correction of newly revealed and deep-seated structural problems — the principal reason why the crisis was as severe and long-lasting as it turned out to be.

The more important financial system weaknesses revealed by the Asian financial crisis may briefly be noted in order to judge how the Canadian system stands up against them.

Macroeconomic policies. In some cases the macroeconomic policy environment was destabilizing: monetary policy was late in taking action to restore price stability which was even more important than fiscal imbalances in as much as the latter was not a problem in most Asian countries during the crisis; and policies of fixed exchange rates resulted in exchange values being held at artificially high levels having in mind the failure of macroeconomic policies to protect their real values.

Structural deficiencies among financial institutions. Domestic policies to a substantial degree shielded domestic financial institutions from international competition. For example, while the United Kingdom introduced major reforms in 1986, Japan ignored this example until the late 1990s. Consequently system rationalization was delayed and serious "moral hazard" problems existed within it, that is, the belief among private institutions that government would rescue them in time of trouble. At the same time the detailed regulation of the systems prevented the emergence of efficiency-generating competition within them. Mergers, acquisitions and even bankruptcies were made very difficult, thereby tending to "freeze" existing system structures at a time when exploding technology and growing international pressures were making such systems obsolete and highly vulnerable to life-threatening attacks. The lesson that emerged from all this was that regulations that operate against, instead of in harmony with market forces are not likely to be effective indefinitely. In most of the industrialized countries, including most recently the United States, old structures were permitted to be transformed through the playing out of market forces and this process is continuing through seemingly endless mergers, acquisitions and even bankruptcies.

Structural deficiencies within corporate operations. In retrospect it became clear that many private sector corporations had hidden deteriorating conditions from the view of public markets. This lack of transparency in accounting, weak financial controls, deficient bankruptcy laws, and inadequate internal risk management permitted abuses to multiply, of which investors were unaware until crisis conditions had been created.

Structural deficiencies within domestic regulatory agencies. The sudden very large flows of short-term international capital to a wide range of private financial and non-financial institutions created risks for which regulatory agencies were unprepared. Inadequate reporting requirements, as for example, exposure to short-term capital outflows and the use of derivatives, poorly trained regulators and the absence of effective international co-operation among regulators were weaknesses that suddenly stood out as the crisis developed. In addition, governments, by hiding deteriorating conditions from markets caused the inevitable adjustment to be more severe than it need have been. An important example of this was the concealment of deteriorat-ing official foreign exchange reserve positions. Just as policies of stability required much more transparency in corporate operations so it was required of official operations.

Structural deficiencies in multilateral surveillance. One of the most significant weaknesses revealed by the Asian financial crisis was the unpreparedness of the multilateral institutions to deal with international financial system problems. Neither the International Monetary Fund nor other multilateral institutions had concerned themselves with structural problems in member country financial systems, for the most part confining themselves to issues of macroeconomic stability and industrial development projects and policies. Recent multilateral efforts, in which Canada is playing an active part, to strengthen domestic financial systems, improve the quality of domestic regulators, establish international standards in the operations of financial institutions and of regulators, constitute serious attempts at addressing these weaknesses.

How the Canadian financial system measures up against those deficiencies. The Canadian financial system measures up quite well when judged against the weaknesses revealed by the Asian financial crisis. The fundamental strength of the Canadian financial system was demonstrated by the fact that it, as were those of the other western industrial countries, was relatively untouched by the crisis. Monetary policy was unequivocally directed towards maintaining a low rate of inflation and the Bank of Canada adopted a policy of increasing transparency in its operations. Low inflation and the move towards budget surpluses provided a stable environment for the financial system and the floating exchange rate removed the risk that the rate would be out of line with market forces.

Not that the exchange rate policy was and is now without controversy. Some would attribute the weak Canadian dollar over recent years to the maintenance of relatively high taxes, excessive government expenditures and inadequate reduction of the public debt, while others would attribute it essentially to weak commodity prices. Be that as it may, the floating exchange rate regime contributed to financial system stability in contrast to the fixed rate systems in many Asian countries — systems that collapsed under pressure.

Also contributing to stability is the fact that the federal government regulatory system overseeing Canadian financial institutions, as distinct from certain regulations themselves, is of high quality by international standards, including the quality of its regulatory personnel. Canada recognized the need to greatly improve international surveillance of the international financial system because of the many-faceted implications of financial globalization. The prime minister raised the issue at the Halifax G7 summit of 1995 and the minister of finance did so at various international fora. When the Group of Twenty was formed to work towards a more stable international financial system the Canadian finance minister was asked to be its first chairman. Furthermore the chairman of the Canadian Deposit Insurance Corporation was asked to head a subgroup under the newly formed Financial Stability Forum to make recommendations on deposit insurance; and Toronto was chosen as the location for the new International Centre for Leadership in Financial Sector Supervision.

Also many, although not all, of the historic barriers between the "four pillars" of financial institutions (banks, trusts, investment dealers and insurance companies) have disappeared, thereby increasing competition between them, and there is a strong foreign presence in most areas of the system, including increasingly in the banking system.

The need for transparency in corporate operations and for strong corporate governance practices has been emphasized by official regulators and by self-regulating institutions. As a result, for example, corporate reports, including those of the banks, are more informative for investors than in past years and many, although not yet all, annual reports now include a section outlining how the corporation's governance practices match up against the guidelines laid out by the Toronto Stock Exchange.

These favourable developments lay back of the ease with which the Canadian financial system withstood the international pressures created by the Asian financial crisis and demonstrated that the system had many strengths in going against increased global competition.

In addition, there is evidence in the recent acquisition actions of Canadian banks in the United States that they understand well that their future prosperity will depend on the development of their North American base, and not just their Canadian base.[8]

Unfortunately, there is one significant aspect of Canadian financial services policy that appears not to measure up well against the lessons learned from the Asian financial crisis and so risks undermining the future competitiveness of the system. This refers to the fundamental importance of permitting structural changes of a kind that reflect the pressure of new forces generated by globalization.

Bill C-8: Canadian Policy for Confronting Globalization

Prior to the federal election of 2000 the Canadian government tabled Bill C-38, a massive bill intended to introduce a large number of changes to the law governing the operation of federal financial institutions in Canada. This legislation appeared after the publication of the *Report of the Task Force on the Future of the Canadian Financial System* in September 1998 (the

[8]A few recent examples may suffice. Toronto Dominion Bank is the largest shareholder of TD Waterhouse, a leading international brokerage firm. The Bank of Montreal through its U.S. subsidiary, Harris Bank, is acquiring First National Bank of Joliet. The Royal Bank is acquiring Centura Banks Inc. with assets of $11.5 billion; prior to that it acquired Security First Network Bank, an Internet bank; also Prism Financial Corp., a mortgage company; Liberty Life Insurance Co.; and Dain Rauscher Corp., a full service securities firm.

Mackay Report) and the government's policy paper of June 25, 1999, entitled *Reforming Canada's Financial Services Sector: A Framework for the Future*. That Bill died with the call of an election. It, however, was reintroduced as Bill C-8 in February 2001 and received Royal Assent a few months later. Bill C-8 introduced no policy changes from Bill C-38 although it did correct a number of errors and ambiguities that hasty drafting had left in that first bill. Space does not permit a detailed review here of the merits of all the measures included in that bill. Therefore this discussion focuses on those of relevance to longer term evolution of the system.

Competition

Some measures in the bill are presented as intending to increase competition in the Canadian financial services market. But others, in practice, will have the opposite effect.

Opening up the payments system to life insurance companies, securities dealers and money market funds will tend to increase competition marginally in the payments area. But encouraging the formation of new small banks, "community-based banks" as the Department of Finance Press Release puts it, by lowering capital requirements from $10 million to $5 million goes directly against the evolution of banking systems most everywhere. Not only is it unlikely to increase competition but it is more likely to lead to future bank failures and a drain on the reserves of the Canada Deposit Insurance Corporation. If the attempt is made to offset this risk with strict regulations and higher deposit insurance premiums for the upstart banks, then the measure will likely be still-born in terms of its results.

The government wishes to facilitate the credit union movement in developing national services entities that may help the movement to survive in a market where economies of scale come from large electronic management and delivery systems. This is quite appropriate although there is little in the bill that will lead specifically to that end. Its eventual impact on competition is likely to be minimal. (It is slightly ironic that here policy recognizes that large systems are needed for survival while elsewhere the bill envisages achieving increased competition through encouraging the formation of new local banks.)

Several measures over the last few years have given increased flexibility to foreign banks in the Canadian market including the valuable ability to engage in wholesale banking through branches of the parent company instead of through the more costly route of a Canadian subsidiary. Foreign bank subsidiaries in Canada have always had all the business and investment powers of Canadian banks and all size limitations on them have been removed. Bill C-8 ensures that they will have all the new investment and business powers being granted to Canadian banks. This, taken by itself, is appropriate since more competition is better than less. However, some measures of Bill C-8, including details of policy not embedded in the bill itself, will have the effect of dampening the ability of Canadian banks to compete with foreign banks.

The discriminatory measures that will have this effect include the restrictive and politicized bank merger policy which, for some time, risks preventing Canadian banks from achieving the economies of scale that their much larger international competitors are achieving; the continued prohibition against the distribution of life insurance through bank branches, which directly restricts competition in the Canadian market and indirectly does so by making bank branches less productive than they could be; the continued exclusion of the banks from the car leasing business, a business almost completely dominated by foreign institutions — a quite incredible case of Canadian law restricting competition in a Canadian market by keeping Canadian institutions from competing with foreign institutions in the Canadian market place; the threat in the bill directed at the large Canadian banks, and not at smaller competing institutions or foreign institutions located in Canada or entering the Canadian market through the Internet, that if they do not provide certain low-cost services they will be forced to do so.

But the most glaring weakness of the new policy as concerns competition is its failure to recognize clearly that by far the most important source of future competition will be large international institutions operating directly in Canada and through the Internet from outside Canada. There is little recognition that the most important issue for Canada will be the survival of at least a few large uniquely Canadian financial institutions.

Restructuring

One of the most significant aspects of globalization and the technological revolution that is driving it is the impact it is having on what constitutes economically efficient private sector institutions. The development of large-scale electronic systems has changed what constitutes optimum-sized institutions and has facilitated enlarging the range of products and services that individual institutions can offer. In response to this, financial system restructuring is taking place in virtually all countries and the size of many international institutions has increased greatly through mergers and acquisitions.

Globalization is also changing past guidelines as to what constitutes concentration in the financial services industry. This is because of the growing importance of cross-border competitors and their ability to deliver services with ease from a wide range of out-of-country suppliers. Past guide-lines as to what constitutes excessive domestic concentration are becoming obsolete.

Domestic restructuring and competition policies that fail to take these developments into account risk undermining the future competitiveness of domestic financial institutions. Some measures in Bill C-8 are helpful in this respect but other ones are not. Also, since many of the important details of the measures will emerge in regulations and many actions that institutions might want to take in response to them are subject to the discretionary approval of the minister, it is not always clear how things will work out in practice.

Holding companies and investment and business powers. A positive change is one that permits the banks and life insurance companies to structure themselves under an upstream regulated non-operating holding company. This increased flexibility recognizes the great variety of activities now undertaken by those institutions and the fact that they need not be subject to identical regulatory oversight and so can be placed in separate subsidiaries of the holding company. Of course, the existing structure where subsidiaries are run off the parent operating company will remain as an option.

Additional investment powers being granted also reflect the changing world. These include, for example, the ability of a bank to own retail and wholesale banks downstream. Also the "in-house" powers of the banks are broadened in information technology, subject to ministerial discretion, and regulations can be used to extend those powers as the government deems appropriate. However, prohibition on bank branch distribution of life insurance and bank participation in car leasing is perpetuated.

Canadian large bank merger policy. Federal government policy relating to the merger of banks with equity in excess of $5 billion is outlined in the government document *Merger Review Guidelines* released along with Bill C-8, but is not reflected in any statute. Not being part of the bill itself the guidelines can be changed by the government with ease, which is fortunate or not depending on how such discretionary policy-making will be used. However, the process itself is tortuous in nature and subject at crucial stages to strong short-term political influences. It has been presented as having three stages.

Stage 1: (a) the banks apply to the Competition Bureau, the Office of the Superintendent of Financial Institutions (OSFI) and the minister of finance for permission to merge, together with assessment information; (b) the banks must prepare a Public Interest Impact Assessment (PIIA) giving the business case, costs and benefits to clients, details on branch closings and their impact, contribution to international competitiveness, employment impact, ability to adopt new technology, transition remedial steps contemplated, and impact on the structure of the industry; (c) the Competition Bureau and OSFI will review the proposal for competition and prudential considerations; (d) concurrently with the preceding reviews, the House of Commons Standing Committee on Finance and the Standing Senate Committee on Banking, Trade and Commerce (Senate Committee) will hold public hearings using the PIIA as their focal point; (e) the Competition Bureau and OSFI will report their views on competition and prudential aspects to the minister of finance, which documents the minister will make available for scrutiny to the Finance Committee and Senate Committee; (f) the latter two committees will report to the minister on the broad public interest issues raised by the merger proposal.

Stage 2: The minister of finance, drawing in part on the information in the aforementioned reports will decide if the public interest, prudential, and competition issues raised, can be addressed. If he deems that they cannot be addressed then he will simply deny permission to merge. If he deems that they can be addressed he will authorize negotiation of remedies — the third stage. A significant flaw in this stage is that the minister must make his decision before the Competition Bureau and OSFI have spelled out the specific remedies they would regard as being satisfactory — ones that would lead them to recommend approval of the mergers. Such decision-making in the dark increases the risk that short-term political factors will predominate.

Stage 3: Competition, prudential and public interest remedies will be negotiated with the banks by the Competition Bureau, OSFI and the Department of Finance. If the minister of finance judges the negotiations to have been successful then he will approve the amended merger proposal. If not, he will reject it.

These guidelines include two improvements to those initially included in the government's policy paper of June 1999. First, the government will seek to complete the whole process in a specified period of time: five months. Unfortunately there is an easy way around this in that it is "subject to the prerogatives of Parliament". Second, the Senate Committee will be involved in the process, which is desirable in that it tends to be more professional and less political in nature than the House of Commons Finance Committee in its consideration of policy issues, particularly those relating to the banks.

This process, while possessing a certain sequential logic to it, is flawed in that it is tortuous, and therefore inevitably subject to delays along the way, and risks being hostage at several crucial stages to short-term political considerations. The Finance Committee has at times shown that its recommendations in matters of bank policy can be highly political in nature, so there is no assurance that its recommendations would be based on objective analysis. The minister has the right to reject a proposal even before the Competition Bureau and OSFI have attempted to negotiate their concerns with the banks involved, as well as after, and the short-term political pressures on him can be decisive. A slightly different problem is that the Competition Bureau has indicated that it takes a two-year time perspective when appraising competition impacts of a merger — which largely misses the emerging competitive factors arising from changing technology and with it increasing cross-border competition, and risks delays in restructuring until it is too late to meet successfully emerging competitive forces. In addition, most significant mergers take at least two years to be consummated in prac-tice, and some more than that, another reason why a two-year perspective makes the Bureau's merger analysis irrelevant.

The restriction on mergers between large banks and large de-mutualized insurance companies is even stricter than that between large banks. They are simply forbidden. The effect is to deny the financial system the synergies in the distribution of insurance products and the utilization of large electronic systems that such integration would make possible — synergies that are being captured by competing international institutions of other industrial countries.

Degree of Regulation and the Regulatory Environment. The government's press releases accompanying Bill C-8 refer to measures that streamline the regulatory process. The bill does reduce ministerial discretionary powers relating to past permitted banking activities. A positive step is giving the Superintendent full authority to approve certain applications, with automatic approval after 30 days if the Superintendent has not raised any objection. Unfortunately these would appear to be confined to matters of a relatively routine nature, with the minister of finance retaining some discretionary authority in all the major new provisions of the legislation — investment and business powers, holding companies and consumer interests.

The body of regulations that will spell out that discretionary authority is likely to be complex and in any case it will be difficult to document clearly what will and will not be permitted by such authority in specific cases. This extensive use of discretionary authority injects a high degree of uncertainty into the regulatory process. So, having in mind the complexity of the regulations that such discretionary authority will require and the uncertainty hanging over a system depending heavily on such authority, it is not likely that the regulatory system over-all will have been made more streamlined by Bill C-8.

New compliance regulations will undoubtedly emerge from the establishment of a Financial Consumer Agency of Canada (FCAC) for enforcing the consumer provisions of Bill C-8. Branch closures will also be subject to a more burdensome regulatory process including the possibility of imposition by FCAC of a consultative process in situations to be outlined in regulations.

One of the more unhelpful and seemingly worthless parts of the new regulatory requirements is the obligation on federal financial institutions with more than $1 billion equity to publish "annual accountability statements that describe their contribution to the Canadian economy and society ... for example ... small business lending, charitable donations and community involvement, and the location of openings and closings of branches" (Finance Canada, 2001). This was first suggested in the Mackay Report. The inherent difficulty, if not impossibility, of measuring long-term economic benefits of restructuring actions taken today in response to competitive pressures means that the reports will likely be exercises in political correctness, serving no useful purposes yet costly to produce as public relations documents.

The over-all effect of Bill C-8 would appear to be an increase in micro-management of some parts of the financial system, including through widespread discretionary powers left in the hands of the minister of finance. In addition to the waste of regulatory and compliance resources and so reduced competitiveness that this appears to involve, its economic costs are magnified by its inherently discriminatory nature — aimed at the large institutions that the authorities can reach and leaving untouched many institutions that they cannot reach, including small federal institutions, all provincial ones, and foreign ones evolving through Internet operations.

Survival of a Unique Canadian Financial System?

A central issue for the future is not whether there will be a financial system in Canada that provides Canadians with necessary financial services. Rather the issue is whether that system will be made up essentially of Canadian institutions, ones that can draw on decades of experience to address effectively the needs of the Canadian economy and society. International competition, coming from all directions, will ensure that Canadians will have satisfactory financial services available to them, but it also means that with inappropriate Canadian policies non-Canadian institutions over the next decade will come to dominate the Canadian market and that Canadian institutions will slip into the role of minor players.

There is a risk that this will happen under the policy directions included in Bill C-8 and the regulations and ad hoc discretionary policies that could emerge from it.

First, the large international institutions already encroaching on the Canadian market, and which will do so increasingly in the decade ahead, can do so with competitive efficiencies through economies of scale that large Canadian banks are, in practical terms, being denied by a restrictive and politicized merger policy.

Second, increasing the limit on individual voting share holdings to 20 per cent from 10 per cent, with ministerial approval, prior to the restructuring of the larger Canadian financial institutions through mergers may make it possible for outside institutions to make strategic investments in major Canadian institutions with a view to having a preferred position when Canadian merger policy does begin to facilitate restructuring. While a Canadian institution could also make such a strategic investment, it seems highly unlikely that the minister of finance would permit two large Canadian banks to develop a relationship in that way while he might well approve a foreign bank doing so. Indeed, the government seems almost to invite this when it states in its news release that the larger shareholding "would allow these institutions to enter into substantial share exchanges, including the ability to enter into strategic alliances and joint ventures" (Finance Canada, 2001). Of course the very uncertainty overhanging such discretionary rule-making illustrates the difficulty that policy is imposing on the strategic planning of the larger Canadian financial institutions.

Third, in recent years government policy has removed restrictions on the operations of foreign banks in Canada and the current bill will continue to give them the same investment and business powers as those of the Canadian banks. At the same time, because they will not be operating through extensive branch systems in Canada and some will use electronic systems almost exclusively, they will not face the regulatory burden of the large Canadian institutions. The Canadian banks meanwhile face regulatory obstacles in creating a branch system that is as low cost as possible — by placing great obstacles to consolidation through mergers, by requiring them to offer some services at low cost and by denying them the right to deliver life insurance products.

Fourth, Bill C-8 in its impact continues to shield foreign financial institutions in the Canadian automobile leasing market, which they dominate, and prevents Canadian banks from even competing with them.

Fifth, for Canadian institutions to become effective players in the emerging global market place will require them to develop strong market positions outside of Canada — not an easy challenge keeping in mind the size and market reach of their international competitors. Some Canadian banks have already closed a number of their foreign branches in the face of such competition while at the same time concentrating on getting a foothold in the

U.S. market — their only option if they wish to grow and retain some place in the international system. Canadian legislation and regulations that inhibit the Canadian banks from developing capital bases of competing size through mergers and that face regulatory obstacles for creating a system in Canada of maximum efficiency have the effect of favouring foreign institutions in both the Canadian and the international markets. Without more realistic policy in Canada their relative position is likely to continue to decline, as it has in the past several decades.

It is rather surprising that Canadian policy would discriminate against the future success of its own large institutions and in favour of non-Canadian institutions, a bias clearly not rooted in economic logic or economic research.

Short-Term Political Considerations versus Long-Term Financial System Needs

Over the last decade and a half there has been an enormous amount of research on the functioning of the Canadian financial system and its regulation; and good research is indeed a necessary condition for good policy to emerge. But it is not at all a sufficient condition because of the decisive role that short-term political considerations can play.

Political considerations have always been an important part of the process of amending banking and other financial services legislation and of government appraisal of mergers and other proposals.[9] The period 1900 to 1930 was one of major consolidation within the banking system. The most significant example was the five mergers completed by the Royal Bank of Canada which helped it increase its size in terms of assets from just under 4 per cent of the banking system to 27 per cent (Neufeld, 1992, p. 99). The mergers attracted the close and personal attention of the then minister of finance, who had concerns of a political nature, but in the end, and without great delay, they were for the most part permitted to go forward and so the necessary restructuring of the system was not unduly impeded.[10]

[9] For a very interesting account of the interplay between the banks and the government, with emphasis on the period after the Second World War, see MacIntosh (1991).

[10] For a detailed account of these mergers and how they came about see McDowall (1993, pp. 123-162).

What distinguishes the current period from previous ones is the extent to which political considerations are impeding restructuring of the system in the face of strong market pressures for change.

Specifically, and by way of example, it is difficult to explain the following other than by short-term political considerations:

- Canadian policy that keeps potentially competitive Canadian institutions out of the foreign-dominated Canadian automobile leasing market;
- Canadian policy that prevents Canadians from buying life insurance at their local bank branch;
- ministerial rejection of bank merger proposals outright, as happened in 1998, that is, without permitting the relevant regulatory agencies from determining if official concerns could be met by the applicants;
- introduction of very complicated bank merger policy procedures that, step by step, include major political hurdles;
- imposition of regulatory burdens on the system that are not based on serious research, that are not evenly applied across the system and that reduce the system's economic efficiency;
- introduction of legislation that is replete with discretionary ministerial powers, thereby creating great uncertainty over what is acceptable to government and what is not.

Even the two most important cases of banking industry restructuring of recent years went forward when they did largely because of the playing out of political forces and not because of coherent federal government policy relating to the needed restructuring of the system. The reference here is to the integration of investment and commercial banking and the integration of the banking and trust business.

Consider first the integration of investment and commercial banking.[11] In February 1986 the federal government announced that Montreal and Vancouver would be permitted to form International Banking Centres. This was in response to local pressures for them and against the advice of a study headed by a former Governor of the Bank of Canada — and viewed by most everyone as essentially a political move on the part of the federal government.

The Ontario government and the City of Toronto were very disturbed over this discriminatory decision, worrying about its impact on Toronto as a financial centre. Quebec even in the early 1980s had permitted outside ownership of its investment dealers, wishing to build up its province-based

[11]For a detailed discussion of how this came about see MacIntosh (1991, ch. 14).

financial sector. These moves finally pressured Ontario to change substantially its historic protectionist position concerning its investment dealers, with greater readiness to consider ways of strengthening them. Opening up that industry to more sources of capital was the most logical way to achieve this and in June 1986 the Ontario minister of financial institutions announced that they would permit banks and other financial institutions to own up to 30 per cent of an investment dealer. The chartered banks, sensing a major change in the political situation, began to lobby to be permitted to have wholly-owned dealers, but they made no immediate progress.

Then in November 1986 another decision by a government agency, and the political rivalry that followed it, in effect decided the issue. The Quebec Securities Commission announced that it would permit the Bank of Nova Scotia to have a full service dealer in Quebec. Of course, the federal chartered banks were prohibited from acquiring such a dealer but the Bank of Nova Scotia achieved it under the "temporary investment powers ..." of the *Bank Act*. The Ontario government then clearly faced the possibility of a major shift of the dealer industry out of Ontario, and so began negotiations with the federal government concerning bank ownership of such dealers and how they might be regulated. By the end of the year both governments had accepted the idea of bank ownership and had agreed on how bank-owned dealers would be regulated by the two levels of government (the "Hockin-Kwinter Accord[12]). This then led within several years to the acquisition of the major investment dealers by the banks and a very large infusion of capital into the investment dealer industry. The interplay of federal-provincial political forces had succeeded where rational economic arguments up to then had failed — they had brought about a fundamental change in the structure of the industry.

The second example of how political exigencies rather than a clear understanding of the need for industry restructuring led to a desirable change in the structure of the industry is the integration of the banking and trust industries. A trust industry separate from banking was unique to Canada with even the United States having integrated it into the banking system at the end of the nineteenth century. Periodic failures among the smaller Canadian trust companies over the years had indicated problems in the industry, including corporate governance, economies of scale and regional diversification problems. The substantial similarity in activities between banks and trust companies because of the dominance of financial intermediation activities

[12]Named after the then federal minister of state (Finance) Tom Hockin and the then Ontario minister of financial institutions, Monte Kwinter.

over trust activities in the latter, had removed any rational justification for maintaining them as a separate industry. But both federal and provincial legislation had done so until the early 1990s.

Then when the federal law was changed in 1992 making it technically possible for a widely-held bank to acquire a trust company, any merger proposal still was subject to the discretion of the minister of finance. One aspect of that discretion was the informal but firm policy of the federal government that "big shall not buy big". But then with little advance warning Royal Trust, the largest Canadian trust company, ran into financial difficulties and faced the prospect of bankruptcy. Had it failed the Canada Deposit Insurance Corporation would have faced a large financial drain because of the guaranteed deposits of Royal Trust, which in turn would probably have required loans to it from the federal Consolidated Revenue Fund. Royal Bank of Canada, after several weeks of intensive due diligence investigations, made an offer which Royal Trust accepted and which was quickly approved by the minister of finance. Thus a "big" bank had acquired a "big" trust company. Within several years the largest part of the Canadian trust industry had been integrated into the banking system — a restructuring that had made perfectly good sense for years but had been opposed by federal and provincial policies.

One aspect of this experience may still be of importance. The earlier rule "big shall not buy big" was presumably modified by the Royal Trust case to "big shall not buy big unless one of the big ones faces bankruptcy". While this rule was ostensibly replaced by the articulated bank merger process outlined above, in fact the wide discretion left with the minister in that process means that the rule may still be very much in place. Yet were one of the big banks or insurance companies to face serious financial difficulties there is little doubt that federal government approval for a merger would come quickly.

A policy that in effect stands in the way of a merger between healthy institutions and requires that one or other of them must be in financial straits before a merger is permitted would not appear to serve the system well. The merger of two healthy institutions, and the controlled integration that it permits, would preserve the strength of both; while waiting until one of the institutions finds itself in financial difficulties would risk wasting much of its valuable resources in terms of customer base and executive talent, to the advantage of other, including some foreign, institutions.

There is a serious danger in permitting major aspects of restructuring to be driven by short-term political considerations. The danger is that the credibility of and the confidence in the official direction of financial system restructuring will be undermined. The "chill" that this has imposed on integration projects of individual financial institutions is probably already an important obstacle to restructuring among the larger Canadian financial institutions, particularly the banks. It would today take courageous bank management to come forward with a merger proposal of any significance under circumstances where the project is to a substantial degree hostage to short-term political considerations.

Summary and Conclusions

Appraising the Canadian financial system against weaknesses revealed by the Asian financial crisis shows that in most respects, but with two vital exceptions, it is well positioned to survive the many challenges of globalization. Its strengths include the stable macroeconomic environment now that inflation is under control and budget surpluses permit a reduction in the public debt; a well-developed regulatory system with qualified regulators; increasing transparency in the operations of financial and other institutions; greater emphasis on corporate governance than in past decades; and a tradition of regular reviews of financial system statutes and regulations.

However, the exceptions, and major weaknesses, are the failure of current restructuring policy to take into account how global forces are reshaping competitive institutions and the dominance of short-term political considerations at the expense of long-term national interest. There appears to be a presumption in Canadian policy that it can be indifferent to its impact on the economic efficiency, that is the cost base, of the large Canadian financial institutions, particularly the banks. The most costly example of this is the practical obstacles placed in the way of mergers. It is in Canada's long-term interest to have at least a few strong and internationally competitive financial institutions, ones that know intimately the character and needs of Canada's economy region by region. This requires policy to facilitate mergers that will achieve that objective. Current policy does not appear to lead to that outcome and risks persistent erosion of the Canadian aspects of the financial system and growing dominance of it by others. This process has already begun and the rapid changes occurring in international competition mean that this trend will not become less important. A change now in Canada's restructuring policies could minimize future damage, but it could not undo damage already done.

The fact that some of the major obstacles to necessary restructuring rest not in the legislation itself but rather in regulations and in the discretionary authority of the minister of finance, means that it would be possible to remove them relatively quickly. Removing them could ensure that Canada, in the years to come, would retain something in the nature of a unique Canadian financial system with institutions that are internationally competitive and important. But this can happen only if there is policy leadership willing to put aside short-term political complications when making industry restructuring decisions and focus strongly on the long-term needs of the Canadian financial system.

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