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Article abstract

Nous remercions M. Guy Glorieux, directeur du Programme de recherche sur les services financiers du Conference Board du Canada, qui nous a permis de publier le mémoire du Conference Board présenté l'automne dernier devant le Comité des finances de la Chambre des communes, concernant la réforme de la législation des institutions financières de régime fédéral. L'analyse du Conference Board fait voir que les propositions législatives reflètent l'évolution des pratiques financières depuis deux décennies. Les auteurs examinent les objectifs de la réforme et tentent d'identifier la nouvelle structure financière qui en émergera au cours des années 90.

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Reform of Federal Financial Institutions Legislations*

by

Guy Glorieux**

and

Michael Andrews**

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Introduction

The industry that now meets the Canadian demand for financial services is very different from what it was in the 1970s and 1980s. An examination of the industry over the past two decades reveals a continuous evolution away from the traditional four-pillar structure which had been at the root of the Canadian financial system. While there are still institutions regulated as banks, trust companies, life insurance companies and securities dealers, a classification by customer, product or market is becoming more relevant than a classification by function.

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*Submission presented by the Conference Board of Canada to the House of Commons Standing Committee on Finance in November 1990.

**This submission is based on research carried out under the auspices of the Financial Services Research Program and was prepared by Mr. Guy Glorieux, Director of the Program and Mr. Michael Andrews, Senior Research Associate.

These changes are recognized in the White Paper issued by the federal government entitled, *Reform of Federal Financial Institutions Legislation: Overview of Legislative Proposals*. The proposals contained in the White Paper essentially ratify most of the changes that have occurred in the Canadian financial services industry over the last two decades and will reduce the barriers to competition among the various types of institutions. The Government's proposals will foster continued integration in the financial services industry through the 1990s and ultimately pave the way for full-service financial institutions.

This submission examines the legislative proposals in light of the changes under way in the Canadian financial system. The first two sections review the changes that have taken place in the industry over time as it moved away from its traditional four-pillar structure to a much more market-oriented structure. The third section examines the legislative proposals in the light of the four key objectives outlined by the Government: consumer benefits; enhanced protection for customers; promotion of strong Canadian institutions; and harmonization. The last section examines the structure of the Canadian financial services industry which is expected to emerge in the 1990s as a result of the federal government's legislative proposals.

The Process of Change

Many forces contributed to the evolution of the industry away from four distinct types of providers of financial services, segregated on functional lines. Among these forces are more volatile interest rates, bouts of high inflation, globalization of financial markets, the increasing importance of institutional investors, and increasing competition, both domestically and internationally.[1]

The sharp swings in financial market conditions and inflation seen in the early 1980s spawned a whole new field of financial services. Derivative products not only helped financial managers to better protect against the risks of fluctuating interest rates, exchange rates and commodity prices, but also led to the development of whole new trading markets. Banks and securities firms, as well as

[1] A fuller discussion of the forces of change is contained in the Conference Board's publication entitled, *Adjusting to New Market Realities: The Canadian Financial Services Industry in Transition*, S. Handfield-Jones and G. Glorieux, December 1988.

other financial institutions, became involved in creating, buying and selling new types of financial products.

Another force affecting the industry was the trend toward securitization. With corporations increasingly tapping the capital markets directly by issuing securities, the banks found their traditional markets being squeezed. Commercial paper was used increasingly as a substitute for credit lines provided by banks. "Disintermediation," the placement of securities directly with an institutional investor, made some inroads in the corporate finance business of investment dealers. Also, a movement away from the long-standing "relationship" links and toward price competitive, single transaction links between users and providers of financial services contributed to increased competition for business.

The impact of globalization of financial markets is evidenced by the increasing role of the foreign sector as lenders to Canadian business, and as holders of government and corporate securities. As providers of financial services, Canadian institutions have had to face not only domestic competition, but increasingly the competition of the global capital markets.

Domestically, the Canadian market is also more open to international competitors. The 1980 revision of the Bank Act provided for the establishment in Canada of wholly-owned subsidiaries of foreign banks. Almost 60 such banks now operate in Canada, with approximately $54.5 billion in assets, but for many institutions, performance has fallen significantly short of that of the large domestic Schedule I banks and of their own expectations.

The elimination of ownership restrictions for Ontario registered securities dealers in 1987 and 1988 resulted in the establishment of Canadian subsidiaries by a number of the well-known international securities firms. As was the case with foreign banks entering Canada, the foreign securities firms have focused primarily on large corporate customers and have not made any significant inroads into the retail market.

The increasing competition from domestic and international sources has led to concern over the size of Canadian financial institutions. With the failure of several regional institutions, considerable attention has been placed on the need to achieve a "critical mass" of business to remain competitive in a particular market. Within

Canada, the trend towards mergers and acquisitions in the trust industry, the purchase of the Continental Bank by Lloyds and its subsequent purchase by the Hong Kong Bank of Canada could be evidence of the need to reach a critical mass to compete broadly in the retail banking market.

The issue of size is especially complicated when the global market is considered. The changing shape of global competition has caused some refocusing of activities by Canadian institutions. For example, ten years ago there were four Canadian banks among the fifty largest in the world, ranked by assets. Now, with no Canadian bank ranking in the top fifty, Canadian banks are increasingly adopting a focus on competing only in selected international markets.

The declining size of Canadian banks relative to banks in other countries, despite their significant presence domestically, raises the questions of whether "world-sized" Canadian institutions are desirable and, if so, whether concentration in domestic markets should be a concern. Internationally, the prospect of a single European market has contributed to a wave of mergers, acquisitions and strategic alliances. For example, in the Netherlands the two largest banks have merged to create a European-sized financial institution. Concentration in the domestic market was evidently of less concern than having a domestic firm positioned to compete internationally.

The tremendous advances made in the areas of technology and communications have facilitated this burgeoning international competition. Distance and physical separation is no longer a barrier to providing financial services, thanks to electronic links. Additionally, advances in computer software have made it possible to offer enhancements of existing products and a whole range of new and custom designed risk management products.

Consumers have benefited from the wider range of products available, improved access and lower transaction costs. However, meeting customer demand for the wide array of emerging electronic services requires substantial investment in technology, often with a very uncertain and long-term payback period. In addition to the issues of developing, financing and implementing the required innovations, there are important policy issues related to technology. Ownership and access to the infrastructure, safeguarding the

integrity of the system and privacy of information will remain key issues to be addressed in the coming decade.[2]

Technology has facilitated innovation, but the real spur for institutions to develop new products, often in areas outside their traditional range of business, has been the driving force of increasing competition. Chart 1* provides a graphical description of the relative growth rates (adjusted for inflation) experienced by the core group of financial institutions in the financial system over the past two decades. Chart 2* highlights the relative distribution of the $1.1 trillion domestic assets held at the end of 1989 by these institutions. An additional $400 billion assets are held outside this "core" financial system by a variety of smaller public and private institutions.

How Many Pillars?

The financial services industry acts as the intermediary between savings and investment. As such, it is driven by the requirements of the household and the non-financial business and government sectors for savings vehicles and borrowing instruments. Historically, the four-pillar structure of the Canadian financial services industry was based on segregation by function. Within the deposit-taking segment, the distinction between "banks" and "trusts" was based on the exclusion of banks from fiduciary trust business such as estate administration, and limitations placed on the investments of trust companies. Co-operatives are distinguished primarily by their unique ownership structure.

Beginning in the 1980s, the financial services industry has tended to restructure itself around two pillars, reflecting the market forces driving the operations of individual firms. On one side, there is a group of institutions whose activities and performance are primarily driven by the asset side of their balance sheet; this group includes the deposit-taking institutions as well as the business and consumer financing institutions. The second group of institutions is primarily driven by the liability side and includes most of the non-deposit-taking institutions.

[2]A fuller discussion of the related issues can be found in the Conference Board's publication entitled, ***Technology and Financial Services: Challenges for Financial Institutions and Policy Makers***, Pierre Vanasse, June 1990.

*Charts 1 and 2 are not reproduced.

The deposit-taking institutions are primarily asset-driven. Although there is an increasing emphasis on non-traditional business activities, the principal business of the banks, trust companies and co-operatives continues to be selling credit in the form of loans and mortgages. A "sale" results in an asset on the institution's balance sheet and carries with it a corresponding need for a liability to fund the asset. In practice, there is a "chicken and egg" relationship between deposit liabilities and loans assets, but considered on the basis of the principal business of the deposit-taking institutions, it is fair to say that they are driven by the demand of the non-financial sector for credit.

With the proposed legislative changes, the distinctions between banks and trusts will be permitted to essentially disappear. This is consistent with the concept of the core business of the banks and near-banks being the granting of credit and raising of funds to meet the demand for credit. In addition to the banks and near-banks, the sales finance companies could be included in the "asset-driven" pillar. These firms are driven by the demand for credit, although they do not meet their funding requirements through the raising of deposits.

The principal business of the non-deposit-taking institutions is the sale of liabilities. Once the sale of a life insurance policy or pension plan creates the commitment to make a payment at some future date, the need arises to invest the "sale price" in assets that will allow the institution to meet its liabilities. Thus, these institutions can be said to be primarily liability-driven since the "sale" of a liability drives the need to invest.

Life insurance companies, pension funds and mutual funds fall into this category as their primary business is the sale of products that compete for long-term household savings. Although property and casualty insurance companies are significant portfolio investors, they are not true financial intermediaries. Property and casualty insurance premium income is largely a fee for a product rather than a channelling of savings.

In an essentially two-pillar structure, the securities industry can be seen as part of the asset-driven bank and near-bank pillar. This reflects the dramatic changes in the Canadian securities industry over the last decade. Increased competition required securities firms to

take on additional risk in the form of bought deals. Larger and riskier transactions required securities firms to have a larger equity base that was difficult to achieve via the traditional partnership equity contribution structure of the industry. The banks, seeing their traditional commercial credit markets squeezed by securitization, and tempted by the success of the international "universal banks," sought to become players in the securities industry.

The combination of need for capital on the part of the securities industry and desire for access to underwriting of securities on the part of the banks led to the establishment in 1987 of ownership linkages between several large Schedule I banks and five of the largest securities firms. In terms of both ownership and increasing business similarities, it is appropriate to think of the securities firms as part of the asset-driven pillar of the financial services industry.

As the industry restructured itself around two pillars, differentiated on the basis of being "asset-driven" or "liability-driven," considerable competition remained between institutions and, by the late 1980s, the distinction between these two groups was itself under increasing pressure. The savings component of whole life insurance has become a close substitute for RRSPs offered by the deposit-taking institutions. Commercial paper purchased by institutional investors is also a direct substitute for commercial credit offered by the banks. Virtually all types of financial institutions are players in the syndicated loans market. Thus, different types of institutions are increasingly offering the same product or products that are close substitutes. The result is an increasingly homogeneous supply of financial products offered by an increasingly diverse range of institutions.

While the two pillars can still be seen in a snapshot of the Canadian financial services industry, the relevance of this framework is eroding as the industry enters the 1990s. In response to continued competition, a growing number of institutions have begun to straddle the two sides of the market, a trend which is not unique to Canada but is also apparent in Europe where financial institutions are positioning themselves for an integrated financial market after 1992.

Where Canadian legislation allows it, a growing number of institutions have brought together asset-driven and liability-driven

institutions under a single corporate structure. The most visible example has been the Laurentian Group, which provides the full range of financial services to its customers through dedicated subsidiaries. La Confédération des caisses populaires et d'économie Desjardins du Québec, under provincial legislation, is another emerging full-service financial conglomerate. Many of the large life insurance companies have acquired a trust subsidiary in recent years and are restructuring into diversified financial conglomerates. However, the Bank Act has not allowed the chartered banks to expand outside of the banking and securities business.

The new legislative proposals, which allow financial institutions to enter new businesses by way of subsidiaries, will foster the continued establishment of financial conglomerates offering a broad range of asset and liability services. In the process, while some institutions may want to retain functional specialization, sustained competition and innovation will tend to drive the industry as a whole away from the two-pillar structure toward a single, fully integrated pillar.

The White Paper on the Reform of Financial Institutions Legislation

The new legislative proposals contained in the White Paper provide implicit recognition of the existing two-pillar system and pave the way to a more fully integrated financial sector. Although it is proposed that banks and federally incorporated trust, loan and insurance companies generally have the opportunity to offer a similar range of services and compete in markets that were previously not open to them, restrictions on insurance retailing by deposit-taking institutions retain a clear distinction between the two pillars.

Objectives of the Proposals

Benefiting consumers, enhancing the protection of depositors and investors, strengthening the competitiveness of Canadian institutions and regulatory harmonization have been common themes throughout the long debate over the future shape of the financial services industry. Supporters and critics of previous legislative frameworks would have little difficulty in supporting the outlined objectives of the White Paper. The contentious issues have been over the regulatory framework that will best meet these objectives.

The federal government's implicit vision of financial services through the 1990s as depicted in the White Paper suggests that conglomerates will be the financial institutions of the future. In response to competitive pressures, many institutions have been seeking ways to compete in businesses traditionally carried on by other types of institutions.

This is dealt with in the White Paper by the proposal that federally chartered institutions will be allowed to enter new financial business through subsidiaries. Some life insurance and trust companies are parts of existing conglomerates, and many life insurance companies already have trust company subsidiaries. The new proposals would allow for bank-owned conglomerates, encompassing the banking, trust and insurance businesses, as well as the securities business which the banks were allowed to enter through subsidiaries in 1987.

Implications for Consumers

Benefits from the legislative proposals will accrue to customers primarily in the form of greater convenience and choice of instruments rather than lower prices for financial services. Over the longer run, synergies arising from the formation of conglomerates together with economies of scale and increased efficiency from networking could have some modest impact on the ultimate costs of financial services provided to consumers. Offsetting the potential gains in this area will be the need to fund the large investment expenditures on technology through the 1990s.

In areas where significant competition already exists, such as personal deposit taking and lending, there may not be any immediately discernible impact from the new proposals. For benefits from increasing competition to be immediately evident to consumers, there would have to be economic rents being reaped by individual institutions or groups of institutions, and instances that this is the case are limited. Many life insurance companies have already moved to compete for personal core business through trust subsidiaries, and the banks, trust companies and co-operatives all compete intensely for this business.

The networking provisions of the legislative proposals will allow a range of products to be delivered by one intermediary.

Under the new policy framework, all financial services with the exception of insurance could conceivably be purchased at a branch of any deposit-taking institution. Also, all financial services could be made available through an insurance broker, as a broker could deliver products such as GICs on behalf of deposit-taking institutions. Many insurance brokers already act as agents for trust companies. However, the entry of the banks into the securities business has not led to "a broker in every branch" and evidence in the United States suggests that "one stop financial shopping" has been less than wholeheartedly embraced by consumers.

The proposed networking provisions will likely result in some additional services being offered through branches of deposit-taking institutions. Yet, the transformation of branches into "financial supermarkets" is unlikely, at least initially. Rather, branch personnel will have a wider range of products to cross-sell through referral of consumers to the institution's specialized subsidiary.

The effect of concentration on consumers has been a key issue throughout the debate over financial services regulation. It has been argued that cross-ownership and cross-distribution of products will inevitably result in domination of the financial services market by a few large entities. It is further argued that this would result in a reduction of competition and higher cost to consumers. One safeguard in this area is the requirement for ministerial approval of any significant change in ownership of a federally chartered financial institution. This will provide the authorities with the ability to prevent any harmful increase in concentration through mergers and acquisitions.

With respect to services provided to businesses, the White Paper contemplates a number of changes. For small business, the removal of commercial lending restrictions on trust companies with capital in excess of $25 million and the allowance to establish specialized financing subsidiaries could enhance the availability of credit. However, there is some question as to whether the small business sector would be aggressively targeted. The experience of the Schedule II banks since 1980 suggests that neither small business nor the commercial mid-market is overly attractive to new entrants to the credit market.

The legislative proposals are unlikely to substantially increase the level of competition for lending to large Canadian firms, despite their more attractive risk-return profile. This is already a very competitive market with very thin profit margins and large Canadian firms are well served by a range of Canadian and international lenders. They can also tap domestic and foreign capital markets.

The networking provisions of the White Paper might result in more services to corporations being provided by banks. For example, corporate trust services provided either by a bank-owned subsidiary, or through the networking of the product of an unrelated firm, could be provided as part of a total banking package. Although the legislative proposals clearly prohibit the use of a branch network to distribute insurance, there is no indication that the new legislation will prevent the deposit-taking institutions from offering group life and health insurance to their business customers in much the same way as payroll services are now offered.

Enhanced Protection for Customers

Canadian experience with financial institution failures has been much less severe than in the United States. Nevertheless, as risks continue to loom ahead, investors' and depositors' protection will remain a significant issue. The three main ways of reducing the risk of loss through failure of financial institutions are through encouragement of market discipline, enhanced prudential supervision and sound management practices.[3] Several legislative proposals deal with this area.

The existing safety nets for federally chartered institutions, deposit insurance provided by Canada Deposit Insurance Corporation, and the life and health insurance industry's CompCorp compensation fund for holders of life insurance policies, will be unchanged by the new legislative proposals. While it is desirable to provide unsophisticated investors and depositors with a measure of protection, safety nets such as deposit insurance do have the disadvantage of lessening the impact of market forces. The reduction in risk of loss eliminates the need for individual depositors and

[3] A fuller discussion of these approaches is contained in the Conference Board's publication entitled, *Safeguarding Investors and Depositors: The Role of Deposit Insurance and Enhanced Supervision*, S. Handfield-Jones, June 1990.

investors to trade off between risk and return. Because the existence of deposit insurance and compensation funds ensures protection against loss, it can be attractive to seek the highest return with little consideration for the risk of the institution.

The proposed requirement for federally chartered trust, loan and stock insurance companies with over $750 million in capital to have a public float of stock representing 35% of voting rights is not presented in the White Paper as a means of enhancing the protection of investors and depositors. However, the resulting market sensitivity may have this effect. Reports by stock analysts, and the barometer of share prices, would tend to widely publicize any difficulties faced by a publicly traded institution, as has occurred recently with the American "money centre banks." This would serve the dual purpose of making investors and depositors more aware of the perceived financial condition of the institution, and make management of the institution aware of the concerns of the market.

The proposals to enhance prudential safeguards already in place relate primarily to the Office of the Superintendent of Financial Institutions (OSFI). The proposed expansion of OSFI's powers to enable the Superintendent to compel the production of required information will ensure receipt of any required data to monitor regulatory compliance and maintenance of a sound financial condition. The requirement for provision to the Superintendent of reasons for the resignation of a director or auditor should enhance early detection of problems. However, under the White Paper the key to protecting investors and depositors remains the effective use of the existing and new powers by the supervisor.

The proposals in the White Paper to strengthen the role of directors of financial institutions are designed to "mandate increased reliance on the self-supervision of financial institutions." The responsibilities of directors in ensuring adherence to sound management practices are spelled out, particularly with regard to the majority of outside directors who must constitute the conduct review committee and the audit committee.

Many of the new proposals dealing with prudential supervision and management practices will help deal effectively with the regulation of conglomerates. The provisions for ownership of subsidiaries engaged in various financial businesses, and the proposed

networking powers, suggest that the financial institution of the future will be a conglomerate. The extent to which such conglomerates do become prevalent in the financial system will, in large part, be determined by the synergies that can be realized among its component institutions.

The principal issue raised by the emergence of conglomerates is the potential that "related party" transactions within the conglomerates — or with its principal shareholder in the case of closely held institutions — might ultimately affect the safety of depositors or investors. It appears from the White Paper that the principal concern of the Government is to deal with transactions between a non-financial parent and its financial subsidiary, since transactions involving a federally regulated financial institution as a parent are specifically exempted from the "related party" definition. In the case of widely held financial conglomerates, this suggests that prudential supervision of related financial institutions will be sufficient to ensure that investors and depositors are not jeopardized by self-dealing and that existing legislative arrangements and the new powers of the supervisor are sufficient to provide adequate safety to the investors.

In the case of closely held conglomerates, the basic approach retained in the legislative proposals is a prohibition (with exceptions) on self-dealing. The proposed restrictions on "related party" transactions will also ensure that a clear line is drawn between those funds deposited or invested with the institution — and covered by a safety net — and those funds which are invested in the commercial parent and which fall outside of the safety nets.

The likely emergence of the conglomerate as the financial institution of the future also raises the issue of conflict of interest and privacy of information. The prohibition on the use by deposit-taking institutions of customer data for selective marketing of insurance products is one concrete example of how these issues will be approached. Specifics of such "Chinese wall" barriers between the affiliated companies of conglomerates are not spelled out in the White Paper. Definition of the "sensitive information" referred to in the White Paper, the extent to which sharing among affiliates is permissible, and steps envisaged to police a ban on "tied selling," will be dealt with through "a regulation-making power to deal with an institution's handling of private customer information." The

nature and extent of these regulations will have a major influence on the synergies that can be realized by a conglomerate.

Promotion of Strong Canadian Institutions

The White Paper recognizes the critical importance of promoting strong national institutions serving Canadian interests, and several proposals will contribute to enhancing the competitiveness of Canadian institutions at home and abroad.

The factors affecting the overall competitiveness of financial institutions are numerous. Some are internal to the firm. They include overall organizational efficiency as well as outward and forward orientation — as measured by managerial skills, human resources flexibility, technological innovativeness. In the context of emerging global financial giants, the question of whether size is a key competitive factor is also important.

Other factors affecting competitiveness are exogenous to the firm. They include the efficiency and dynamism of financial markets, the overall outward orientation of the financial system, the cost of economic and financial resources and the regulatory framework. The latter will determine the extent to which the "playing-field" is level for various groups of institutions in Canada, but there are also important issues associated with market access in foreign countries.

More research is still required to better understand how these various factors impact on the long-run competitive position of individual institutions and the financial system as a whole. Quite apart from the need to develop an integrated conceptual framework, there also are major problems of measurement. The importance of building competitive financial services organizations as an additional contributing factor to the safeguard of depositors and investors was identified by the Conference Board of Canada in its earlier submission to the Senate Standing Committee on Banking, Trade and Finance.[4]

The policy proposals do not explicitly recognize the importance of size as a factor behind the long-run competitiveness of Canadian

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[4] *Challenges Ahead for the Canadian Financial Services Industry*, Submission by The Conference Board of Canada to the Senate Standing Committee on Banking, Trade and Finance, December 1989.

institutions. The ownership regime envisaged in the White Paper will allow over time the emergence of large financial conglomerates offering a wide array of services through dedicated subsidiaries. However, the Minister of Finance will retain considerable latitude to determine whether or not this can be done through acquisitions. Ultimately, the formulation of the regulations governing interactions within a conglomerate will also have a major impact on the potential for economies of scale and scope.

Coupled with the retention of the 10/25 ownership rule for Schedule I banks, the emergence of bank-owned conglomerates will ensure that major portions of the Canadian financial system remain Canadian-owned. Even without these restrictions, international experience suggests that foreign firms have generally experienced difficulty in penetrating the retail market for financial services. In Canada, the removal of the ownership restrictions in the securities industry in 1987 has not led to foreign domination of the retail brokerage market. In fact, just the opposite occurred and major U.S. brokerage firms have made well-publicized withdrawals from the Canadian retail market.

The White Paper recognizes the importance of technological innovation as a factor affecting the competitiveness of financial institutions by allowing unrestricted investment in an information services corporation. This could provide incentives for financial firms to undertake R&D in the field of financial services technology and to commercialize such technology in Canada or abroad.

The White Paper does not address the cost of economic and financial resources as a factor behind competitiveness of financial institutions. Financial institutions are required to maintain "adequate" capital and liquidity behind their operations. At present, the capital requirements for the banks are governed by the BIS agreement on minimum capital standards. As similar standards are developed for the other sectors of the financial services industry, the regulators will need to focus on whether the new capital requirements may affect the relative competitive position of financial institutions at home and abroad.

An additional important related consideration is whether and how the tax system may affect the competitiveness of financial institutions — both between groups of institutions in Canada and in relation to other countries. This is particularly relevant when capital

taxes interact with higher capital requirements. As institutions increasingly compete with all other types of institutions, there is a need to ensure that the effect of taxation is equivalent between groups of institutions and in relation to other countries. A level playing field requires that the impact of taxation on the cost of competing products be comparable, regardless of what type of institution offers the product.[5]

Regulations governing market access can have a significant impact on the competitiveness of financial institutions to the extent that they affect the potential for individual firms to fully exploit their expertise. This has been recognized as an important issue in the context of the Canada-U.S. FTA and the GATT is now focusing specifically on this issue in the Uruguay Round of Multilateral Negotiations.

In a number of foreign markets, Canadian institutions encounter constraints arising from the regulatory regime applying locally to foreign institutions. In several instances, these affect their ability to establish some form of commercial presence. In most instances, specific features of the regulatory regime have constrained their ability to fully exploit the opportunities offered by the market. The problems have been particularly significant in the case of the securities affiliates of the chartered banks operating under the Glass-Steagall Act in the United States and under Article 65 of the Japanese securities legislation.[6] Conversely, many foreign institutions operating in Canada have expressed similar concerns about various features of the Canadian regulatory regime.

The White Paper does not deal explicitly with the issue of market access but indicates that the regulatory regime applying to foreign firms established in Canada will not be changed. In the context of the GATT negotiations, this is consistent with the approach

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[5]A fuller discussion of these issues is contained in two Conference Board publications entitled, *Sales Tax Reform and the Canadian Financial Services Industry: Exploring the Options* and *Operating as a Tax-Exempt Corporation: Canadian Financial Institutions and the GST*, Pierre Vanasse, November 1989.

[6]A fuller discussion of the issues surrounding market access is contained in the Conference Board publications entitled, *Strengthening Market Access in Financial Services: The Financial Services Provisions of the Canada-U.S. Free Trade Agreement*, P. Rochon, 1989; *The Canadian and Japanese Financial Services Industries: Opportunities and Prospects from Mutual Access*, T. Papailiadis, 1989; and *Building on Success in the Dynamic Asian Economies: The Recent Experience of Canadian Financial Institutions*, G. Glorieux and D. Slater, October 1990.

followed during the negotiations on the Canada-U.S. FTA and provides a strong position for the government as it seeks improved market access from other key countries. However, to the extent that the rules governing U.S.-based Schedule II banks are less constraining, the White Paper is open to the criticism that there remains some measure of discrimination against those banks whose home jurisdiction is outside the United States.

Regulatory Harmonization

The need for regulatory harmonization has intensified as the clear demarcation lines between types of financial institutions has become blurred. Institutions of various types must be subject to similar regulation if they are to compete on an equal footing in the same markets. To the extent that overlapping jurisdictions lead to management inefficiencies and higher operating costs, multiple regulatory requirements can create competitive inequities domestically as well as in international operations.[7]

The prospect that financial conglomerates will be the norm in the future reinforces the need for regulatory harmonization. An example of the issues to be dealt with is found in the 1987 decision to allow banks to own securities firms. Changes in both federal and provincial legislation were required, as was the development of a memorandum of understanding between the federal and provincial regulators.

Further complications may arise from the possibility of differing regulatory approaches between federally chartered institutions and the various provincially chartered trust and insurance companies. Inclusion of provincially chartered institutions in conglomerates owned by federally chartered institutions would create a substantial overlap of regulatory authority if compatible legislation and prudential supervisory approaches are not developed. Apart from the issues raised by conglomerates, there is also a need for consistency among the legislation of the various jurisdictions if, for example, federally chartered trust companies are to compete on an equal footing with provincially chartered trust companies.

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[7]A fuller description of the issues surrounding regulatory harmonization is contained in the Conference Board publication entitled, *Harmonization of Financial Regulation*, S. Handfield-Jones, 1989.

The White Paper is presented as a basis for the necessary further discussions with provincial governments and significant progress will be required to ensure that a level playing field is established throughout the financial services industry. The federal government has indicated its intention to make progress in this area but there also remain unresolved differences at the provincial level, most notably between the "equals approach" retained by the province of Ontario and the "designated jurisdiction" approach generally adopted by other provincial governments.

Conclusion: Financial Services in the 1990s

The overall thrust of the White Paper proposals is a reflection of the evolving financial services marketplace. The last two decades have seen a steady progression away from four pillars, distinguished along functional lines, towards a financial services sector where distinction based on product or market is much more relevant. This progression has sometimes been reflected in legislative change, such as allowing banks to own securities firms in 1987.

The proposals contained in the White Paper will pave the way for further integration of the financial system through the 1990s and for the emergence of large conglomerates competing with one another to offer a wide array of services to their customers. These are expected to form the "core" of the industry but, as presently is the case, there will also remain substantial competition from highly efficient and innovative niche players in the trust and life insurance business.

The extent and the speed at which the financial system restructures around financial conglomerates will be affected by the regulations governing implementation of the new legislation. The White Paper envisages that considerable ministerial latitude will be retained when reviewing requests for the incorporation of new federally chartered institutions and/or significant shifts in the ownership of existing institutions. The set of prudential regulations to be developed over time by the supervisory authorities will also have a significant impact on the ultimate shape of financial conglomerates and the extent to which they can develop significant internal synergies. In an environment of rapid change at home and abroad, the considerable latitude extended to both the regulator and the supervisor will provide greater flexibility than in the past to address unforeseen

developments. At the same time, it reduces the transparency of the legislation and will create a measure of uncertainty as to future operating rules in the industry.

The financial system will also continue to involve a broader set of institutions which are touched only peripherally or not mentioned in the White Paper. The blurring of demarcation lines has occurred not only among the traditional pillars of the financial services sector, but also around the edges of the sector as well. Over time, it will become increasingly important to clarify the line between those entities which are regulated as financial institutions and those which are treated as strictly commercial operations.

Although pension plans are often overlooked in a consideration of financial intermediaries, they play an increasingly important role as the holders of an increasing percentage of the household sector's wealth. Together with mutual fund managers and life insurance companies, these institutional investors have to be considered as competitors with other financial institutions for personal savings.

Other firms, such as the sales finance companies, specialized leasing companies and venture capital firms play important roles in certain segments of the financial marketplace. These firms should also be taken into account when examining the future of the financial services industry in the 1990s.