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Résumé de l'article

Afin d'évaluer la nature et l'orientation des changements que subit l'industrie des services financiers au Canada, le Conference Board du Canada a rencontré les chefs de la direction des 35 plus importantes institutions financières au Canada ainsi que 60 conseillers en politique aux niveaux fédéral et provincial pour connaître leur opinion sur le système financier. Voici quelques unes des principales conclusions de cette enquête : (i) les institutions financières entrent dans une période de consolidation majeure et de concurrence accrue entre les divers secteurs ; (ii) les divers secteurs financiers cherchent à offrir des services à valeur ajoutée et à se rapprocher de leurs clientèles. Nous reproduisons ici les deux sections suivantes du rapport du Conference Board : (i) Perceptions of current market conditions (ii) Prospects for the future

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The Future of Financial Services*

by

Brent Sutton**

Afin d'évaluer la nature et l'orientation des changements que subit l'industrie des services financiers au Canada, le Conference Board du Canada a rencontré les chefs de la direction des 35 plus importantes institutions financières au Canada ainsi que 60 conseillers en politique aux niveaux fédéral et provincial pour connaître leur opinion sur le système financier. Voici quelques unes des principales conclusions de cette enquête : (i) les institutions financières entrent dans une période de consolidation majeure et de concurrence accrue entre les divers secteurs ; (ii) les divers secteurs financiers cherchent à offrir des services à valeur ajoutée et à se rapprocher de leurs clientèles.

Nous reproduisons ici les deux sections suivantes du rapport du Conference Board:

(i) Perceptions of current market conditions

(ii) Prospects for the future

Perceptions of Current Market Conditions

A new era in Canadian financial services is coming upon us. This transition is the result of a number of interrelated factors, including the liberalization of Canadian financial

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markets, restructuring of the Canadian economy, growing use and importance of technology in the provision of financial services, and reforms to the federal financial institutions legislation. These and other factors will lead to some significant changes to the financial sector in the period ahead.

To assess how the industry will respond to the challenges of the next 5 to 10 years, researchers from the Financial Services Research Program (FSRP) interviewed the chief executive officers of 35 of Canada's leading financial institutions and 60 senior federal and provincial policy advisers and regulators concerning their views of the financial system. The interviews focused on two main areas of inquiry: (1) perceptions of current market conditions and (2) expected changes to the financial services industry. In addition, chief executive officers were asked how their own institutions will respond to changing market conditions, and regulatory authorities were asked for their observations on the system of regulation and supervision in Canada.

Performance of the Financial System

Canada enjoys one of the strongest and most efficient financial systems in the world. There is a high degree of confidence in the health and competitiveness of the system among chief executive officers (CEOs) and regulatory authorities.[1]

The majority of financial institutions are seen to be extremely well managed, financially healthy and well capitalized. Current difficulties being experienced by a few institutions are believed to be the result of poorly conceived firm-specific strategies rather than deeper structural problems in either the functioning of the financial system or the manner in

[1] Regulatory authorities include: (1) policy advisers, who recommend to policy makers principles and guidelines to govern financial institutions and markets; (2) regulators, who design rules and regulations to effectuate desired policy parameters; and (3) supervisors, who monitor the solvency of financial institutions and ensure regulatory compliance. Unless specifically noted to the contrary, these three groups are treated as a single entity throughout the report.

which it is being regulated. Consumers are seen to have considerable choice in financial institutions and products, and high levels of competition in all market segments ensure them financial services at costs that are among the lowest in the world.

The overall strength of the financial system can, at times, mask considerable variations in the performance of different types of financial institutions. The major chartered banks are generally seen as pillars of strength, while certain elements in other financial sectors have raised some concerns.

Regulatory authorities are satisfied with the performance and soundness of the major Canadian banks and believe the profitability reported in 1991 truly reflects underlying strength. Their perception is that stronger balance sheets, more effective management, and more sophisticated reporting and risk containment systems than existed in the past have enabled the major banks to weather the current recession much better than the last one. Bank CEOs and most other CEOs agreed with these assessments.

A dual structure is emerging among trust and loan companies. While some trust companies are among the healthiest financial institutions in the country, others are less so. The most pressing concern of regulatory authorities is the weak commercial loan portfolios of a number of regionally based trust and loan companies. Of more long-term concern is the possibility that smaller trust and loan companies will be unable to match the cost structure of larger financial institutions and, as a result, may pursue riskier business to offset the higher costs. Many CEOs shared these concerns, but there was considerable difference of opinion over how large a financial institution needs to be to attain lowest-cost production.

The major life insurance companies are considered to be in good shape, although their lacklustre profit levels have raised some red flags. Regulatory authorities believe life insurance companies face two challenges: (1) improving the profitability of their trust and loan company investments and (2) managing exposure to real estate. Life insurance companies were given

high marks for their ability to manage interest rate risk, but some regulators commented that these companies were slow to understand credit risk. The life insurance sector is viewed by regulatory authorities and CEOs as an important source of competition for the major Canadian deposit-taking institutions.

Property and casualty insurers remain a source of some concern to regulatory authorities. They believe there are too many firms in the business and the degree of competition on some lines of insurance has driven premiums well below the cost of servicing the policies.

The securities business is highly cyclical, and securities regulators tend to take a very short-term view of industry developments. Like other sectors, the industry as a whole is considered to be healthy, although there are a few investment dealers that are not as strong as regulators would like. The institutionalization of securities markets in Canada is of some concern because it could reduce market liquidity, leading to more volatile markets.

Foreign financial institutions, with some notable exceptions, have performed poorly in Canada. Regulators are not especially troubled about this because the market share of foreign financial institutions is not large (except in property and casualty insurance) and is concentrated in the more sophisticated commercial markets. Policy advisers are more concerned because foreign financial institutions are an important source of competition.

The current economic downturn has led to renewed attention to the possibility of capital market "gaps". While even the most concerned regulatory authorities acknowledged that there is no conclusive empirical evidence to support the presence of capital market gaps in Canada, they also pointed to the increasing number of rural communities that do not have ready access to a full range of financial services and numerous small businesses that have difficulty obtaining financing.

The main issue is not whether "gaps" (however defined) actually exist; these problems are perceived to be real, and some regulatory authorities believe they have an obligation to act in the public interest to ensure that the needs of their constituencies are met, even if this requires influencing the decisions of financial institutions and the functioning of capital markets through regulatory initiatives. Needless to say, CEOs were in universal agreement about the efficiency of Canadian capital markets. They also agreed that the primary role of deposit-taking institutions is to invest depositor funds in low-risk activities, not venture financing.

Challenges to Financial Institutions and Markets

CEOs believe the most pressing challenge to financial institutions is the intense (and some would go so far as to say dangerous) level of competition that currently exists in Canadian financial markets. Profit margins have fallen, and this has driven many financial institutions to accept more risky classes of business to offset earning losses and, in addition, to pursue more fee-based businesses.

The larger number of financial institutions operating in Canada relative to the size of the market is seen as a major contributor to this situation. There is also a belief that cross-subsidization is being used by some of the more aggressive financial institutions in their efforts to establish themselves in new markets, further intensifying competition. While regulators and supervisors agree that aggressive product pricing may be disruptive to the financial system if it leads to the failure of financial institutions, policy advisers view this development more benignly, pointing out that competition is consistent with the promotion of efficient markets and consumer interests.

Excessive industry regulation was identified by CEOs as the second most important challenge facing Canadian financial institutions. Most CEOs were distressed by the fact that the latest reforms to the federal financial institutions legislation have created substantially more regulations, which will require a

larger bureaucracy to ensure compliance and will generate higher operating costs.

Duplication and overlap between federal and provincial regulations was also identified as a problem. While regulatory authorities also want to reduce duplication and overlap, they were less inclined to believe that the financial sector is over-regulated; they feel the regulations are necessary to ensure the prudential operation of financial institutions and the protection of depositor, policyholder and investor funds.

Regulatory authorities see the weak state of the Canadian economy as the biggest source of risk to the health of financial institutions and the financial system. The current recession has already eroded the value of many assets held by financial institutions, and a further downturn in the economy, or even lacklustre growth, could erode asset values further.

A related concern arises from the pace of restructuring in the Canadian economy. What business activities should financial institutions be lending to? Because profit margins are much narrower now than in the past, there is little room for error when assessing credit risk. In the final analysis, regulatory authorities believe the health of the financial sector reflects the health of the economic region it serves. Most CEOs, although less pessimistic, agreed that the current climate of political discontinuity is also adversely affecting Canada's economic prospects.

CEOs from all but the largest Canadian financial institutions identified a host of other challenges. One of these is the need to secure a strong capital base. Increasing attention to capital adequacy on the part of regulators, financial analysts and (to a lesser extent) consumers means that ongoing access to capital is crucial for growth. A related challenge concerns achieving "critical mass"—that is, the minimum size a financial institution must reach to be cost-competitive. While almost all of the CEOs feel their institutions have currently reached critical mass, a number believe they will have to grow rapidly to maintain it in the future. Necessary expenditures on technology and the need to maintain a "presence" in the marketplace are two

of the factors cited as driving up the minimum size of financial institutions. Continued access to the payments and settlement system on equitable terms was a concern of a number of non-bank CEOs. Regulatory authorities share this last concern.

Perceived Inequities Among Financial Institutions

Reforms to the federal financial institutions legislation have focused the attention of industry executives on perceived inequalities between financial institutions. Not surprisingly, the greatest source of inequalities is seen to exist in the differential treatment of financial institutions, especially on matters of business powers.

CEOs of deposit-taking institutions are highly critical of the prohibitions on distributing insurance products and the ban on automobile leasing. They believe that agents are an expensive way to distribute insurance products and that it could be done more cheaply through the branches of banks, trust and loan companies, and credit unions. There is also a feeling that consumers should be free to purchase insurance products wherever it is most convenient, rather than having distribution channels dictated by government. These limits on business powers are seen to be artificial and not based on sound policy analysis. Needless to say, life insurance executives generally disagreed. They expressed concerns about tied selling and the ability of the banks, given their much larger size, to quickly dominate the life insurance industry, much as they have done with the securities industry since that sector was opened to them.

The fact that different financial institutions competing in the same market are regulated differently is viewed as a major inequity. For instance, trust and loan companies are regulated by both federal and provincial authorities, a situation that results in more restrictive and onerous regulatory requirements and higher operating costs. The expanded in-house securities powers of banks have raised "competitive equity" concerns on the part of some in the securities community because the operations of securities dealers are regulated by provincial securities

commissions whereas bank activities are regulated by the federal government.

Some CEOs believe the Canadian financial services market is more open than those of other countries. This observation was especially pronounced among the CEOs of securities firms constrained in U.S. activities by the Glass-Steagall Act. While the Federal Reserve has recently reinterpreted a number of the Act's provisions, resulting in increased opportunities for Canadian-owned firms, there remain formidable barriers. The crux of the issue is that because access is based on national treatment, U.S. securities firms and banks can come into Canada to offer services that Canadian firms are not permitted to offer in the United States due to their bank affiliation.

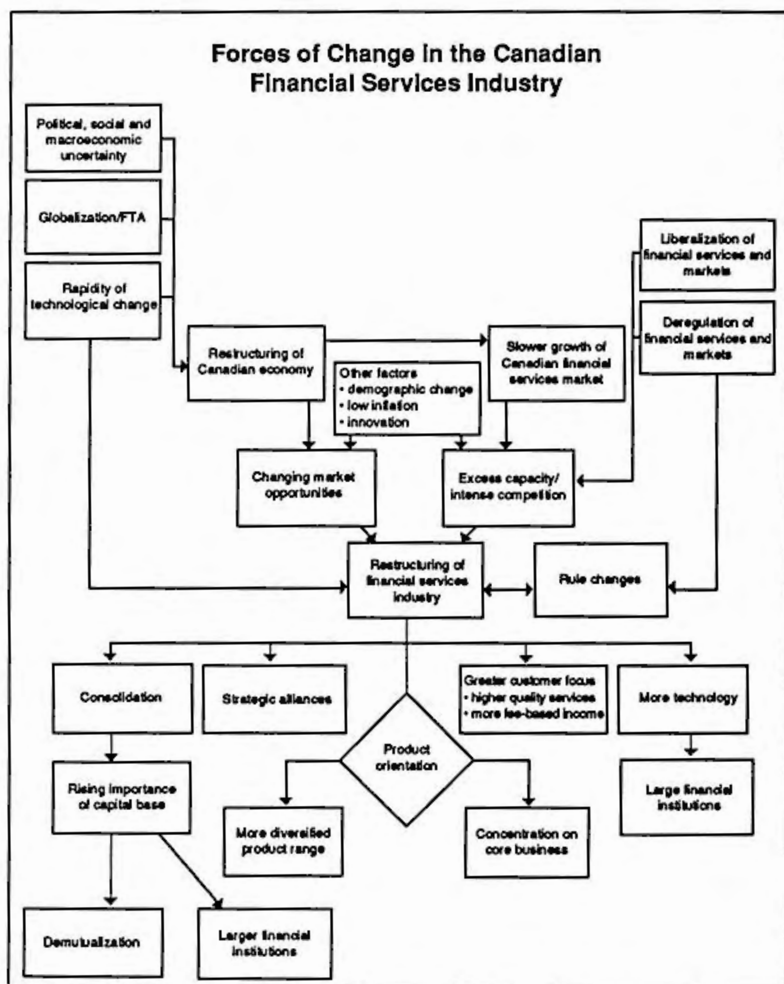
From a different perspective, many foreign financial institutions pointed to the onerous restrictions placed on their Canadian operations. Schedule II bankers were especially critical of having to operate as separate subsidiaries in Canada when Canadian banks are generally permitted to operate on a branch basis in their home countries. This requirement, coupled with Canadian withholding tax provisions, means assets and liabilities cannot be easily transferred between the foreign subsidiary and its parent. Paid-up capital of the subsidiary must be employed exclusively in Canada, and this is difficult during recessionary periods when lending opportunities are scarcer.

Prospects for the Future

The Financial Services Industry in 5 to 10 Years

Profound changes are taking place in the Canadian financial services industry in response to a variety of competitive pressures. The forces of change in the industry are largely the same as those affecting the Canadian economy generally: globalization; deregulation; political, social and macroeconomic uncertainty; and rapidity of technological change (see next page). These are pushing financial institutions to bring down unit costs and provide more value-added services to clients. As a result,

structural changes are expected to take place within the industry in terms of concentration, technology intensiveness, the regulatory framework, and product and service orientation. This section outlines the expected course of these changes over the 1990s.



Forces of Change in the Canadian Financial Services Industry

Consolidation

Consolidation in all sectors of the financial services industry is seen as inevitable. Most CEOs and regulatory authorities believe there are too many institutions for the amount of business available in Canada and this has reduced margins and eroded asset quality. While consumers have benefited from this situation, it has weakened a number of small and medium-sized financial institutions, which will need to link up with stronger firms to remain competitive. Greater expenditure on technology is also driving the consolidation process, as are reforms to the legislation permitting financial institutions to own a broader range of subsidiaries. The process of consolidation is expected to cause few market disruptions as weaker firms are merged with stronger ones.

The CEOs, on average, expect that in 5 to 10 years one Schedule I bank and a number of Schedule II banks will have disappeared. The loss of a major Canadian bank is expected to be the result of a merger, not a failure, and will happen only if Ottawa relaxes its prohibition on "big merging with big". It will also depend on other factors, such as whether potential cost savings from mergers can actually be realized. In addition, successful mergers are most likely when one institution (generally the stronger one) effectively takes over another. The strength of all the major banks, coupled with the determination of their management to succeed, means that none would accept being anything but the dominant partner in a merger.

The number of Schedule II banks in Canada is expected to decline, although regulatory authorities believe this decline could be offset by the conversion of insurer-owned trust companies into Schedule II banks. Foreign banks have suffered from low profitability in Canada because most are focused on the commercial market, where margins are thin and real estate problems are growing. Schedule II banks are small, with resulting higher unit costs, and Canadian regulations and tax laws make it impractical to transfer assets and liabilities between Schedule II banks and their parents. A number of CEOs also

commented that many of the Schedule II banks lack a clear strategy in Canada.

CEOs and regulatory authorities believe there will be further consolidation in the trust sector. In 5 to 10 years' time, two major and many smaller trust companies are expected to be gone from the market. While trust companies engaged solely in the asset-management business can be quite small, the critical mass for trust companies acting as financial intermediaries is much larger (estimated to be in the range of $10-15 billion in assets). Technology, market presence and the ability to accept and spread risk are all factors pushing up the minimum efficient size of deposit-taking institutions.

There are currently in excess of 160 life insurance companies in Canada, although the largest 20 dominate the market. As in the trust sector, smaller institutions will be unable to absorb rising technology costs without incurring higher unit costs. This is especially true for health-care and employee-benefits businesses, which require large information-processing centres. The high cost of insurance distribution is also encouraging consolidation because it is difficult for smaller companies to maintain adequate distribution systems. While consolidation is expected among smaller companies, concentration within the life insurance sector is not expected to change very much. Mergers among the largest life insurers are not expected because most are mutual companies owned by their policyholders.

Many CEOs believe that within five years a few life insurance companies will probably have demutualized, or will be in the process of doing so, in response to the need for capital.

While there has already been a great deal of restructuring in the securities industry in the wake of the regulatory changes in 1987 and the poor performance in 1990, further consolidation is expected, especially among those firms specializing in corporate finance and institutional equities. The general view is that while there is room for perhaps one or two major independent firms (providing they are well-balanced), the sector will be dominated

by the bank-owned firms, but only if the more bureaucratic management culture of the banks does not extend into their securities subsidiaries. Some independent firms will be needed as long as the banks resist asking for competitive bids, independent valuations, etc., from competitors' securities subsidiaries. It should be noted, however, that most security executives stressed that the pace of consolidation will ultimately be determined by the banks.

Universal banking/cross-pillar diversification

There is widespread belief, especially prominent among securities executives, that Canada is heading towards a universal banking system where financial institutions will be permitted to provide all types of financial services. The speed with which this develops will depend on government policy on business powers and the soundness of the Canadian financial system. The more stress the system comes under, the sooner a full universal banking structure is expected to emerge. Many executives feel this trend, while not without risks, is better than following the U.S. banking model.

Despite the perception that Canada is moving towards universal banking and despite legislative changes permitting financial institutions to own a wider range of subsidiaries, few financial institutions expect to take advantage of these new powers to branch out into new areas. Most (but not all) are more interested in focusing on "core" businesses and will meet the demands of customers for products outside their core by distributing those of other financial institutions. Diversification is expected to occur at a modest pace at first, with larger financial institutions branching into new areas through the purchase of relatively small, well-managed subsidiaries or through *de novo* incorporation.

Regulatory changes

While the legislative reforms further liberalize financial markets in Canada, many regulatory barriers remain in place.

Some of these barriers are expected to be removed or relaxed over the decade, perhaps at the quinquennial revision of the financial institutions legislation (in 1997).

Several industry executives believe that the prohibition on distribution of insurance by deposit-taking institutions will not last. Bankers argue that the prohibition will be withdrawn as soon as the policy makers recognize the inefficiencies this ban produces in the financial system. On the whole, life insurers are more cynical. They also believe the ban on insurance distribution will eventually be removed, not because it is in the best interests of consumers or the soundness of the financial system, but because the banks carry more influence in Ottawa.

Provincial regulatory authorities are more cautious in their assessment of whether changes to insurance distribution are imminent, stating that the burden of proof will be on the banks to bring forth more evidence on the benefits of retailing insurance through branches before the provinces will permit bank employees to be licensed as insurance agents.

To a lesser extent, there is a feeling that the rules on ownership may also be relaxed. Some executives (primarily those from institutions with a dominant owner) consider close ownership safer than wide ownership because a dominant share-owner stands to lose his or her investment first, should the institution fail. This creates strong incentives for the major share-owner to encourage conservatism in the operation of its financial subsidiary. Changes to ownership rules are most likely if the industry becomes weakened and new capital can only be obtained from non-financial sources.

Institutional Changes

Several factors are intensifying competition in the financial services industry and altering the types of services being demanded. Financial institutions are assessing their ability to respond to these and other changes in the industry and are making structural and operational changes in areas where they feel deficient.

Incremental change

It is important to point out from the start that most CEOs do not believe their institutions will undergo *fundamental* change over the next five years or so. As a group, they are generally pleased with the way their organizations are positioned to respond to coming changes in the financial services industry. They see change as an ongoing process of "tinkering" with existing structures to ensure that organizational goals are met. Wholesale changes are seen to be expensive, time-consuming and risky. Significant transformation can lead to customer confusion and even alienation, resulting in customer loss. The senior management of all financial institutions will be ever-vigilant to realize synergies within existing operations and to reduce duplication of tasks wherever possible.

Provision of higher value-added services

Financial institutions will provide more value-added services to customers as a means of increasing customer satisfaction and improving profitability. There is strong recognition that customers value service and are willing to pay more for financial services that are convenient, reliable and trustworthy. They are also willing to pay for more sophisticated services tailored to their specific needs. The CEOs believe providing more value-added services will allow financial institutions to increase customer satisfaction and that this will result in greater loyalty. Service quality also enables financial institutions to differentiate their products in the marketplace, which is important for marketing purposes.

Greater focus on core businesses

The majority of CEOs indicated they would be focusing more closely on "core competencies" in the future. Several reasons were offered for this strategy:

- Core businesses offer sufficient opportunity for growth for well-managed financial institutions.

- Higher value-added services can be offered only in areas where an institution maintains sufficient expertise; this is achieved by remaining focused.
- Other sectors of the financial services industry are already well served and extremely competitive.
- Financial institutions feel they do not have the expertise to compete in markets outside core businesses.
- There is an advantage to being the first to serve a market, and this works against financial institutions moving outside their core areas into new business.

Diversified financial institutions that offer a wide range of financial products were no less likely to indicate an interest in focusing on core business. Smaller financial institutions indicated that in pursuing core businesses they will probably end up with fewer clients but will have more "intense" financial relationships with those that remain. Larger financial institutions do not expect the number of clients served to be reduced.

More relationships with each client

Another goal of most financial institutions is to increase the number of relationships with each client. The purpose is to make it more difficult for clients to be "stolen" by another financial institution, something that has become easier with the commoditization of so many financial products. Financial institutions will offer more sophisticated financial services by packaging different products together. They are also working on "life-cycle" products that are sufficiently flexible to adapt to the changing financial needs of customers as they move from the cradle to the grave. Strategic marketing to encourage cross-selling of products and incentives to reward loyal customers will be important parts of this process. Developments along these lines also serve to create a "ring-fence" around customers, making it more complicated for them to transfer business from one financial institution to another.

More technology

Most CEOs expect the amount of technology they use in their operations will continue to increase. Technology will be used to reduce operating costs through automation, to assist in the development and production of sophisticated financial products, to distribute these products, and to manage risk more effectively through advanced information management systems. Financial institutions that do not have the resources to keep pace with industry spending on technology will find it difficult to sustain their competitiveness.

Some CEOs speculated about possible future changes in the way technology is developed within the industry. At present, there is limited co-operation in technology development among financial institutions, and this results in tremendous duplication of effort. Common industry facilities could be established, for example, in data processing or communication networks. This would reduce industry-wide expenditures on these activities, making Canadian financial institutions more cost-competitive relative to international competitors. An obstacle to co-operation of this type is the fact that proprietary technology systems can confer a competitive advantage on the company that develops and implements them first. Canadian competition law is also seen as a potential barrier to increased "back-office" co-operation.

Larger Institutions

Most CEOs expect their organizations to be larger in five years' time—between 50 and 200 per cent larger (based on assets and/or revenues). Expected sources of growth are: natural growth of the Canadian market; expansion into foreign markets, especially the United States; and acquisition opportunities arising from industry consolidation. However, while many CEOs indicated they would continue to look seriously at acquiring other firms, few were willing to predict that an acquisition would definitely be made over the next five years. Timing, price and strategic fit determine the attractiveness of acquisitions, and

these cannot be predicted ahead of time. The chief rationale for larger size is to reduce per-unit operating costs and to establish and maintain market "presence".

Establishment of strategic alliances

The use of strategic alliances provides one way to broaden the range of financial products available to customers, and CEOs from all financial sectors indicated this is an option that will be pursued seriously. Strategic alliances are most likely to be established for products demanded by customers outside the core businesses of a financial institution. To meet this demand, financial institutions will seek to distribute products produced by others. Growth in strategic alliances may be constrained by fear of losing customers and the possibility that customers may prefer to select for themselves the institutions they deal with.

Changes to management structure and culture

Entrepreneurship, risk-taking and empowerment are organizational characteristics valued highly by CEOs; management systems are being redesigned to better promote these objectives. Part of this will involve making organizations "flatter" to simplify bureaucratic procedures and permit decisions to be made more quickly. Also, employees will be trained to make better decisions over the activities they control. Decentralization will extend to the operation of subsidiaries. Securities firms, in particular, stressed the importance of maintaining a partnership-oriented, risk-taking culture within their institutions.

The International Dimension

Canadian deposit-taking institutions and securities firms outside North America

There is a great deal of pessimism regarding the ability of Canadian deposit-taking institutions to succeed in markets outside North America. Most (but not all) CEOs believe

Canadian banks and trust companies cannot successfully break into the local markets of foreign countries (other than the United States) in any significant way and will not be in a position to become world suppliers of financial services. The involvement of securities firms in markets outside North America will be limited to distributing Canadian securities in foreign markets and selling foreign securities in Canada.

Several factors are seen to undermine the ability of Canadian deposit-taking institutions and securities firms to establish an international presence.

- There is not enough Canadian trade and investment outside North America for Canadian financial institutions to support.
- Canada's domestic market is not large enough to support world-class financial institutions.
- Canadian financial institutions are "gun-shy" after doing poorly in international markets during the 1980s and are uncertain of the strategy they should pursue.
- Government regulatory policy towards the financial services sector is too inward-looking and not always supportive of the international aspirations of Canadian financial institutions.
- All financial markets have a significant local character, and it is difficult for foreign financial institutions to offer services that are fully sensitive to these differences.

Despite these drawbacks, several reasons were put forward as to why Canadian deposit-taking institutions should be internationally competitive. Canadian financial institutions are efficient and are world leaders in branching technology; Canadians are considered trustworthy and conservative in their business practices; and Canada is considered a "decent" country that does not engage in extraterritoriality. Canadian financial institutions are expected to maintain a modest international

presence to meet the international needs of domestic clients through niche marketing and the building of strategic alliances.

Canadian life insurance companies on the international scene

Canadian life insurance companies have done very well in markets outside Canada—more than 40 per cent of the industry's revenues are from foreign markets—and most life insurers are confident that Canadian companies will continue to be internationally competitive. However, CEOs believe two forces could diminish the amount of foreign life insurance provided *from* Canada, leading to more insurance being delivered through relatively autonomous subsidiaries established in host countries. One is the high cost of operating in Canada. Most business expenses—especially taxes, wages and telecommunications—are seen to be higher in Canada than elsewhere, and this is pressuring firms to service foreign markets through local subsidiaries in order to be competitive with indigenous competitors. The need to service foreign markets through subsidiaries is also due to the unique nature of each market. Health programs, worker compensation laws, tax rules, etc., require the design of specifically tailored products, marketing initiatives and distribution mechanisms.

Canadian financial institutions in the United States

The U.S. banking system is at its weakest point since the depression. Many U.S. banks are undercapitalized and laden with poor loan portfolios. The savings and loan sector is in turmoil, and a number of life insurance companies have suffered large losses on their investments in real estate and junk bonds. On the whole, American financial institutions are less well capitalized than their Canadian counterparts, and the majority of CEOs believe this will permit Canadian financial institutions to expand their presence in the United States. This trend is also being driven by the integration of the U.S. and Canadian economies. A number of industry executives believe the only way to survive this new economic reality is to compete on a North American

basis, and this means establishing a greater presence in the United States.

Many U.S. financial institutions are engaged in significant restructuring and capital-raising exercises and, as a result, are not pursuing new business as aggressively as they have in the past. As consolidation proceeds in the United States, opportunities are seen for foreign financial institutions (including those from Canada) to capture market share and to purchase U.S. subsidiaries. Some argue this "window of opportunity" will last only two years. Others say it will last much longer because future opportunities will arise from the failure of some early mergers and acquisitions. Similar product lines, financial laws and business customs also make expansion into the United States attractive.

Perspective and Policies

This final section provides a comparison of the views of regulatory authorities with those of the CEOs, highlighting areas of agreement and divergence, and concludes by outlining emerging public policy issues.

Comparison of Regulator and CEO Perspectives

Health and competitiveness of the financial sector

There is strong agreement among regulatory authorities and CEOs regarding the overall health and competitiveness of the Canadian financial services industry. The industry is seen to be largely composed of well managed and capitalized institutions that have been able to earn solid returns. The difficulties some financial institutions are now experiencing does not reflect deeper structural problems in the industry. Canadian financial markets are considered to be among the most efficient in the world, due to the high degree of competition in the marketplace and the quality of supporting infrastructures (e.g., telecommunications, the payment and settlement system). The financial system is supported by strong prudential regulations,

knowledgeable and vigilant supervisory agencies, and adequate compensation mechanisms.

One concern of regulators not shared by the CEOs is the possibility of "gaps" in capital markets. A number of regulatory authorities expressed concern regarding the *possible* failure of the financial system to ensure an adequate supply of financing to all regions and business sectors. The regulators do not necessarily put all the blame on the financial system—gaps in financing could be due, for instance, to risk differentials—but they are concerned that certain businesses and regions have consistent difficulty in raising capital and fulfilling growth potential.

Two concerns about the financial system raised by CEOs were given less attention by regulatory authorities. One is what CEOs see as the growing cost of regulatory compliance. The fragmented regulatory system allows many financial activities to be carried out only through convoluted (and costly) structures. There is also a feeling that regulation is preventing Canadian financial institutions from adjusting to the new realities of the international marketplace as quickly as financial institutions in other countries and a concern that if this trend is permitted to continue it will undermine the competitiveness of Canadian financial institutions.

A second concern expressed by the CEOs but not by regulatory authorities has to do with the ability of financial institutions to gain access to capital. Regulators and investors around the world are paying much closer attention to capital adequacy, which means that ongoing access to capital is crucial for growth. There is some uncertainty in the minds of several CEOs as to whether financial institutions are attractive investments.

Source of risk to the financial system

Regulatory authorities and CEOs share the view that a major source of risk to the financial system is the weak state of the Canadian economy, although regulators and supervisors tend

to be more concerned about this than policy advisers and CEOs. The current economic slowdown has eroded asset values, especially for real estate, and led to a substantial rise in the loan loss provisions of most financial institutions. The recent difficulties of Olympia and York have reinforced these concerns. Moreover, regulatory authorities and CEOs believe the Canadian economy will grow slowly over the rest of the decade, which means that asset values are unlikely to appreciate rapidly. Economic restructuring and the resultant need for quicker assessment of loan exposure are related sources of risk.

Another source of risk to the financial system seen by both regulatory authorities and CEOs is the high level of competition in the industry. Excessive competition could erode capital by driving down profits and could lead financial institutions to accept more risky business, potentially undermining the strength of the financial system. Policy advisers tend to be less concerned about the high level of competition because it makes domestic capital markets more efficient and benefits consumers through lower prices and more innovative products.

Three sources of risk identified by regulatory authorities but not by the CEOs are loss of public confidence in the financial system, inadequate managerial competence with respect to cross-pillar diversification, and unethical business practices. Regulatory authorities do not believe any of these pose major risks to the financial system, but they were unwilling to dismiss them outright. Some CEOs also acknowledged these concerns but saw them more as problems for *specific* institutions than a systemic problems.

Future changes to the industry

There is little doubt among regulatory authorities and CEOs that the Canadian financial services industry is about to enter a period of consolidation. One reason for this is the widely held view that there are too many financial institutions in Canada for the amount of business available. Consolidation will also emerge as a result of the new federal legislation that permits financial

institutions to own a broader range of financial service subsidiaries. Large financial institutions looking to round out the package of services they offer could purchase smaller companies with expertise in market segments they do not currently service. In the opinion of the CEOs, a third factor driving consolidation is the need to maintain "critical mass". The provision of financial services is becoming more technology-intensive, and only large financial institutions can afford to make the expenditures involved.

Other matters on which CEOs and regulatory authorities are in agreement include the following.

- The greatest amount of consolidation will occur among trust companies and property and casualty insurance companies.
- The extent of consolidation among investment dealers will be determined largely by the actions of the major banks.
- The consolidation process will be relatively smooth and will not be disruptive to the Canadian financial system, although there may be some "hiccups" along the way.
- Consolidation will improve the health of the financial system, although policy advisers are concerned that competition in the marketplace could be reduced.

Both regulatory authorities and CEOs believe that financial institutions will be larger in the future, due in large part to the need to make significant expenditures on technology. The main casualty of this process will be the aggressive mid-sized players. These firms are too large to be effective niche players, but too small to be able to compete on the basis of price.

Concerning the extent of cross-pillar diversification financial institutions will engage in, regulatory authorities believe this will be much greater than do the CEOs. While most CEOs indicated their organizations would offer more services in the future in order to establish more contacts with each customer, they also talked at length about the need to remain focused on

"core competencies". CEOs believe efforts to diversify into new financial activities will be modest.

Regulatory authorities were guarded in their observations on future changes to the regulatory environment. They were sensitive to the political considerations that factor into the regulatory process and indicated that they were unable to predict what sort of changes might occur. The CEOs were more forthcoming, arguing that many of the regulatory barriers on business activities, including the prohibition on the retailing of insurance by deposit-taking institutions, will be gone by the end of the decade. In their view, Canada is firmly on the road to universal banking.

Emerging Public Policy Issues

Change in the financial system is an ongoing process between industry and the public policy makers. Industry developments both reflect past changes in the regulatory system and pave the way for further response by the regulatory authorities. The current situation is no different in this respect, and as financial institutions adjust to the new legislative framework, their response will trigger a new round of issues the authorities will need to address.

Competition policy and ownership

Consolidation has a direct impact on competition. The prevailing view is that over the next 5 to 10 years there will be fewer small companies and those that remain will focus on highly specialized niche markets. Most of the medium-sized companies are expected to disappear through mergers and acquisitions; barring unexpected difficulties with any of the very large financial institutions, "elephant weddings" will be rare. Industry concentration is expected to increase modestly, and the intensity of price competition in financial markets is expected to be less than under current market conditions.

Canadian competition policy (as set out in the Competition Act and financial legislation reforms) will affect opportunities

for mergers and acquisitions among federally registered financial institutions. Only with approval from the minister may one financial institution acquire another. Because of concerns about excessive concentration in financial services markets, the size of both the acquiring and target firms will be one of the factors in the decision on whether to permit the transaction to take place.

While there are a number of CEOs who believe future mergers by large financial institutions are probable and would be beneficial to Canada, all recognize that federal government policy will ultimately determine the extent to which this occurs. In considering the issue the regulatory authorities will not only have to develop a better view on the relative advantages of size against increased concentration, they may also be required to address once again the balance of advantages and prudential risks associated with increased commercial ownership of financial institutions and/or increased foreign presence in the domestic financial system.

Regulatory uncertainty

The regulatory environment that governs federally registered financial institutions is not as clearly defined as many would like it to be. Many CEOs indicated they are not completely certain which business activities and practices are permitted under the new legislation and which are not. While this will provide the authorities with considerable flexibility for dealing quickly with unexpected developments in the financial system, the uncertainty makes long-term planning difficult and could result in the pursuit of activities that are eventually ruled out as illegitimate. It also adds to the cost of doing business because of the lengthier consultative processes required.

Several factors have contributed to this situation. The most obvious is that many of the new regulations have not been "tested". In many areas there is sufficient ambiguity that different interpretations of the precise nature of regulatory injunctions are possible. It will be some time before these areas are clarified by regulators, the minister, or the courts. Efforts to

harmonize federal and provincial regulations introduce another source of regulatory uncertainty. While the federal government has set out its objectives in this process, it is not clear what the outcome will be. Finally, the legislation permits a great deal of ministerial discretion, and until clear guidelines are brought forward, the way in which this discretion will be exercised is not known. Further complicating matters, the minister is expected to deal with major issues, such as the merging of large financial institutions, on a case-by-case basis.

Dealing with the new players

The regulatory reform process has failed to address the rules governing a number of important financial players, including those, such as leasing institutions, that fall under the Investment Companies Act. In a number of instances, these have become sizeable intermediaries in the Canadian market, and their foreign parents have developed considerable status as "non-bank banks" in the United States.

The new legislation has also failed to address the question of the role and prospects of foreign institutions in Canada. This matter is unlikely to be addressed until the GATT negotiations on trade in financial services are completed. Yet, with rapid technological innovation and increased geographical integration of capital markets, there is growing potential for foreign institutions to undertake significant cross-border activity even without a sizeable presence in Canada.

There are a host of financial intermediation and advisory services that operate largely outside the system of financial regulation. These include small independent businesses and partnerships providing services in the areas of financial planning, deposit brokering, mortgage brokering and loan brokering. The value of business handled by these "non-traditional" financial professionals has grown in recent years. While there have been few complaints against the activities of these professionals, regulatory authorities see a number of areas where abuses could arise and want to ensure that consumers are protected.

Regulations under consideration by some provinces to reduce the possibility of abuse include minimum proficiency requirements; full disclosure of fees, commissions and risks; and mechanisms to ensure that funds entrusted to these financial professionals are protected in the event of bankruptcy.

Payment and settlement system

Key concerns with respect to the payment and settlement system centre on access, efficiency and risk minimization. Regulatory authorities want to be sure the payment and settlement system develops in a way that best promotes a strong and healthy financial services industry in Canada. Its centrality to the overall functioning of the financial system, coupled with complaints from some industry quarters about potential dominance of the system by a small number of financial institutions, has generated a need to review conditions in this area.

That said, it would be wrong to imply that regulatory authorities are unhappy with the current structure and functioning of the payment system; instead, they want to be certain existing arrangements are and will continue to be consistent with broader policy objectives. It is entirely possible that, after extensive review, regulatory authorities could determine that present arrangements (perhaps with some minor changes) are those best suited to current and future needs.

A related area of concern is *privacy of information*. Financial institutions maintain extensive customer databases, and there is growing concern about the use and safety of this information. The issue encompasses more than the financial services sector and, as a result, will most likely be dealt with in a larger regulatory context. Many believe that privacy will be *the* issue of the 1990s.

Institutions Interviewed

Financial Institutions

Bank of Montreal
Bank of Nova Scotia
Barclays Bank of Canada
Burns Fry
Canada Trust
Canada Life Assurance
Credit Union Central of Canada
Citibank Canada
Confederation Life Insurance
Desjardins
Deutsche Bank (Canada)
E-L Financial
General Motors Acceptance Corp.
Great-West Life Insurance
Hongkong Bank of Canada
Laurentian Group
London Life Insurance
Manufacturers Life Insurance
Midland Walwyn Capital
Montreal Trust
Mutual Life Assurance
National Trust
National Bank of Canada
Nesbitt Thomson
North American Life Assurance
Power Financial
RBC Dominion Securities
Richardson Greenshields
Royal Bank of Canada
Royal Trust
ScotiaMcLeod
Standard Life Assurance
Sun Life Assurance
Swiss Bank Corp. (Canada)
Toronto-Dominion Bank

Government Departments, Agencies and Self-Regulatory Organizations

Alberta Treasury Department
Alberta Stock Exchange
Bank of Canada
British Columbia Ministry of Finance and Corporate Relations
British Columbia Securities Commission
British Columbia Financial Institutions Commission
Canada Deposit Insurance Corporation
Canadian Investor Protection Fund
Consumer and Corporate Affairs Canada
Finance Canada
Manitoba Securities Commission
Manitoba Department of Cooperative, Consumer and Corporate Affairs
New Brunswick Department of Justice
Nova Scotia Department of Consumer Affairs
Office of the Superintendent of Financial Institutions
Ontario Securities Commission
Ontario Insurance Commission
Ontario Ministry of Financial Institutions
Quebec Ministry of Finance
Quebec Inspector General of Financial Institutions
Quebec Securities Commission
Saskatchewan Department of Justice
Saskatchewan Securities Commission
Toronto Stock Exchange
Vancouver Stock Exchange