

# The Canadian Financial Services Industry and the Challenge of Global Competition

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Résumé de l'article

Nous remercions M. Guy Glorieux de nous avoir autorisés à publier l'allocation qu'il a donnée à l'occasion de la Conférence annuelle des surintendants des institutions financières, tenue à Kingston le 5 février 1990. À titre de directeur du Programme de recherche sur les services financiers au sein du Conférence Board du Canada, l'auteur est bien placé pour présenter son point de vue sur la situation des institutions financières au Canada face aux défis de la concurrence mondiale. M. Glorieux aborde quatre questions spécifiques : l'évolution des structures des institutions financières, les perspectives d'une réforme de la réglementation, les défis des années 90 et les aspects saillants de la réforme en cours.

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149

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## The Canadian Financial Services Industry and the Challenge of Global Competition<sup>1</sup>

by

Guy Glorieux<sup>2</sup>

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<sup>1</sup> This speech was delivered at the 1990 Annual Conference of the Office of the Superintendent of Financial Institutions, held in Kingston on February 5, 1990.

<sup>2</sup> Mr. Guy Glorieux is Director, Financial Services Research Program, The Conference Board of Canada.

*des institutions financières au Canada face aux défis de la concurrence mondiale. M. Glorieux aborde quatre questions spécifiques : l'évolution des structures des institutions financières, les perspectives d'une réforme de la réglementation, les défis des années 90 et les aspects saillants de la réforme en cours.*



150

I am pleased and honored to have been invited as the first speaker to the 1990 Annual Conference of the Office of the Superintendent of Financial Institutions. With the 1980s coming to a close, this is indeed an opportune time to build on the experience of the last decade and anticipate the challenges building ahead.

I have been asked to speak about globalization and the Canadian financial services industry. Looking back at what has happened to the financial services industry during the last decade, this can be a daunting task. Not only has there been a revolution in the world of finance over the 1980s, but the pace of change seems to have accelerated through the decade.

As we leave behind these turbulent years and look ahead to new challenges for the 1990s, there are three key points that I would like to highlight from my remarks today.

The first point is that the forces of competition in the financial services industry have dramatically increased over the last decade and there is no indication that this will change in the near future. This is true for Canada as well as for the international financial system. These forces have and will continue to be a source of significant restructuring across the financial services industry.

The second point is that, in a world of rapid change and restructuring, the future success of our institutions will critically depend on whether their competitiveness remains in line with international developments. At the same time, competitiveness is critical to ensure the ultimate soundness of our financial system, and this should be a major consideration in the current discussions over regulatory reform.

Finally, against the background of repeated delays in financial sector reform, I believe that there is some urgency for policy makers

to move ahead with a new legislation in this area. The financial system plays a key role in fostering private saving, supporting capital formation and facilitating the growth of economic activity. To help their customers meet the challenge of global competition, financial institutions need a predictable policy environment in which they can thrive and succeed.

## **1. The Changing Structure of the Financial Services Industry**

According to the polls, Canadians attach little importance to the issue of financial sector reform. This should not come as a surprise since, for the average Canadian, the bronze plates which identify our financial institutions have not changed dramatically over time. In fact, when seen from the outside, the changes in the industry seem to arise from a fairly smooth evolution rather than a revolution.

151

Yet, behind the scenes, the Canadian financial system has gone through a period of unprecedented transformation since the late 1970s. The process has been characterized by significant shifts in market share between the key sectors of the industry and by considerable restructuring both among and within individual sectors.

The changes reflect, in part, new attitudes on the part of the non-financial public vis-à-vis the financial intermediaries. They also reflect the response of financial institutions to a powerful combination of forces which materialized over the past decade.

Beginning in the early 1980s, sharp swings in financial market conditions and the inflation rate led to a tightening in the financial management of both financial and non-financial corporations. There was a significant shortening in maturities, a shift away from fixed-rate instrument and an explosion in the range of derivative products designed to limit exposure to risk. Not all institutions were in the right position to develop these products and some sectors experienced considerable difficulties in adjusting to the emerging competition.

Securitization was a second powerful force on the industry. As corporations found it more attractive to borrow under their own name than through a financial institution, there was an abrupt shift in activity away from the traditional lending institutions to the securities markets and to the investment dealers community.

The globalization of financial markets was a third important force acting on the Canadian financial services industry. Through most of the decade, wide differences in financing costs developed between the markets in Canada, New York, London or Tokyo, and for a time Canadian borrowers relied extensively on foreign institutions at the expense of domestic institutions. At the same time, the need to accumulate significant provisions against Third World loans placed most of our banks at a comparative disadvantage in the domestic market vis-à-vis other lending institutions.

152

Finally, spectacular changes in the area of technology and telecommunication provided considerable scope for financial innovation, and this became a major competitive weapon between institutions in Canada and abroad.

The combination of these forces led to a significant increase in competitive pressures on traditional lines of business across all sectors of the industry. Faced with stiffer capital requirements and with the emphasis shifting away from asset growth to return on equity, financial institutions began to search for new opportunities outside their traditional boundaries, contributing to the erosion of the so-called "Four Pillars" of our financial system.

As the pillars eroded, the level of competition in financial markets further increased, adding pressure on the weaker institutions and encouraging further industry restructuring. Toward the middle of the decade, several of the smaller regional deposit-taking institutions experienced considerable difficulties and there was some concern about the ultimate safety of the Canadian financial system. In retrospect, however, the system demonstrated considerable resilience and the magnitude of the problem proved to be much smaller than was the case, for instance, with the savings and loans institutions in the United States.

The net outcome of these developments has been the emergence of a new industry structure that is markedly different from that of the late 1970s. A natural alliance has now developed between the banks and the securities dealers, and all of the major Schedule I banks, together with several Schedule II are involved in the securities business.

In parallel, there has been considerable restructuring within the trust and insurance sector, leading to the emergence of large financial conglomerates which can offer a broad range of financial services.

Finally, the rapid expansion of the cooperative sector, particularly in Quebec, together with the growing presence of foreign institutions has ensured a continued healthy level of competition in all markets.

## **2. Response from the Regulators**

As financial institutions adjusted to their changing environment, regulatory authorities also responded, but with a lag.

Their objective was to strike an appropriate balance between the three goals of ensuring depositors protection, safeguarding the soundness of the financial system and fostering the competitive efficiency of the industry.

153

In most cases, their actions involved a considerable strengthening of the balance sheet and the capitalization of financial institutions. Restrictions across lines of activities and geographic areas were also reduced to encourage greater competition and greater diversification of risk.

### **Developments in Canada**

In Canada, the two levels of government have long recognized the need for a thorough review of their financial legislation. Significant progress has been made at the provincial level but, so far, the federal government's attempts at a comprehensive reform have not been successful.

Nevertheless, far-reaching measures to liberalize the regulatory framework were introduced on a piecemeal basis after 1984, reflecting rapid changes in the domestic and international environment.

The most dramatic move occurred in 1987 when the provinces unilaterally removed the ownership restrictions on the securities industry. With the risk that important parts of the industry might fall under foreign ownership, this precipitated the removal by the federal government of its long-standing barriers between the banking and securities industries.

Significant steps to strengthen the system of supervision at the federal level were also introduced after the failure of several regional institutions. These include the creation of the Office of the Superintendent of Financial Institutions as well as the establishment of

improved coordination mechanisms between the Department of Finance, the Office of the Superintendent of Financial Institutions, the Bank of Canada and CDIC<sup>3</sup>. This has led to a significant tightening in the overall supervision of the financial system and to a corresponding improvement in the ability of the authorities to respond to emerging difficulties.

154 Finally, additional measures were implemented to increase the level of competition in the Canadian financial system, primarily through a significant relaxation of existing limitations on foreign institutions. These include an increase in the ceiling for foreign banks, the financial services provisions of the Canada-US Free Trade Agreement and the commitment to grant a banking license to American Express.

Considerable progress was also made by the provincial governments to reform their regulatory framework and towards improved cooperation in the fields of regulation and supervision. However, in the absence of comparable movement at the federal level, the initiative has remained with the provinces and for a time there has been some rather unhealthy regulatory competition.

### International Developments

In response to the globalization of financial markets and to the growing competition between and within financial systems, most OECD<sup>4</sup> countries have also moved to modernize their financial regulation and the pace of reform has gathered momentum since the late 1970s. The focus has been on dismantling inefficient regulations and strengthening the role of market forces.

In parallel, there has been a significant increase in the cooperation between regulators across all countries. The objective was both to ensure a more "level playing field" between financial institutions and to strengthen prudential supervision of the financial system. The most visible example of this cooperation was the BIS<sup>5</sup> agreement in 1988 on Minimum Capital Standards. More recently, pressures within the European Community to integrate their financial markets

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<sup>3</sup> Canada Deposit Insurance Corporation.

<sup>4</sup> Organization for Economic Cooperation and Development.

<sup>5</sup> Bank for International Settlements.

by 1992 has been a source of continued progress in international cooperation.

In many ways, the move towards financial deregulation was more abrupt outside Canada than in our country. This is in part because we had moved much earlier, through successive adjustments to the Bank Act as well as through ad-hoc adjustments in the federal and provincial legislation. However, with the process of reform losing its momentum, there has been some concern that Canada may well be losing its leadership in this area.

### **3. Challenges Ahead for the Financial System**

155

As we look ahead to the 1990s, the financial services industry and the regulatory system will continue to be affected by powerful domestic and international forces. These in turn will raise new challenges for financial institutions and the supervisory authorities.

#### **The Challenge of Competitiveness**

Against the background of substantial restructuring in financial services worldwide, competitiveness is emerging as a critical issue for the industry. In most markets, Canadian participation has been quite modest compared to that of the global giants from the United States, Japan and Europe, and competition among these institutions has intensified through the 1980s. This could have a significant bearing on Canadian performance abroad in the years ahead.

The United States is a key market for Canadian financial institutions and the Canada-US Free Trade Agreement will provide increased scope for our institutions to expand their activities in that market. At the same time, however, the relaxation of the constraints on US financial institutions in Canada will be a source of competitive pressure in the domestic market.

As regards the European market, the experience in recent years has been somewhat disappointing and several Canadian institutions have scaled back their presence in London, Germany and France. Yet, considerable restructuring is currently underway in this market as European firms look forward to the challenge of Europe 1992, and this will also be a source of increased competitive pressures for our own institutions.



Looking west towards the Asia-Pacific region, the Canadian experience has been mixed with some institutions doing rather well in the markets of South-East Asia, despite the proliferation of regulatory barriers to foreign institutions. As regards Japan, this market remains essentially closed to foreign institutions and, with one or two exceptions, the Canadian performance has been quite unsatisfactory.

156 Considerably more work is required to understand the competitive strengths and weaknesses of Canada's financial services industry. Throughout the 1970s, asset growth and market share were considered to be key measures of success. By these standards, Canadian institutions were doing rather well. However, now that the focus is shifting towards return on equity, the relative performance of many of our institutions is much less glamorous.

With the international trend toward a removal of functional and geographic barriers to access, the focus will increasingly shift to the forces influencing international competitive positions and the pricing of financial services in various markets.

### **The Challenge of Technology**

Developments in the field of technology and telecommunication will also have a major influence on the operations of financial institutions, and there is no evidence at this stage that the technological revolution has run its course in the financial services industry.

The introduction of new technology will continue to alter the nature of the financial services industry. Debit cards and home banking systems will fundamentally alter the nature of retail branch banking over the course of the 1990s and will encourage continued restructuring. In the area of corporate banking, technology will also contribute to sustained financial innovation as financial institutions respond to the changing needs of their customers.

At the same time, technology is emerging as a key factor behind the competitiveness of financial institutions. The ability to develop and use the proper technology to manage and innovate in the provision of financial services will be a key determinant in the competitive position of individual institutions, both domestically and internationally.

Within the context of the globalization of financial activity, Canadian institutions will need to make the necessary expenditures to develop an infrastructure that is consistent with international developments. However, compared to the emerging global financial giants in the US or Japan, the investment capacity of our institutions is substantially smaller.

As new products are developed, the limits of existing legislation will be challenged on a continuing basis, and this will require ongoing response from the regulators. More importantly, however, both the policy makers and the supervisory authorities will need to ensure that technological innovation does not lead to increased risk for individual institutions and the financial system as a whole.

157

#### **4. Immediate Issues for Financial Sector Reform**

Let me now say a few words about the current debate over financial sector reform in Canada. The process has been stalled for some time now and, as I said earlier, I believe that there is some urgency for the policy makers to move ahead in this area. Three issues stand out as major areas of concern for policy makers.

First is the extent to which the regulatory regime should allow for the creation of "full-service" institutions through a further blurring of the distinctions between the old four pillars of the financial system.

Second is the question of the ownership of financial institutions and particularly whether ownership linkages should be allowed between the industrial and the financial sector of the economy.

Finally, there is the question of the role of foreign institutions in the Canadian financial system, particularly in the light of the developments in international markets.

These issues have been debated at length over the past several years in Canada. However, a consensus has yet to emerge as to the ultimate implications for the efficiency and safety of the financial system and as to appropriate steps for the legislator.

#### **Lessons from the International Experience**

There are no easy answers to these problems and the international experience does not indicate a clear trend either in favor of or against either position.

In countries where the so-called universal banking system has been in existence for some period of time, the success seems to reflect the economies of scale and scope enjoyed by large financial conglomerates. Strong positive synergies have also generally developed between the commercial and the financial arms of the conglomerates, particularly in the development of overseas markets.

It is important to note, however, that the experience with universal banking may not be entirely relevant for the debate in Canada. Universal banking involves the downstream ownership of industrial corporations by a financial institution, and this will raise a different set of prudential issues than in the reverse situation where the institution is owned by an industrial or commercial corporation.

In countries that have maintained tight limitations on ownership and tight separations between functions, the concerns have centered on the potential risks to the financial system arising from self-dealing and conflicts of interests, and the debate has been at least as acrimonious as in Canada.

Obviously, care should be exercised in assessing the relevance of foreign experiences for Canada. There are significant cultural and historical factors behind the approach followed by individual jurisdictions which may not apply in the Canadian context.

Wide differences can also arise between the legislative framework and the *de facto* situation in individual countries.

In Japan, for instance, the existence of the powerful *kereitsu* groupings runs intuitively counter to the tight legislative ban on commercial-financial ownership linkages. In the United States, where a similar ban also exists, a number of large "non-bank banks" have developed under the ownership of large commercial entities. Several savings and loan institutions have also recently been purchased by industrial corporations.

Nevertheless, when it comes to solvency and the management of conflicts of interest, some lessons can be learned from the experience in other jurisdictions.

Clearly the most common approach to dealing with concerns over solvency has been to set high standards of capital adequacy and to develop limitations on exposure to any single account (or categories of accounts) in relation to capital.

In several instances, this approach is reinforced through the so-called "Chinese Walls." These provide for a strict separation of functions within the same corporate grouping, through the creation of separately capitalized subsidiaries and control over non-arms-length transactions. These "Chinese Walls" can help reduce the risk that financial difficulties spread from one part of the organization to the rest of the conglomerate. Together with tough disclosure requirements, they are also seen as a powerful mechanism to handle self-dealing and conflicts of interest.

Obviously, "Chinese Walls" will limit the potential for economies of scale and synergies arising from product diversification or ownership linkages. However, the conglomerates will continue to benefit from increased market power and better risk diversification. This could prove to be a decisive factor in strengthening competitive positions over time.

159

In the final analysis, there is no perfect answer to any of these problems. Even under the most sophisticated system of regulation, the risk of default will remain inherent to the financial system.

The burden will remain on the supervisory authorities to monitor the safety of individual institutions and to develop both early warning systems and fast action procedures. Considerable progress has been made in this area since the creation of the Office of the Superintendent of Financial Institutions, but this has generally not been recognized by the general public.

At the same time, most of the studies on failures of financial institutions have highlighted the critical role of management and board of directors in the safeguard of their institution. To quote Susan Krause from the Office of the Comptroller of the Currency in the US: "Any bank that is waiting for an external solution to its problems," whether that be from Congress, the Federal Reserve, or other regulatory agencies, "needs to remember that the burden for ensuring safety and soundness rests first and foremost with the bank's own management and board."

## Conclusion

Financial institutions have a unique responsibility of trust since they handle the financial transactions of the Canadian public. In looking ahead to the challenges of the 1990s, the safeguard of

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investors and depositors must therefore remain a prominent objective of the regulatory system. While the regulatory regime is important to set the conditions that will ensure the soundness of our financial institutions, the Office of the Superintendent of Financial Institutions also has a key role to play in this respect.

At the same time, in a world of global change, the regulatory framework should foster the emergence of strong institutions which can meet the challenge of competition, both in the home market and abroad. Ultimately, the soundness of the financial system and the safety of depositors and investors will be critically influenced by the competitive efficiency of its institutions.

160

In the debate over regulatory reform and the future of the Canadian financial system, I believe that considerably more focus should be placed on the factors that will affect the competitive position of our institutions.

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### **Commerce, numéro spécial du 40<sup>e</sup> anniversaire, Montréal**

À l'occasion de son 40<sup>e</sup> anniversaire, la revue *Commerce* vient de faire paraître un numéro spécial fort intéressant, qui est consacré à un certain nombre d'entreprises et d'initiatives. Nous en recommandons la lecture, car il y a là un document fort intéressant sur l'évolution de la province de Québec au point de vue économique, durant cette période. On a là des témoignages extrêmement intéressants qui indiquent ce qu'a été la génération de 1960 et ce qu'elle a accompli dans un certain nombre de domaines, au point de vue économique en particulier.

G. P.