

**The Economics of Canadian Banking Regulation:
The Separation Issue**

by
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A Thesis
Submitted to the Faculty of Graduate Studies
in Partial Fulfilment of the Requirements
for the Degree of

MASTER OF ARTS

Department of Economics,
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REGULATION: THE SEPARATION ISSUE**

BY

EVA ORBAN

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ABSTRACT

This thesis examines the economic impact of Canadian banking regulation, focusing on the issue of functional and ownership separation in the financial services industry. It also observes the role of technological change in the structural regulation in the industry, and the contribution of regulatory change to the separation issue.

The thesis employs a historical-analytical approach towards the traditional institutional and regulatory framework. This method provides the basis for a thorough study of recent changes in that industry in Canada and in other countries.

In the thesis it was found that technological change has caused major transformation in the financial sector in the last two decades, facilitating the globalization of financial markets and the introduction of innovative products. These elements have shifted the demand and the supply of banking services, pressing for structural and regulatory changes. Competition has intensified in domestic and international markets, weakening the power of Canadian banks. Regulatory reform in Canada has opted to retain the separation of functions to preserve security and stability in the industry, but has allowed the integration of ownership among financial institutions to adapt to accelerating transitions.

The thesis recommends further regulatory changes to improve the performance of Canadian banks. It proposes the enhancement of more competitive and efficient services in domestic financial markets, to equally benefit consumers, institutions and the economy in general.

TABLE OF CONTENTS

CHAPTER ONE - INTRODUCTION

1.1 Overview	1
1.2 Objectives and Scope	5
1.3 Procedure	6

CHAPTER TWO - CANADIAN BANKS IN THE FINANCIAL SECTOR

2.1 Introduction	9
2.2 Rationale for Financial Intermediation	9
2.2.1 General Approach	10
2.2.2 Economic Adjustment and Financial Sector	12
2.3 The Canadian Financial Sector	14
2.3.1 Canadian Financial Institutions and Their Core Function	14
2.3.1.1 Commercial Banks	15
2.3.1.2 Trust Companies	16
2.3.1.3 Insurance Companies	17
2.3.1.4 Securities Dealers	19
2.3.2 Functional and Institutional Changes	20
2.3.3 Canadian Financial Services Industry	21
2.4 The Separation Issue	24
2.4.1 The Question of Separation	24
2.4.2 The "Four Pillars" Approach	27
2.4.3 Functional or Ownership Separation?	28
2.5 Summary	32

CHAPTER THREE - THE REGULATORY STRUCTURE OF THE CANADIAN BANKING INDUSTRY

3.1 Introduction	33
3.2 The Regulatory Scene	34
3.3 Regulation in Finance	35
3.3.1 Reasons for Financial Regulation	35
3.3.2 Types of Financial Regulation	36
3.3.3 The Role of Financial Regulation	39
3.4 Financial Regulation in Canada	43
3.4.1 Governments and the Financial System in Canada	44
3.4.2 Banking Regulation	47
3.4.3 Regulation of Trust Companies	52
3.4.4 Regulation of Life Insurance Companies	54

3.4.5 Regulation of the Securities Industry	56
3.5 Summary	57
CHAPTER FOUR - INTERNATIONAL DIMENSION OF THE SEPARATION ISSUE	
4.1 Introduction	59
4.2 Regulatory Structure in Various Countries	61
4.2.1. The Changing Structure of Regulation in the British Financial System	62
4.2.2 Financial Regulation in the U.S.A.	67
4.2.3 The Separation Issue in Japan	73
4.2.4 Banking Regulation in Europe	77
4.3 Need for International Coordination	78
4.4 Summary	85
CHAPTER FIVE - THE ROLE OF TECHNOLOGY IN FINANCIAL INTERMEDIATION	
5.1 Introduction	86
5.2 Economics of Technological Change	87
5.2.1 Supply of Banking Services	87
5.2.2 Demand for Banking Services	95
5.3 Financial Innovation	98
5.4 The Globalization of Financial Markets	102
5.5 Summary	108
CHAPTER SIX - STRUCTURAL CHANGES IN FINANCIAL MARKETS	
6.1 Introduction	110
6.2 Canadian Institutions in Domestic Market	111
6.2.1 The Impact of Changes on the Industry	111
6.2.2 Financial Institutions in the Economy	118
6.2.3 Competition in Domestic Market	121
6.2.3.1 Banks' Performance in Canada	124
6.2.3.2 The Impact of Foreign Entry	128
6.3 Canadian Banks in the International Market	132
6.4 Canada - U.S. Free Trade Agreement	136
6.5 Summary	138
CHAPTER SEVEN - ECONOMIC IMPLICATIONS OF TECHNOLOGICAL AND REGULATORY CHANGE	
7.1 Introduction	139
7.2 Regulatory Structure	140
7.2.1 Jurisdictional Agreement	140

7.2.2 Competition	143
7.2.3 Ownership of Financial Institutions	146
7.3 Future of Canadian Banks	148
7.4 Technology and Innovation	150
7.5 Summary	152
CHAPTER EIGHT - CONCLUSION	153
BIBLIOGRAPHY	158
APPENDICES	163 - 165

LIST OF TABLES

1. Canadian Financial Services Industry, 1967 - 1990	22
2. Canadian Financial Services Industry Capital Expenditure, (1967 - 1987)	88
3. TD Bank Non - Interest Expenses, 1986 - 1990	89
4. Number of Foreign Banks or Banking Offices and Their Relative Importance in Selected Countries, 1960 - 1987	103
5. Total Assets of Selected Canadian Financial Intermediaries, 1967 - 1990	112
6. Mortgage Credit Outstanding in Canada, by Category of Lender, Amount and Distribution, 1967 - 1990	114
7. Share of Total Assets Among Financial Institutions in Canada, 1967 - 1987	116
8. Employment in the Finance, Insurance and Real Estate Industry, 1984 - 1990	120
9. Selected Financial Market Concentration in Canada, 1979 - 1987	123
10. Deposit Accounts in Canada by Category of Institutions, 1980 - 1990	127
11. World Ranking of the Five Largest Canadian Banks, 1981 and 1987	134

LIST OF APPENDICES

- | | | |
|----|---|-----|
| A. | Chart 1: Average Annual Rates of Growth of Nominal Assets of Major Banks in Selected Countries, 1980 - 1987 | 163 |
| B. | Chart 2: Growth of Bond Issues in Canada, in the U.S.A., and in International Markets, 1980 - 1988 | 164 |
| C. | Chart 3: Funds Raised on International Markets as a Proportion of GDP in Selected Countries, 1982 - 1987 | 165 |

CHAPTER ONE

INTRODUCTION

1.1 OVERVIEW

This thesis examines the impact of banking regulation on the economic activity of Canadian commercial banks and their performance. It focuses on the so called "separation issue", the fact that different financial institutions can offer different services limited by regulations. Depository financial institutions are heavily regulated out of concern for the stability of the economic system. This concern has led regulatory agencies sometimes to overregulate the banking sector, preventing market forces from prevailing. Improved financial markets, the globalization of banking, and technological changes have recently drawn attention to the question of competition and its regulatory constraints in the financial services industry. Fair competition among different types of financial institutions is possible only if the regulatory environment provides the same conditions for each financial institution within the industry. Regulations change over time, and the direction of the change is determined by public policy goals underlined by major economic objectives of the government.

Commercial banking has always been the major element in a country's financial system, which not only contributes to the economic growth of the country, but fundamentally determines its economic stability. For the purpose of this thesis, although emphasis is put on banking activities, Canada's financial system as a whole must be taken into account. Financial institutions

are essential intermediaries between savers and borrowers, and in this respect "... the financial services industry is a vital sector of the Canadian economy and plays a key role in fostering private savings, supporting capital formation and facilitating the growth of economic activity." (Handfield-Jones and Glorieux 1988, 1) The four major contributors to the Canadian financial services industry are the "four pillars", namely: the commercial banks, the loan and trust companies, the insurance companies, and the securities dealers.

In the 20th century, financial institutions have undergone many changes. After the Great Depression, regulating the financial sector became increasingly important for the Canadian government to maintain a stable environment for the Canadian economy. The Canadian government (and as a matter of fact, also the U.S. government) intervened, and built up artificial barriers between the different types of institutions through regulation. The main intention of Canada's "four pillars" approach was to maintain the safety, soundness, and solvency of its financial system by the contradictory effects of these regulations: on the one hand the limitation of competition, on the other, the dispersal of the power of a few large firms. Functional separation - in contrast with the German universal banking - allocated different functions to different financial institutions, separating the allowed activity of each type of institution from that of the others.

Institutional and technological developments have characterized the financial services industry throughout the world, and the Canadian system is no exception.

Financial activities in Canada, especially commercial banking had been

viewed as unique, distinct territories of the economy. Are they unique enough that natural intrasectoral barriers can develop between the different financial functions? This question became more serious in the 1970's, and early 1980's, when the computerization of the industry made it possible for the institutions to penetrate into new markets geographically as well as functionally. The technological evolution, and the globalization of financial markets fundamentally changed the structure of the financial sector. The by then traditional, and thought to be natural barriers between functions started to disappear.

This thesis elaborates the economic concepts of the separation issue in general, and at the same time, it focuses on its Canadian aspects. The main question is to identify the basis for such regulation, its pros and cons, and its effect. The role of the financial system in a country's economy is fundamental, therefore government intervention has always been present, although the extent of government involvement changes from country to country and from time to time. The comparison of different financial systems in historical retrospective can give a more complete picture of the problem, highlighting the similarities and the differences with the Canadian system. It also gives an opportunity to compare the institutional background behind the race for market shares. In the discussion of that industry, one cannot neglect the impact of technological changes that basically caused the debate concerning the separation issue: the globalization of the banking industry did not only give rise to the need for regulations for access to geographical markets, but also for regulations for access to services markets with all the new products offered by the different type of institutions. Although

innovations have always been present in the banking industry, their influence on economic performance is increasing to the point of determining the success or the failure of a financial institution. Even with the strict regulatory constraints of commercial banking, banks have gained market shares in not traditionally banking services through innovations, as have other type of financial institutions in commercial banking.

While at the right time regulation is the appropriate solution of a problem, as it was for Canada until the 1970's, it can become an obstacle later on. As the international banking scene is changing, and competition is increasing, the Canadian banking industry cannot afford to lag behind. The present Canadian regulatory framework seems to prevent Canadian banks from fulfilling their role in international markets. Financial experts agree that the separation issue in Canada restricts the activity of Canadian commercial banks at home and abroad, and gives an advantage to other, less controlled financial institutions. It will be emphasized in this thesis, that with the globalization of banking, Canada cannot set up its own rules, if it wants to succeed in international financial markets. Canadian commercial banking services must adjust to the fundamentally changed environment, and the regulatory bodies must accommodate the need for this adjustment. It will also be argued that international coordination would be required to eliminate the differences among different countries' financial regulation to secure fair competition. Though, there is no "globalized" regulatory framework, there is a tendency towards international cooperation. To adapt to this international scene, Canada first has to deal with the changing financial environment on its own: should it follow the U.S. example and head towards

major deregulation, or should it keep its economy on its already trembling four financial pillars?

The subject of this thesis has been relatively neglected in industrial or financial literature. Much attention has been given to regulations governing monetary policies in the financial sector, safety regulations for depository institutions, and their economic impact on individual financial intermediaries. These works are important and complementary to this thesis. The thesis contributes to the economics of banking activity with particular emphasis on the connection between technological change and structural development, and the dynamics of banking activity and its regulation.

1.2 OBJECTIVES AND SCOPE

The purpose of this thesis is to study the implications of institutional as opposed to functional regulation for the structure of the financial sector and the economic operation of major financial institutions, especially banks. The analysis is addressed towards three major questions:

- 1.) What is the economic role and significance of separation in the banking industry?
- 2.) What has been the impact of technological change in the structural regulation in the industry?
- 3.) What has been the contribution of regulatory change to the separation issue in the banking industry?

To derive the economic analysis, a thorough discussion is provided

about the structure of the Canadian financial intermediation and the regulatory framework behind it. The economic impact of this regulatory influence on the banking industry will also be shown. It will be seen that regulation has limited the economic activity of commercial banks, causing losses in profits and market shares. Functional or institutional separation will, however, be a serious consideration to any concern about the soundness of the financial system.

Given the relatively slow reaction of regulatory agencies to changing market conditions, innovations will play a vital role in allocating efficiently already existing resources during the period of adjustment to new customer demands in the banking industry. Major technological evolution in the financial sector is discussed in the context of innovations. This includes the computerization of data processing and system management in banking with the result of declining cost, faster service, but at the same time, with the new problem of economies of scale.

To provide focus and perspective for the Canadian system, a summary of international banking regulations is given comparing the stand of different countries on the separation issue.

1.3 PROCEDURE

This thesis is organized into eight chapters. Following the Introduction, Chapter Two provides a review of the rationale for financial intermediation, with reference to the historical developments of Canadian

financial institutions. Priority will be given to the elaboration of the structure of the Canadian financial system, focusing on functional and institutional changes, and on the debate about functional or ownership separation of financial services.

Chapter Three deals with the regulatory structure of the Canadian banking industry. The economic motivations behind the strict functional separation in Canadian banking are examined. This chapter also points out the unique and distinct regulatory position of Canadian financial institutions originating from the very special situation of the Canadian federal and provincial jurisdictional system.

The fourth chapter examines the international dimension of the separation issue in the light of traditions, major economic objectives, and public policies. Different approaches toward the question of banking regulation are reflected through a brief summary of the financial regulatory systems of a few countries, with special attention given to the U.S. regulatory framework as the most influential on the Canadian scheme.

Chapter Five elaborates the fundamental structural changes in financial intermediation due to the revolutionary developments in banking technology. The globalization of financial markets is discussed as the means, and at the same time, the product of financial innovations supported by the technological evolution

Chapter Six discusses the economic effects of technological and regulatory change. Following the identification of the economic principles of modern banking, the argument proceeds to an examination of the inconsistency between present Canadian banking regulations and the

expectations of good Canadian economic performance on the international financial playing field.

Chapter Seven provides a summary of economic implications of recent changes for the future. It also includes recommendations to improve the performance of Canadian financial institutions.

Chapter Eight concludes the thesis with a concise summary of the research findings. It offers answers to the three basic questions raised as the objectives of this study.

CHAPTER TWO

CANADIAN BANKS IN THE FINANCIAL SECTOR

2.1 INTRODUCTION

This chapter provides a general overview of the importance of financial intermediation, its role in the economy, and its different forms offered by various financial institutions. In the last two decades, the financial services industry has undergone fundamental changes everywhere, and Canada is no exception. The traditional institutional functions have expanded, and the historical Canadian "four pillars" approach, the functional separation of financial institutions has been questioned. To reflect this trend, first the original core functions of the major Canadian financial institutions is discussed, followed by a brief outline of functional changes. The greater economic role of the industry induced by the transition is mentioned. Finally, important considerations in the separation issue are identified.

2.2 RATIONALE FOR FINANCIAL INTERMEDIATION

To analyze the financial services industry, the basic nature of financial intermediation needs to be understood. In addition, the financial system's role in the process of economic adjustment needs to be elaborated to illustrate the various economic structures and the dimensions of government interventions.

2.2.1 GENERAL APPROACH

Financial intermediation plays a critical role in every economy by assisting economic growth and development. Its basic function is to facilitate the transfer of funds between ultimate borrowers (economic spending units with deficits) and ultimate lenders (economic spending units with surpluses).

Financial intermediaries hold assets that are obligations of the borrowers. The liabilities of financial intermediaries are the assets of the lenders. Financial intermediaries typically offer liabilities of smaller default risk than their assets. Most of the financial institutions' liabilities are also of greater liquidity than their assets. Financial institutions can perform these transformations between the nature of the obligation of the borrower and the nature of the asset of the lender because of their strong position in the economy derived from their oligopolistic strength. They also have expertise in negotiating, accounting, appraising, and collecting. In addition, they are able to reduce the risk per dollar ratio of lending by pooling independent risks. They also enjoy the privilege of a safety net designed by the governments to assure the solvency and liquidity of the institutions.

The explanations for the existence of financial intermediation centre upon three specific roles of financial activity. The first approach emphasizes the asset transformation character of the financial institutions based on the ability to diversify and evaluate assets. According to this view, the "fundamental role of intermediation is transformation of large-denomination financial assets into smaller units". (Santomero 1984, 577) Since depositors face unit constraints in their portfolio choice, they are

willing to accept a risk-return combination in a financial firm's asset. As asset evaluators, financial firms function as assessors and monitors of credit risks in a financial environment with limited information.

The second view relates the different liabilities issued and their central role in the monetary economy as medium of exchange. The distinctive feature of the medium of exchange is its ability to minimize the cost of transactions that convert income into the desired consumption bundle, while ultimately generating profit potential for the issuing institutions. The pricing decisions of financial firms can attract deposits for their liabilities in return. These deposits may be reinvested at a positive spread creating profit for the institutions.

The third approach to explain the reason for financial intermediation is borne in the two-sided nature of financial firms. This model develops a maximizing firm in a financial market with uncertain rates of return. The covariance between the return on loans and deposits encourages the risk-averse maximizing firm to transform deposits into loans, hence supporting intermediation.

Though the reasons for financial intermediation are different, all these models capture the ultimate character of intermediation, which is the simultaneous satisfaction of the portfolio preferences of borrowers and lenders.

Economic financing is characterized by two general methods; direct finance that "results in primary securities ending up in the portfolios of surplus spending units" and indirect finance or financial intermediation that "results in indirect securities ending up in the portfolios of surplus spending

units" (Courchene 1985, 2). Primary securities are all debt and equity issues of non-financial spending units, while indirect securities are defined as the issues of financial institutions. Thus, financial intermediation is the process of a financial institution purchasing primary securities from ultimate borrowers and issuing indirect securities to ultimate lenders. It is the financial sector that provides the economic and legal conditions for both direct and indirect finance.

Direct finance is managed through market intermediaries or the securities industry that provides efficient primary and secondary markets for primary securities. Indirect financing is served by financial intermediaries, including monetary financial intermediaries, the banking sector; and non-monetary financial intermediaries or near banks, such as trust companies, credit unions and insurance companies.

Although, the magnitude of distinctions between the different intermediaries is not the same in every country and changes over time, the analysis highlights the difference between market intermediaries and financial intermediaries, and shows that the overall role of the financial sector is to ensure the efficient allocation of resources in the form of funds.

2.22 ECONOMIC ADJUSTMENT AND FINANCIAL SECTOR

The nature of a country's financial markets is a critical factor in the mode in which government and business interact, and also in the economic adjustment or restructuring process. According to the workings of the financial system, three prototypes can be distinguished. The first is the system

of a leading capital market with competitive pricing, in which corporate finance is supplied competitively by the capital markets. In this scheme, capital markets play a more important role than loan financing, and appropriately, the structure of the financial industry is disintegrated into separate sectors with separate functions. The economic adjustment is essentially company led, and the government's function in the process is regulation. The U.S.A. conforms to this model.

The second model is the state-dominated, credit based financial system, in which the longer-term corporate financing is achieved through credit rather than equity, and both the price and the allocation of capital are monitored closely by the state. In this case, business financing is achieved through loan markets, and economic adjustment is essentially state led with the government as economic administrator. Japan and France are the best examples for this framework.

The third category is the bank-dominated, credit based system, in which again corporate financing is managed through loans, but in this case, the structure of the financial system is totally different from the previous ones. Typically, in this system, financial intermediaries are very active as market intermediaries, or as providers of long-term corporate finance. This unlimited power ensures that a limited number of institutions dominate the system without state assistance, therefore government policy realization is subject to negotiations between the government and the banks. An obvious example of that system is the former West Germany with its universal banks which not only dominate the sources of business financing and allocative choices, but also are able to hold substantial stock in corporations.

Where does the Canadian financial system belong in this classification? Canada's financial system is basically a capital-markets based system, with a tendency to more state involvement than in the U.S.A. Although, this does not imply a state-led economic adjustment, the Canadian securities industry has been inadequate to facilitate a proper company-led adjustment. The other unique characteristic of the Canadian system is that market intermediaries are under provincial jurisdiction; thus, should the federal government decide to move towards a state-led adjustment strategy, it must meet with the approvals of the provinces.

2.3 THE CANADIAN FINANCIAL SECTOR

The Canadian financial system is classified into four major groups of institutions. Although, there also exist other financial institutions, these four categories represent the dominant participants of the financial sector, and embody the four pillars of the industrial structure. Until recently, this categorization also implied a classification according to the function these institutions executed.

2.3.1 CANADIAN FINANCIAL INSTITUTIONS AND THEIR CORE FUNCTIONS

The core function of the institutions is the traditionally developed main service of a segment of the financial sector. The four major groups of

financial institutions are: commercial banks, trust companies, insurance companies, and securities dealers.

2.3.1.1 COMMERCIAL BANKS

Banks emerged in Canada during the early nineteenth century and they remained virtually the only financial intermediaries accepting funds from the general public until the second decade of this century. The 1867 Constitution Act passed the jurisdiction over banks to the federal government and the existing banks were required to operate throughout Canada by federal measure. The first permanent legislation governing banking in Canada was passed in 1871. The Dominion Banking Act (or as it is known today the Bank Act) provided a general banking statute requiring existing banks to obtain charters and to meet certain capital prerequisites. Since then, the term bank is always used to refer to chartered banks.

The Bank Act has undergone regular periodic review and amendment since 1871. Changes were made concerning banking activities, but the core function of banks has remained the ability to engage in commercial lending, hence the name "commercial banks". By making loans and investments, commercial banks add to the funds of the credit market, and, by reducing their loans, they decrease the supply of funds. By their lending policies, banks affect the level of interest rates, and thus the volume of aggregate spending of both consumption and investment.

Commercial banking is the buying and selling of evidence of debt and, in the process, that means creating and destroying money. In this procedure,

they are limited in scale by the same kind of economic means that determine the aggregate size of other financial intermediaries. Banks, through their dominant role in the financial system, create the major part of the money supply of the country and are therefore responsible for the fluctuations in the stock of money and the working of monetary policy. Since commercial banks deal in both short- and long-term funds, they are important links between the credit markets of different maturities. Monetary authorities enforce their policies in the credit markets through their influence on commercial banks. "By their lending and investing activities commercial banks play a crucial role in determining aggregate economic activity, both with respect to the volume of goods and services produced and the prices at which the goods produced are sold." (Boreham/Shapiro/ Solomon/White 1969, 80)

2.3.1.2 TRUST COMPANIES

The exclusive right of trust companies is to provide a variety of executor, administrator and other trustee services. They are financial intermediaries handling a single pool of funds, and they are the only incorporated institutions in Canada that have the power to act in fiduciary capacity. "Even now, banks, loan companies, life insurance companies, and credit union cooperatives are not permitted to engage in discretionary fiduciary activities." (Moull, Waitzer, Ziegel 1985, 121)

Since the administration of estates and related activities form the principal business of trust companies, their most important source of funds is estates, trust and agency (ETA) accounts. The funds may be invested in

government securities, school and hospital bonds, and first mortgages on residential property. Trust companies can also obtain funds from the public by deposit accounts, investment certificates, and by the sale of their share capital. Deposits and certificates are considered "guaranteed funds", because they cannot exceed a limit, a certain multiple of the company's shareholders' equity, fixed by federal law. Trust companies offer deposits and certificates payable on demand as well as term deposits and investment certificates. Since the late 1950's trust companies shifted the largest proportion of their assets into the higher yielding mortgage loans business. In the 1960's, they were among the most important originators of mortgages, and financed their activities mainly through term deposits.

Trust companies have enlarged progressively the scope of their activities in the last few decades following the trend of other financial institutions to drift away from narrowly specialized services. Despite this trend, trust companies have preserved the exclusive right of their core function.

2.3.1.3 INSURANCE COMPANIES

Life insurance was introduced into Canada by British companies. The first Canadian life insurance company was formed in 1847 under the name of Canada Life Assurance Company.

Over the past century and a half, Canadian life insurance companies have become major accumulators and distributors of savings through their attractive products to savers. Their original function was to sell insurance and

to invest the proceeds wisely. The basis of the accumulation of funds in this industry, as in other types of financial intermediation, is the offering of liability instruments to the public (mainly life insurance) for annual payments. Their investments have traditionally been conducted towards Canadian capital markets, increasing therefore Canadian capital market activity. The funds collected through the sale of annuities are invested in personal and commercial mortgages, and in government and corporate bonds and stocks.

Considering the number and the size of the companies, the industry experienced a long period of expansion, reaching asset size second to that of chartered banks among financial intermediaries by 1968, and keeping that position since. The main competition for life insurance companies came in the 1960's when retirement plans, mutual funds, and trusteed pension plans emerged. The life insurance industry has taken the challenge and with innovations, they have secured their position in the Canadian financial system.

In 1987, more than half of the actively operating 165 companies in Canada were foreign owned. They accounted for 18% of the assets of the life insurance industry. (ECC 1989a, 18)

There are property and casualty insurance companies in Canada, but they are relatively of smaller size, and many of them are linked to foreign corporations.

2.3.1.4 SECURITIES DEALERS

In the direct financing process many investment firms are involved, although, in different roles. Large investment firms, however, participate in all aspects of that activity.

Investment firms can engage in placing new securities issues on an agency or underwriting basis. That means a participation in the primary distribution of securities.

Securities firms can also act as stockbrokers, buying and selling common and preferred stocks for clients on a commission basis, mostly through the facilities of organized exchanges. This activity generates more than half of the industry's income.

The third function of the industry is to maintain a secondary market for securities by trading fixed-interest securities among each other and with clients. This "over-the-counter" market requires dealers to hold an inventory of securities, thus they are principals in such activities. Without the liquidity provided by such secondary markets, it would be difficult and more costly to borrowers to raise new capital.

The large "integrated houses" engage in a full range of activity, and they frequently maintain separate departments for the different functions of their business. "Specialty houses" are more restricted in their activity, and they can engage only in limited business.

Reflecting the tendency in recent years of shifting towards direct financing, this sector experienced the largest jump in employment between 1984 and 1988, with an average annual rate of increase of 18.1 per cent. (ECC

1989a, 19) There has, however, been some contraction following the 1987 stock market crash.

2.3.2 FUNCTIONAL AND INSTITUTIONAL CHANGES

Although, the Canadian financial system is still organized basically according to the four pillars scheme, in which the major financial functions are executed by separate categories of institutions, there have been major changes in the workings of the system due to the transformation of the international system.

The most significant change involved the commercial banks and trust companies. While, until recently, each type of institution kept its exclusive rights to perform the core function, the powers of the two separate pillars were gradually extended over time, causing some overlap in services offered. As trust companies were allowed to include deposit taking as well as mortgage lending in their services, they emerged as important providers of mortgages financed through their term deposits. With the banks entering the mortgage market after the 1967 Bank Act revisions, their share of this activity increased, representing serious competition for the trust companies. In 1990, banks provided more than 43.7% of the residential mortgages, while trust companies obtained a 30.5% market share. While banks had increased their share in the residential mortgage market in the previous years from 40.8%, trust companies slipped back from 31.1%, definitely a shift in favour of the banks. (Bank of Canada Review, various issues)

The overlap of activities brought these two groups of institutions into

direct competition in the domestic market. They compete not only in the services offered, but also in the way they raise funds to finance these services: they both rely primarily on deposits. They still differ from each other in the exclusive right or dominance of their core functions: only trust companies can provide fiduciary services, and banks are primary sources of personal and commercial lending, although, trust companies are now permitted to participate in both businesses. The network of trust companies is less extensive with much fewer branches domestically; they also have very limited activities abroad compared to the banks.

In addition, a major institutional change took place in the early 1980's, when financial holding groups emerged as the owners and managers of financial institutions. These groups brought together different institutions to achieve the most efficient way to diversify their operations, and to offer various products to their customers within one deal. Originally, insurance and trust companies, mutual funds, securities firms were involved, but more recently, banks have also joined the movement.

2.3.3 CANADIAN FINANCIAL SERVICES INDUSTRY

The financial services industry is a fast growing sector of the Canadian economy and plays a critical role in encouraging saving, supporting investment, and facilitating the growth of economic activity. As an industry, this sector also contributes to economic growth through employment opportunities, income generation and capital formation.

The industry's increasing importance in the Canadian economic life

can be measured by the fact, that in 1987 the finance, insurance and real estate sector accounted for more than 14% of Canada's GDP. The value added by the industry through its activities in constant 1981 dollars more than doubled in twenty years, moving from \$21.9 billion in 1967 to \$54.4 billion in 1987 (Table 1). This represents an average annual rate of increase of 4.6%; a considerably higher rate than the 3.3% attained by the whole economy in this period.

TABLE 1
CANADIAN FINANCIAL SERVICES INDUSTRY, 1967 - 1990
(includes finance, insurance and real estate)

<u>Indicator</u>	<u>1967</u>	<u>1977</u>	<u>1987</u>	<u>1990</u>
GDP (originating from sector) In 1981 \$ mill.	21,941	37,578	54,359	61,126
% of Can. GDP	11.2	12.8	14.3	14.7
Employment Thousand persons	226.0	524.6	687.5	654.9
% of total employment	3.6	5.4	5.8	5.3

Source: Handfield-Jones, S. & Glorieux, G. "Adjusting to New Market Realities". Conference Board of Canada Report 31-88, 1988, p.1; Bank of Canada Review, December 1990.

In 1990, the financial services industry (including real estate activity) employed 5.3% of the total employed work force in Canada, up from 3.6% in 1967, but a decrease from the 5.8% figure in 1987. Since 1967, total employment has increased by 432.1 thousands, a yearly rate of increase of

18,000 jobs (Bank of Canada Review, various issues). Most of the jobs are in the savings and credit institutions as these are dominating the financial markets. Until recently, as financial funding shifted towards securitization, employment in investment companies and at securities dealers increased. (See Table 8, p.120) A fundamental question arises in the context of the rapid growth of employment in the industry. Is it an indication of productivity lagging behind, or is it a deepening of financial market activities that is the sign of a maturing system? Taking into account the progress in financial innovation and computer technology that has taken place in recent years, the sector should not lag behind. And indeed, this is not the case, according to the Conference Board of Canada: "The financial industry's growing share of the economy is much more a reflection of what has happened in financial markets (i.e., there has been a progressive 'layering' of financial activity and an increase in the number of financial transactions that separate the ultimate saver from the ultimate borrower)." (Handfield-Jones & Glorieux 1988, 4) While this does not necessarily mean a more efficient system of resource allocation in the classical static concept of least cost production and cost pricing, it certainly improved efficiency in more dynamic notions of efficiency. The more dynamic notions of efficiency include the optimal introduction of new techniques of production and delivery of financial services (Freedman, 1985).

On the other hand, in the same period the employment rate in U.S. banks decreased, and is decreasing, supposedly, because of automation. Since 1986, when employment in the US commercial banking industry reached its highest level (1.5 million), the number has been shrinking primarily because

of substitution of equipment for employees. Since Canadian banks spend about the same proportion of their capital expenditure on machinery and equipment, technological disadvantage cannot be the cause. It is very likely, that the different Canadian industrial structure in the financial sector is the explanation behind this phenomenon. The extensive branching network of banks, the widespread popularity of financial cooperatives, and the strict separation of trustee and banking operations are all contributors to the difference. Or can it be that the Canadian banking industry now too has reached its highest employment level, and this year's decrease is not a temporary setback, but a trend for the years ahead? This is a possibility which can only be verified in the future.

2.4 THE SEPARATION ISSUE

Since the real sector of an economy depends on the stability of the financial system, it has always been a country's priority to establish the proper structure for its financial needs. The development of a financial system is determined by traditions and government intervention. In many countries, governments or traditions regard some financial activities as irreconcilable within a financial institution.

2.4.1 THE QUESTION OF SEPARATION

One of the key issues governing the regulation of financial markets in

the major financial centres has been the separation of banking from securities business. This principle now has been eroded with the emergence of multinational conglomerates with a trend towards integrating money and capital markets. In contrast with this trend, it is interesting that two of the world's three leading financial centres, New York and Tokyo, have legislations preventing banks from engaging in certain kinds of stock-market activities.

The theory behind the separation of banking and securities business rests on three arguments: first, that securities activity is more risky than traditional commercial banking, and can thereby threaten the banks' existence; second, that the mixing of banking and securities business can initiate conflicts of interest that can cause abuses of principles; third, that the damaging consequences of mixed banking can be avoided only by prohibiting banks from engaging in certain securities activities, and not by merely restricting bank activities. The prohibition of banks' diversification into securities operations originated from the "special" status of banks in that the failure of the stability of the banking system is more damaging to the economy as a whole, than is the failure of any other business.

Mixing banking and securities business can result in conflicts of interest. Richard Dale provides a list of the arising conflicts of interest (Dale, 1989):

- 1/ The conflict between the promotional role of the banker as an investment advisor and the commercial banker's role as an impartial informer to depositors.
- 2/ Using the bank's securities authority to issue new securities in order to

finance risky loans.

- 3/ Economic tie-ins of different financial products.
- 4/ Placing unsold securities in the bank's client accounts.
- 5/ Personal conflicts of directorial interlocks.
- 6/ Issuing bank loans to support buying of securities.
- 7/ Imprudent loans to issuers of securities underwritten by the affiliate.
- 8/ Bank loans to the affiliate to keep it in business.
- 9/ Insider information conflicts.

In recent years, the separation issue has come under attack from both sides of the regulatory procedure: from the regulators and from the regulated financial services industry. There has been an argument that the risks involved in underwriting corporate securities may be even less than those incurred in the traditional commercial lending. The basics of such theory is, that banks can even reduce their overall risks by diversifying into securities business because, in the latter, the returns tend to vary inversely with returns on conventional banking activities. Risks, therefore, move in opposite direction in a diversified financial institution, resulting in a balanced probability of losses and profits.

Those, who believe that banks should operate in securities businesses emphasize the likely positive impact on the competitiveness and efficiency of the financial market. They argue that the overall social benefit would be demonstrated in significantly lower costs in the securities business. These arguments have some merits as the success of universal banking in Europe demonstrates. It is evident, and the long history of the Swiss banking monopoly in the international field before World War II has shown, that risk

characteristics are not more serious in universal banking than in banking where demarcations are maintained. On the other hand, the advantages are considerable: banks can benefit from the reduced risk offered by diversification; the financial system benefits from increased efficiency; and customers benefit from the lower prices facilitated by the increased competition. Of course, certain measures have to be introduced within the institution to eliminate conflicts of interest.

The major financial centres have followed different approaches to the problem of mixing banking and securities activities. U.S. and Japan have employed legislation to separate commercial and investment banking, while Germany stayed with its traditional universal banking. The U.K. is experiencing a fundamental restructuring process in its financial markets, breaking away from its historical arrangements of separate banking and securities operation, and establishing new financial conglomerates with the fusion of banking and securities businesses.

2.4.2 THE "FOUR PILLARS" APPROACH

In Canada, the separation issue means more than just the separation of commercial banking and securities industry. The four pillars of the Canadian financial system embody the separation of different functions, although the boundaries are not that clear anymore.

Canada has traditionally followed a regulation by institution (or the four pillars) approach, in which it is the institution as a whole which is regulated, regardless of the functions it performs. Until the 1970's, major

institutions limited themselves to a single function - the core function. Performance, and thus regulation by institution, was, at the same time, also regulation by function. By the late 1970's, however, institutions started diversifying into other functions through the use of innovations. As institutions succeeded in evading restricting rules, and court decisions modified the definition of core function, regulatory authorities tried to comply with the fundamentally changed financial surroundings. But the regulatory power remained with separate authorities for each category of institutions, and the existing functional separation prevailed. This functional separation was combined with ownership separation in which financial sector cross-ownership was still prohibited.

2.4.3 FUNCTIONAL OR OWNERSHIP SEPARATION?

The Canadian financial system has traditionally been based on functional separation of activities, appropriately supported through regulation by institution. As near-banks moved into new areas of activities and established contact with federal agencies or services, such as deposit insurance, their jurisdictional control became increasingly questionable. This problem, however, brought into the picture the dilemma of defining precisely the various financial functions and their combined impacts on policy goals.

Two, seemingly contradictory theories emerged in the last twenty years. Seemingly only because, though the outcomes are different, the goals are the same: increasing competition and efficiency while reserving the soundness of the system and assuring consumer protection. Over the years, however, the

relative importance of each of these objectives and the priority attached to them has shifted in response to events and market trends. The debates reflect certain circumstances of the time they were discussed. In the 1970's through to the 1980 Bank Act revisions, increasing competition and efficiency in the financial sector motivated the reform proposals. However, after 1980, a series of institutional failures in the trust, insurance and banking sector raised system stability and soundness to a higher priority. Between 1980 and 1985, 16 federally regulated institutions failed: two banks, nine trust and mortgage-loan companies, and five insurance companies (Carr 1986, 12). The federal Green Paper in 1985 responded to these solvency concerns.

In 1976, the Economic Council of Canada, recognizing the changing times, recommended a functional approach to regulation to improve efficiency. This regulatory method involves the control of activities of deposit institutions on a function-by-function basis instead of restricting particular institutions to particular functions, allowing them to undertake similar functions provided they meet the regulatory requirements for each function.

From an efficiency standpoint, institutional diversification would be desirable. However, there are some disadvantages of functional regulation. The main concern is the solvency problem, which is basically an institutional and not functional obstacle. The move toward functional regulation, in turn, would result in the establishment of a regulatory agency that would embrace all functions, and would be in a position of power to control the total financial conglomerate. (Courchene, 1985)

Federal regulatory powers had already integrated into the provincially incorporated near-bank system by the accessibility of CPA (Canadian Payments

Association) and deposit insurance for these institutions. In some cases, although the institutions officially remain under provincial control, provinces willingly hand over supervisory responsibilities to federal authorities. Had the original plan been executed, according to which all deposit-taking institutions had to join the CPA and maintain minimum cash reserve with the Bank of Canada, this would have created constitutional debate about provincially regulated institutions being subject to federal legislation. One must realize that this issue was the first attempt to introduce functional regulation by pulling different institutions under one system related to their payment activities.

In 1985, the federal government recognized the need for regulatory change in the fast changing financial world, and issued its new policy perspectives in "The Regulation of Canadian Financial Institutions" (henceforth referred to as the Green Paper). In its program, the federal government intended to decrease the "imposition of a preconceived structure on the financial system", and planned to endorse greater flexibility in the institutional scheme.

These principles were to integrate the Canadian financial industry into the transformed international financial markets where competition substantially intensified. The Green Paper was also the answer for the concerns about the shape of the Canadian financial market itself and the influence on it by the U.S. deregulation process. To increase the competition in commercial lending, the Green Paper suggested allowing trust companies and other non-bank institutions to enter into commercial lending through financial holding companies that own a bank (Schedule C banks). And subject

to provincial regulations, the proposal would allow these holding companies to own market intermediaries. As the established financial holding companies will remain distinct legal entities, regulation by institution continues to be the chosen regulatory form over functional regulation. In effect, the Green Paper proposition basically conserved the institutional four pillars separation, but allowed a "sidestep" between the pillars through a holding company. Thus, "the federal Green Paper has come down in favour of functional or institutional separation but opted for ownership integration." (Courchene 1985, 28) The reason of this decision lies in solvency concern as policy objective on one hand, and movement towards financial integration due to technological change on the other.

One problem, however, remains open in this context, namely the question of conflict of interest that could arise in a multifunction company, and connected to that, the self-dealing issue. The holding company approach evades the fundamental argument of increased risk taking by the integration of banking and securities business, and it definitely does not solve the conflict of interest problem.

Another difficulty is the regulatory background of such a holding company. If a company has a federally incorporated subsidiary as a Schedule C bank, the company would have to be federally incorporated and thus regulated as well. This situation is more complicated if a financial holding company owns a market intermediary institution. The fact that securities firms belong under provincial regulation would raise the dilemma that provincial jurisdiction could possibly overrule a federal charter.

2.5 SUMMARY

This chapter has provided a perspective on general financial intermediation and on the Canadian financial system. The main objective has been to demonstrate the importance of financial intermediation and its implementation in the Canadian economy. Specific attention has been given to the four major groups of the Canadian financial sector and their relationship. There is a significant trend towards changes in the traditional structure of the Canadian financial services industry, which had been characterized by the separation of the functions different financial institutions had been allowed to deliver, and the separation of their ownership. The new tendency of intense competition requires more functional integration. However, the imperfection of the system indicates that some measure of separation is desired to assure the stability of the industry.

CHAPTER THREE
THE REGULATORY STRUCTURE OF THE CANADIAN BANKING
INDUSTRY

3.1 INTRODUCTION

After the Great Depression, the economic environment changed substantially: more and more government intervention was needed to ensure the smooth flow of economic activity. The time of a really free-enterprise system was over, due to the weakened confidence in the self-correcting power of the market economy.

In recent years, however, the belief that traditional tools of direct government intervention can guide economies to success has been increasingly questioned. State involvement has begun to focus more on introducing regulations. One form of state involvement has been replaced by another.

The question arises: is this form of government intervention more beneficial to the public? The answer is not unambiguous. (Posner, 1974) Sometimes, there are different interest groups involved in every regulatory device, many times representing only a small group of people. But the cost of regulation is divided through the whole society. Thus, to evaluate regulations correctly, one has to weigh their cost, against the gain of regulations.

The objective of this chapter is to analyze the economic motives of regulations in general, and those in the banking sector in particular. This chapter also investigates the economic roles of financial regulations in terms

of their various types, recognizing that the structure of financial regulation in Canada reflects the unique framework of the country's federal-provincial jurisdictional system.

3.2 THE REGULATORY SCENE

What is regulation? By definition, it is the imposition of controls and restraints, and the application of rules. Depending on the source of the control, regulations can be divided into two basic forms: self-regulation and external regulation. (Swann, 1989) Self-regulation involves the parties regulating themselves. External regulation is when the control is imposed by a body which is outside the regulated group. The external regulator is usually the government or one of its agencies.

Regulations have three main categories. One is the antitrust policy, in which regulators intervene to provide the appropriate conditions for greater competition. It is a neutral policy approach to ensure that markets perform their basic function of allocating resources efficiently, thereby reducing the need for direct government intervention. The second form of regulation is the social regulation which is concerned with externalities, consumer protection, and safety. The third category is economic regulation which is the form what we think of in the context of government intervention.

3.3 REGULATION IN FINANCE

The most regulated industry everywhere is the financial services industry reflecting its importance in the economy. The objectives of regulation can be economic, social, or political. The goal is always to ensure constant economic growth through a stable financial system, although the priorities of these objectives can change over time accommodating events and following shifts in market trends.

3.3.1 REASONS FOR FINANCIAL REGULATION

The financial system we know today, everywhere in the World, is the product of past government decisions to allow, prohibit, restrict or induce various types of lending and borrowing. The impact governments have had on the structure and performance of the financial systems has been established through regulation.

The reasons for government intervention in the financial market arise from different economic phenomena. First, governments use their control over financial variables to reduce instability in other spheres of the economy. Second, the financial market itself is not a perfectly efficient market; thus government intervention may improve resource allocation. Third, the objective of the government may be the protection of savers and borrowers. Fourth, the government may want to achieve other, non economic goals that cannot be achieved either in a perfectly or imperfectly functioning capital market. (Cameron 1984, 355-369)

Governments have different ways to shape and influence the financial system. They regulate financial practices, including accounting rules and standards, financial trading procedures, the rights of borrowers and lenders, and methods of enforcing contracts. Since governments are large scale borrowers, government bonds are important liquid assets in the financial system. Governments have established specialized financial intermediaries to supplement, compete with, or replace private intermediaries. Governments manipulate financial markets in order to stabilize the financial or the real sector of the economy, and to achieve the desired equilibrium position. It is always easier and faster to act on the financial side of the economy, therefore it is not surprising that governments use every possibility to put the financial system to the use of government goals through heavy regulation.

To avoid market failure in the banking industry, some regulation is intended to decrease competitive pressure, and therefore reduce increasing risk taking. Hence, it is difficult to separate safety regulations and structural regulations in the financial sector, since one is connected to the other. The objectives of regulation are both micro and macro oriented.

3.3.2 TYPES OF FINANCIAL REGULATION

Regulation in the financial sector is more broadly defined than legally imposed external constraints. It contains externally imposed and self-imposed rules of behaviour, which limit the activities and operation of financial institutions.

David Llewellyn (Llewellyn, 1989) classifies six forms of financial

regulation established through behavioural rules:

- 1/ Environmental regulation is related to the government's monetary policy. (e.g. credit restrictions)
- 2/ Legal regulation limits the business activity of a particular group of institutions by law.
- 3/ Self-imposed regulation denotes restrictions chosen by the industry to govern its business activities or pricing policies.
- 4/ Moral suasion is regulation originating from the general authority of the institution.
- 5/ Self-regulation is when an industry-agency is given the formal authority to regulate the business activities of its industry, and to impose standards and norms for the conduct of the industry.
- 6/ External agency regulation implies the case where an independent external body is given the authority to regulate an industry and monitor its business operation.

In the financial sector, different forms of regulation are often used to perform the same role, to achieve the same objectives, but they can be considered by the industry itself or by the regulator as alternatives. They may also have the same effect and, therefore, the self-imposed restraints are sometimes preferred by the authorities.

When the forms of regulation are relevant to different sectors or groups of the financial system, different areas of regulation can be identified.

- 1/ Geographical regulation ties different rules to activities in different geographical regions, as in the U.S.A., where restrictions are imposed on inter-state banking.

- 2/ Institutional regulation prescribes the types of permitted activities of different financial institutions. The obvious example are the regulations separating the banking, insurance, securities business, and fund management activities allowed to different financial institutions. (e.g. Canada's four pillars)
- 3/ Functional regulation specifies the requirements for an institution to undertake a particular function.
- 4/ Ownership regulation restricts the extent of cross-ownership within the financial sector, for instance, between insurance companies and banks. In the U.S.A. and in Canada it is legally enforced, while in the U.K. it is a self-imposed matter of the industry.
- 5/ Pricing regulation is when restrictions are placed on the setting of interest rates or charges by voluntary or legally imposed regulations. This was the case in Canada and in the U.S., when interest rate ceilings on bank loans were enforced by legislation.
- 6/ Entry and establishment regulation limits the establishment of certain types of financial institutions by regulation or through licensing system.
- 7/ Business operations regulation constrain the conduct of business. It is rather a safety regulation, e.g. the liquidity requirements of banks.

In some countries (e.g.U.K.), functional and institutional regulation are not distinguished, since functional regulation also implies the separation of permitted activities of different institutions. This was also the case in Canada before the regulatory reform, when institutions performed one function which was distinctively permitted to each group.

Combining the forms and areas of regulation gives a regulation matrix,

that shows the differences of financial regulation in different countries by the way in which the matrix is completed. Deregulation or reregulation does not necessarily mean a reduction of entries in the matrix, but rather repositioning them.

Regulation frequently restricts the range of allowable business activities of different financial institutions. With the growth of competitive pressures on financial institutions and with technological change in this industry, financial institutions try to diversify their range of services. In countries, where demarcations of services have been maintained, there is a trend for change. It is easier where the relevant regulations have been self-imposed, like in the U.K., than in countries where the restrictions for demarcation have been enforced by law, like in the U.S.A. or in Canada. Demarcation regulations are usually anti-competitive in the sense that they provide protection against competition originating from outside the regulated group. They can also increase risk for institutions through the lack of options to diversify.

3.3.3 THE ROLE OF FINANCIAL REGULATION

By regulating the financial sector, governments try to achieve ultimate goals of policy through different instruments available to the authorities. Between the two end points, in the centre, there are the intermediate goals, which are the means whereby the ultimate goals can be achieved, but they are not techniques or instruments used to accomplish the objectives. (Freedman 1985)

Generally, there are three principal ultimate goals of regulatory policy in the financial sector :

- Stability of the financial system. The financial system must be believed to be sound if it is to fulfil its functions properly as a payment system, and as an efficient allocator of savings.

- Protection of depositors. This means the protection of unsophisticated savers against loss due to the failure of financial institutions.

- Efficiency. This includes the classical static concept of efficiency of least cost production given the available technology, and production cost pricing. There is, however, a more dynamic notion of efficiency, that embodies the optimal introduction of new techniques of production and delivery of financial services.

In addition, in some countries, like in Canada, two other goals can be the objective of financial regulations:

- Prevention of excessive accumulation of power. This is mainly a political objective.

- Measure of domestic control over the financial system. This goal incorporates political as well as economic purpose.

The intermediate targets that stand between the ultimate goals and the instruments used by authorities can be viewed as short run objectives associated with certain goals. They connect a chosen goal with various instruments:

- Preventing runs. In order to ensure the stability of the financial system, authorities want to avoid the spillover effect of increased concerns from one institution to the other. The instruments Canadian authorities

have relied on are deposit insurance, the lender of last resort and supervisory facilities.

- Solvency of financial institutions. In addition to the concern about the system as a whole, there is also emphasis on the solvency of individual institutions. This concern is related to the stability of the system by maintaining an overall confidence, and the protection of depositors. There are two components in this issue: the prevention of self-dealing and the avoidance of excessive risk taking in investment. The evidence of self-dealing and the failure of an institution due to excessively risky investments can raise doubts about the soundness of the system in the minds of the depositors. In Canada, authorities have used widespread ownership of financial institutions to minimize problems of self-dealing. They have also employed supervision and a variety of limitations on types of permitted investments and on lending powers to reduce the problems of excessively risky portfolio investments of financial institutions. These regulations are to offset the incentive for high gain-high risk portfolio investments caused by the given protection of deposit insurance. There have been debates (Kane 1985; Humphrys 1985; Carr 1986; Etc.) however, that in spite of the above mentioned investment rules, the uniformity of the required deposit insurance does not distinguish enough among institutions with portfolios carrying different degrees of risk. The argument addresses the question of a risk related deposit insurance premium system with an effective monitoring and risk assessing function. This approach also emphasizes the discretionary rights of institutional management.

- Avoidance of conflict of interest in financial-financial relation. This

target is concerned about the loss of one customer to the benefit of another or to the benefit of the institution itself. Conflict of interest can be harmful for customers, but it does not endanger the solvency of an institution. Hence its avoidance is connected with the goal of the ultimate protection of depositors. In Canadian financial regulation the separation of functions has been used as an instrument to cope with this problem. This fact implies then, that the separation issue, or the "so-called four pillars structure is not an object of policy but simply a means to a goal." (Freedman 1985, 82)

- Competition. The ultimate goal of efficiency in satisfying consumer demands can be attained by the encouragement of competition in different markets. Entry-exit rules and merger rules serve as instruments to deal with efficiency problems. These instruments, however, can also threaten the solvency of an institution, and therefore can influence the stability of the system.

Merger rules have also been used in Canada to cope with the concern over concentration of power. The maintenance of Canadian control over the domestic financial system has been achieved by limitations of foreign ownership.

The differences between regulating financial and non-financial industries arise from the goals that authorities try to achieve in the two sectors, and from the difference in nature of the institutions. For the non-financial sector efficiency is the main concern, and protection has less importance. There is no emphasis on system stability as a goal for non-financial industries.

These differences induce differences in the system of control. While

non-financial institutions are largely regulated by remedial regulations, financial institutions are controlled by preventive regulations. The cause of such a distinction can be found in a cost-benefit analysis. The potential cost to society from using remedial controls over financial institutions instead of preventive ones is greater than the benefits that might occur from cost savings. The reasons why social costs can be higher in the case of the financial industry originate from the fact that the assets of financial institutions are much more fungible than those of non-financial institutions, that is, they can be misappropriated much more easily than the fixed capital of a non-financial company. Financial firms have a much higher leverage ratio, hence it can be more profitable to run a financial company into bankruptcy. Since there is deposit insurance on the bulk of a financial institution's liabilities, there is also less incentive for depositors to monitor the activity of an institution or to check the behaviour of the firm's management.

3.4 FINANCIAL REGULATION IN CANADA

In Canada, the regulation of the financial sector is responsibility of two levels of government, reflecting the constitutional framework of the country. Federal legal regulation is characteristic of the banking sector, while external agencies control most of the trust, securities, and insurance business under the aegis of provincial governments. Despite the fact that most Canadian financial activity is originally of British origin, self-imposed or self-regulation did not become widespread in the history of the Canadian financial services

industry. The Canadian government has always tended to be heavily involved in economic control.

3.4.1 GOVERNMENTS AND THE FINANCIAL SYSTEM IN CANADA

Historically, Canada has had a stable financial system, but internationally, it did not capture leading place as a financial centre. Since the middle 1970's, Canada's financial market has been witnessing a wide spread of financial innovations due to spontaneous structural changes in the financial sector. Interest rates increased at the end of the 1970's, the competition among financial institutions intensified, and automation developed in the industry. As international conditions changed during the 1980's, regulatory reform was needed in industries in Canada which are subject to direct regulation, like the financial market. Regulatory reform has come to Canada more slowly and later than in the U.S., and very often not even in the form of outright deregulation. Nevertheless, in a number of industries, regulatory regimes have been liberalized in important ways.

In Canada, where two-thirds of primary lending passes through financial intermediaries, the government regulates the range of intermediary activities permitted to each type of financial institution, through different kinds of legislation. These laws specify limits on asset holdings, on liabilities, on ownership. The Bank Act is the most important financial regulation because banks have always been the major type of financial institution. Even today, as other types of financial institutions are gradually taking over a large share of the financial market, banks still dominate the short-term markets in

Canada.

The objectives of the Bank Act are threefold: first, it secures the protection of depositors; second, it ensures the realization of the transmission procedures of the government's monetary policy; and finally, it assures the efficiency of the financial system by exposing banks to a limited competition with other financial institutions. The last objective is based on the recognition that competition initially leads to better market performance, with smaller profit margins, more innovation, but in the longer run, uncontrolled competition would lead to mergers or weaker institutions going bankrupt. That would result in monopoly power for banks, since it is very likely they would stay alive with their size, market power, and better, more experienced management. (Cameron, 1984)

The Bank Act specifies conditions for entry into banking. A minimum size of capital is required. Entry into banking is possible through a relatively easy process, by letters patent. Domestic Schedule A banks must be widely held, thus the ownership is limited for any group of associated shareholders. This regulation reflects the concern of the Canadian governments not to allow enormous financial power to concentrate in few hands.

These rules show, that in the past, the Canadian financial system followed a very strict structural standard chosen by the government, and controlled by legislation. The Bank of Canada has a central role in the Canadian financial life, although, it is restricted rather to operational leadership than to exercising regulatory control.

In the case of financial institutions, regulatory reform of the second half of the 1980's was designed both to increase competition and to increase

discipline in the adherence to regulations developed to protect depositors and other creditors and to prevent self-dealing.

Some of the changes in regulation have been made and initiated by provinces, especially by Quebec and Ontario. Provinces regulate investment dealers, incorporate trust, savings, loan, and insurance companies, as well as credit unions and stock exchanges. One of the most important reforms was, that in 1983, the Quebec Securities Commission removed ownership restrictions on provincially registered securities dealers and permitted dealers to acquire other financial institutions. This resulted in both financial and non-financial enterprises being able to own securities dealerships. In 1983, Quebec and Ontario permitted banks to sell brokerage services through their branches. Quebec continued to play the leading role in the financial regulatory reform scene, when it allowed insurance companies to set up downstream holding companies, invest in new activities, and diversify into other areas that had been restricted for them before. Similar changes were introduced in Ontario in 1986, when the province wanted to act in the light of ~~expected federal policy decisions.~~ expected federal policy decisions.

In December 1986, the federal government released its new policy about the regulation of banks, loan, and insurance companies. This plan deals with the powers of the various institutions, changes in the supervisory system, and new rules about the ownership of federally regulated financial institutions, which proved to be very controversial.

"In the case of trust, loan, and insurance companies, incorporation will not be granted to applicants with 'significant commercial interests', that is, more than 10 per cent ownership of a firm producing goods or non-financial services. Trust, loan, and insurance companies which are now linked to commercial enterprises and have a capital base exceeding \$50 million are required to have at least 35 per cent of their shares publicly traded and widely

held by 31 December 1991. This provision effectively 'grandfathers' the big industrial conglomerates that have recently acquired financial institutions (e.g. Brascan Ltd., Imasco Ltd., Power Corp.)." (Stanbury, 1989, p. 71.)

It seems that the demarcation of financial activities has started to blur in Canada as changes in the international financial markets required adjustments from the part of national governments. Canada has adopted an evolutionary approach towards the reform of directly regulated industries, although, in the financial services, more outright deregulation can be expected as it spills over from the U.S.A.

3.4.2 BANKING REGULATION

As stated earlier the constitutional jurisdiction to regulate financial institutions in Canada is shared by the federal and provincial governments. With the exception of banks, the conduct of business by all factor of the financial services industry falls primarily within provincial jurisdiction, though, there is no exact boundary in the division of responsibilities.

The 1871 Bank Act clearly specified banking activity of the time, strictly separating banking from other businesses. The Act became the corporate charter of all banks. The establishment of a general banking statute was the result of the federal government's determination to assure control over the banking system.

Until about World War I, the number of chartered banks in Canada remained constant. After the War, the concentration in the industry increased as a result of raised minimum paid-up capital requirements that created barriers to entry, and as a consequence of the lack of legislation prohibiting

amalgamations and mergers.

In 1934, the Bank of Canada was formed for the purpose of holding banks' cash reserves and to act as lender of last resort for banks. The Bank of Canada soon began to manage cash in the monetary system and execute the government's monetary policy.

The power of commercial banks was extended in 1954, when banks were allowed to engage in government-guaranteed residential mortgage loans under the National Housing Act. This development put commercial banks in direct competition with trust, loan, and insurance companies. The competition further intensified with the 1967 Bank Act revision, that permitted banks to make conventional unguaranteed mortgage loans.

The 1967 Bank Act revision showed the new direction of government policy that was to promote competitive banking markets. Historically, chartered banks had been a tightly knit oligopolistic group with a few large firms, high entry barriers, interdependent pricing and low level of nonprice rivalry. Prior to 1967, this financial environment was appropriate to the Canadian government's policy objectives. In particular the stability of the financial services industry and the effectiveness of monetary policy were promoted.

In the early 1960's the aggressive competitive behaviour of near banks and rapidly rising interest rates threatened the chartered banks' market power. Until 1967, banks were required to maintain a 6% interest rate ceiling on loan charges. This restriction became an obstacle as interest rates rose. The report of the Porter Commission (1964), recommended a more competitive environment within the financial market, and among the banks themselves.

Market entry barriers facing chartered banks in various markets were removed, while barriers were raised to the creation of new institutions. Collusive pricing was formally prohibited, and ownership was restricted across institutional boundaries. The government, thus, opted for absolute ownership separation, while loosening up partly on the functional restrictions. Yet, functional separation still existed as institutions were able to keep the privilege for their core function. Neither the regulatory authorities, nor the industry itself, were ready at that time for a fundamental change. The technological and international financial conditions were still missing to impose pressure on the Canadian banking industry.

The effectiveness of the 1967 revision on the promotion of the competitive objective differed in different markets. (McArthur, 1981) The revision caused overall competitive improvement in the commercial credit, mortgage credit and transaction deposits market. The legislation removed the 6% interest rate ceiling on chartered bank loans, making banks able to offer more competitive rates on deposits. Banks could enter the market for conventional mortgages for the first time. A less competitive environment was found in the consumer credit and term deposit markets. The greater competitive freedom led to significantly higher market shares for the banks and increased market concentration ratios in these markets.

Prior to 1967, there was no evidence of price competition in the financial markets where chartered banks controlled a major share. Oligopolists have an incentive to cooperate rather than compete in order to maximize joint industry profits. Oligopolistic coordination might raise prices towards monopoly levels. The ability of firms to coordinate their actions is

influenced by the legal framework within which they operate. With the revision prohibiting price collusion, banks developed an alternative oligopolistic pricing technique, namely the price leadership model which involves one of the firms acting as price leader.

The 1967 Bank Act revision increased the overall competitive atmosphere in Canadian financial markets with the expanded power of the commercial banks. This legislation was the first sign of eroding barriers between functions.

Also in 1967, the Canada Deposit Insurance Corporation (CDIC) Act was introduced, which requires all federally incorporated depository institutions to hold deposit insurance with the CDIC. Provincially incorporated deposit-taking institutions are also allowed to apply for insurance at the CDIC if they agree to follow the appropriate federal regulatory provisions.

As commercial banks prepared for the 80's, the emphasis was put on efficient resource allocation and more competition in the financial markets, though still keeping the stability of the system. Regulatory authorities recognized the need for change, and the Bank Act of 1980 opened up many new opportunities.

In contrast with the 1967 Bank Act revision, when higher entry barriers had been erected prohibiting foreign controlled banks from operating in Canada, the 1980's Bank act permitted the entry of foreign bank subsidiaries into the Canadian financial market. Banks were allowed to engage in commercial leasing and factoring through subsidiary corporations. Banks could form subsidiary joint venture corporations and export finance companies to provide financing and loans to Canadian corporations. Banks

were given the authority to sell retirement savings plans, home ownership savings plans, and retirement income funds.

Prior to 1980, banks had not actively participated in underwriting or distributing corporate securities on the ground of traditional functional separation. In the absence of any legal restriction, the obstacle of information acquisition caused by not yet well developed technology, played the regulatory role. By 1980, technology having had its impact on the whole industry, globalization having run its course, regulation was needed to protect the four pillars of the Canadian financial system. Federal regulation prohibited banks from underwriting securities, but allowed them to act as part of a selling group. The 1980 Bank Act revisions also established the Canadian Payments Association (CPA) as a general national cheque-clearing system.

Since 1980, greater emphasis has been placed on the role of competition in the financial market, as foreign bank subsidiaries were allowed to enter the Canadian market. More and more foreign banks try to break into the Canadian market, especially in the big financial centres. By 1986, more than fifty subsidiaries of foreign banks were operating in Canada. The Bank Act imposes growth limits on foreign bank subsidiaries. To allow competition from foreign banks but within limits, the Minister of Finance decides the total amount of authorized capital which may be held collectively by foreign bank subsidiaries. Over the years, regulation has changed the permitted asset holdings of foreign banks to encourage entry and to increase competition in domestic markets. For example, while in 1980, foreign banks were allowed to take up to 8% of total domestic deposits, by 1984 this limit was raised to 16% and has remained there ever since.

There are asset restrictions to limit banks to banking, in order to restrict financial-commercial links. Banks can have no more than 10 % ownership in Canadian companies functioning in other than the banking field. There is no restriction on ownership of foreign subsidiaries. Banks' other activities are limited as well. They cannot sell trustee services, mutual funds, life insurance, or computer services which are not related to banking. They cannot underwrite corporate securities, nor solicit brokerage business. To enable the Government to keep a close track of their activities, foreign bank subsidiaries are allowed to have no more than 10 % ownership of any foreign corporation of any kind.

Since 1980, commercial banks have further eroded the traditional four pillars concept in the Canadian financial system. First, the Toronto Dominion Bank entered into the securities business by offering its Greenline Investor Services. This discount brokerage access service took advantage of price deregulation in the securities industry, and proved that the Ontario Securities Commission (OSC) defined the core function of the securities industry as underwriting or the new issue process. Discount brokerage was not considered the core function of the securities dealers by the OSC, and they argued that despite allowing the TD's new service, the four pillars concept had been kept intact.

3.4.3 REGULATION OF TRUST COMPANIES

Trust companies can be incorporated both at the federal and the provincial level. Early trust companies were mostly incorporated at the

provincial level. Today, however, federal incorporation is the more popular.

The first general legislation to govern trust companies was passed in 1897 in Ontario, and soon after it was followed by other provinces. In 1914, Parliament enacted the first general legislation governing federally incorporated trust companies. The objectives of this Trust Companies Act were the same as those of the provincial acts, primarily ensuring that trust companies would not engage in banking activities.

Legislation also attempts to guarantee the security of funds deposited in trust companies by regulating the ratio between guaranteed liabilities and funds that the companies are required to maintain. The institutional solvency problem is solved by limitations on the type of investments trust companies are allowed to make.

As a result of recent active merger movement in the industry, the number of small companies operating only in their incorporation province, has declined, and been replaced by larger federally incorporated trust companies. Federally incorporated trust companies are subject to federal regulation. The Canada Deposit Insurance Corporation Act of 1967 requires federally incorporated trust companies to be insured with the CDIC, and allows provincially incorporated companies to qualify for such insurance. Quebec has its own insurance scheme for provincially incorporated trust companies.

Trust companies too have been embraced by the regulatory reform movement. In the 1986 federal government policy, federally regulated trust companies were allowed to broaden their proportion of shares in any type of regulated financial institution that is incorporated in Canada through

subsidiaries or holding company, but were given certain restrictions on ownership positions in commercial interests. (Minister of State for Finance 1986, 17) They were given increased powers to undertake consumer and commercial lending. Thus, the structure of regulation became a mixture of institutional and functional form. The separation issue has partly been kept intact with its functional segmentation, but ownership integration has been facilitated through the holding company approach.

3.4.4 REGULATION OF LIFE INSURANCE COMPANIES

The constitution did not specifically grant regulatory authority over insurance companies to either level of government. Because of its financial importance, for more than a half century, the federal government attempted to claim jurisdiction over the conduct of the insurance business in Canada, but was refused by the courts.

Today, as a result, the provincial governments have the power to regulate the insurance industry within their borders regardless of the law of incorporation of the company. The federal and provincial governments have worked out an effective regulatory control system that generally avoids excessive duplication.

The first general legislation governing life insurance companies was the federal Insurance Companies Act in 1868, which largely originated from earlier non-life insurance legislation. The objective of the Act was primarily to control the legal status of the companies, and to ensure their solvency, since they were mostly foreign companies.

Later legislation focused mainly on controlling investments insurance companies were allowed to make. The Canadian and British Insurance Companies Act in 1932 was a federal government attempt to establish its constitutional rights over the insurance business, and relied on federal legislative authority over federally incorporated companies, interprovincial and international trade, and the prevention of insolvency of institutions in the industry. Since then, federal control in the industry has been achieved on the basis of provincial and industrial cooperation.

Provincial legislation provides now the complete corporate chartering of insurance companies. Provincially incorporated companies can register at the federal level according to the Canadian and British Insurance Companies Act, and thereby spread their area of activity throughout Canada. As a condition of such registration, companies must comply with all applicable provisions of the Act, and can, thereby, satisfy the various requirements of each province, because of the substantial similarity of federal and provincial legislation.

Today, the federal government is largely responsible for registering and supervising federal and foreign insurance companies, while provincial governments are responsible for the provincially incorporated companies. The objectives of regulation are generally directed towards solvency concerns and customer protection.

In recent years, as the financial intermediary role of chartered banks broadened, and as new pension plans developed, the traditional character of life insurance companies as providers of safe, long term investments has been challenged. Although life insurance companies have the exclusive right

to sell life insurance, through innovations they have expanded into selling variable value policies and contracts of annuity, a close substitute for term deposit, and have become interested in long term investments. Life insurance companies have acquired significant interests in trust companies, and have expanded their investments into equities.

In Quebec, insurance companies are allowed to engage in non-insurance related financial activities like selling the services of other institutions, engaging in leasing, or managing immovables. Where the non-insurance activity of a company exceeds 2% of its gross revenues, the establishment of a subsidiary to carry out these businesses may be required.

The federal government treated life insurance companies the same way as trust companies in the 1986 regulatory reform.

3.4.5 REGULATION OF THE SECURITIES INDUSTRY

Legislative authority over the securities industry within a province lies with the provinces.

Until 1912, securities legislation in Canada was focused on disclosure requirements, similar to the English companies acts. In 1912, the Sale of Shares Act in Manitoba was directed towards controlling issuers of securities by requiring them to obtain permits before offering securities, and by demanding the registration of securities, salesmen, and agents of the issuer. A uniform frauds prevention act was passed by the provinces in 1930.

The federal government made the provisions of the Companies Act applicable to federally incorporated companies issuing securities in 1935. The

Ontario Securities Commission (OSC) began operating in 1937, and was authorized to audit the affairs of brokers, and to give consent for carrying stock exchange businesses. The Toronto Stock Exchange (TSE) was formed in the mid 1800's, and eventually was brought under the supervision of the OSC.

Today, Canada has five stock exchanges (Toronto, Montreal, Winnipeg, Alberta, and Vancouver) and the Toronto Futures Exchange under provincial legislation. Although they are largely self-regulating bodies, they are subject to provincial regulation.

The Porter Commission in 1964 recommended that the Canadian securities market be federally regulated. The Canada Business Corporations Act in 1975 introduced insider-trading, proxy solicitation, and take-over bid requirements for federally incorporated business corporations. The Report of the Federal Task Force on Proposals for a Securities Market Law for Canada in 1979 recognized the national scope of financial markets in Canada and drafted a federally coordinated system of regulations for the securities industry, administered with the cooperation of the provincial regulators.

3.5 SUMMARY

The main reason for financial regulation is to ensure the stability of the economy. There are various types of financial regulations, but they all serve three ultimate goals: the stability of the financial system; the protection of depositors; and the efficiency of the financial services industry. The formal

regulatory position of the financial institutions in Canada is very complex. Only the commercial banks are regulated by one level of government, while the other segments of the financial services industry are exposed to multiple levels of government control.

The regulatory structure of the Canadian financial system has become more flexible, but has remained with its traditional institutional form. The federal government, in its regulatory reform, opted for keeping the four pillars, but allowing ownership integration under the umbrella of a holding company to adjust to the pressures for change.

CHAPTER FOUR

THE INTERNATIONAL DIMENSION OF THE SEPARATION ISSUE

4.1 INTRODUCTION

The origins of economic regulation are usually explained by the public-interest argument, referring to market failure. In banking, that means the limitation of excessive competition in order to afford the public protection against larger social costs which might be generated by widespread bank runs. In many countries, legal rules were introduced which prevented individual banks from excessive risk-taking and competition.

Economic regulation may also be a means of dealing with structural problems. In the financial sector, with the emergence of the different non-bank financial institutions and with the high internationalization of banking activity, a serious structural change has taken place in the last two decades. The introduction of economic deregulation was inevitable in most Western countries, to secure a proper regulatory climate for financial activities in this new structure.

This chapter contrasts the regulatory approach of various countries. Emphasis will be put on the discussion of three dominant international financial systems, those of the U.S., the U.K. and Japan and their treatment of the separation issue. These three countries' financial systems are very relevant to Canada. The U.K.'s financial framework was historically the pattern of its Canadian counterpart. Although many major differences have developed, there are still substantial similarities in the problems being faced

by the financial industries of both countries. There is also a resemblance between the two institutional positions. "..... both countries have principal means of payment provided by a small number of very large banks operating nationwide branch systems, both countries attempt to maintain central control over monetary conditions via asset ratios imposed on the principal institutions, and both countries need to pay the greatest attention to the consequences for international capital flows of their domestic monetary activity." (Green 1974, 2) Nonetheless, there are important differences between the Canadian and British situation. The first is the Canadian constitutional demarcation between federal and provincial jurisdiction of the various types of institutions. The other distinction originates from the structural difference of the two industries. In Canada, a group of institutions corresponding to the U.K. secondary banks is nonexistent. Services offered by British secondary banks, such as wholesale banking or intermediation in foreign currency deposits, are embraced in Canada by the chartered banks.

The U.S. financial system and its regulatory policy has had major influence on the Canadian financial sector, especially recently through the Canada-U.S. Free Trade Agreement. The U.S. deregulation process has made its mark on the whole international market, including the Canadian banking operation.

Japan's strong emergence on the international scene highlights the role of proper government involvement in the regulatory process. The financial sector is another industry in which Japan is gaining international prominence and an examination of its approach of regulation, involving the separation of banking and investment dealing, would seem to be mandatory.

A brief presentation of other financial models managing the separation issue in different ways will follow. The need for international regulatory harmonization will be elaborated in light of the recent structural changes in financial markets.

4.2 REGULATORY STRUCTURE IN VARIOUS COUNTRIES

Each country has a traditionally developed regulatory framework for its financial services industry. It can be self inflicted as in the U.K. or legally imposed as in the U.S.A. or Japan. The globalization of the financial industry, however, has changed the structure of the regulatory system in many countries. Recent financial market trends have also changed the regulatory approach towards such questions as the separation of banking activities or the separation of institutions through ownership restriction.

In all three major geographic economic areas, financial regulation is undergoing considerable change, though the focus is different in each agenda. While in the U.S.A. the primary goal is the strengthening of the banking system, Japan is working towards more integration in its segmented financial sector. Europe is concentrating on the international rules of its future community in 1992.

4.2.1 THE CHANGING STRUCTURE OF REGULATION IN THE BRITISH FINANCIAL SYSTEM

The British financial system has been remarkably stable in terms of both its structure and the operation of individual financial institutions. The distinctive British style of bank regulation is reflected in the fact, that in England the major areas of commercial banking, investment banking, insurance, and securities trading have been kept separate, in contrast to universal banks everywhere else in Europe. Banks, however, can engage in trust business, but to satisfy the conflict of interest rule, institutions sustain a "Chinese Wall" between the two activities.

The dominant structure of the financial system, therefore, has been a group of differentiated and specialized financial institution where the primary form of regulation has been self-regulation. As competition intensified in the 1970's with the entry of foreign banks, the old British banking system wasn't adequate anymore for successfully satisfying market demand, and a fundamental structural change became necessary.

In the 1980's, this change produced a trend towards financial conglomerates, and diversification in the industry. At the same time, with the development of new trading and information technology, financial services have become highly internationalized, exposing domestic institutions to competitive pressures from a global financial system.

Compared to other countries, the U.K. has never had a strong tradition of legislative regulation of financial institutions. The approach has, instead, been based on informal, self-regulatory principles, reliant substantially on the

moral suasion of the Bank of England. This informal mode of regulation has always depended upon trust and the personal knowledge of the bankers. The regulatory system was largely based upon "clubs" of similar institutions where membership was determined by the members themselves on condition that the new member would follow the rules of the "club".

Three characteristic features helped the development of such a financial system. First, in the beginning of the twentieth century, London became the centre of the British financial market, more so than any other city in other countries. This gave the opportunity to a homogeneous group of people, members of the same "club", to dictate the rules of banking, rules, that were based on trust. The second cause of a less formal regulatory structure was the dominant position of the Bank of England. In this highly centralized financial system, the Bank had a threefold role: the government's banker, the bankers' banker, and the manager of the national debt. In all these roles, the Bank was dealing in the markets where banks were operating. Through these transactions it acquired knowledge of people, financial state and business operations of banks, and also influenced their daily liquidity position. The third characteristic helping the establishment of the form and style of informal regulation can be found in the British tradition of specialist financial institutions. Regulating a homogeneous financial system is easier, especially if a clearly defined membership of a "club" imposes self-regulatory restrictions for its members.

It is not surprising then, that formal regulation in the U.K. financial system was developed relatively late, in the late 1970's. The regulatory system has been a mixture of statutory regulations, administered by governmental

agencies, and non-statutory regulations administered by self-regulations. Having had a long role of moral suasion, the Bank of England was given statutory responsibilities in 1979 for the supervision of deposit-taking institutions other than building societies.

What was the cause of the change? During the 1970's, and especially during the 1980's, the pressures for change from the informal self-regulatory system to a more legal regulatory arrangement became substantial.

In the 1970's, the changes in the operation and the structure of the financial system, the banking crisis of 1974, and the effort towards harmonization of banking within the EEC made it clear that the traditional British way of regulating the financial conduct was not enough anymore. This effect was reinforced in the 1980's by major structural change, especially in the securities industry, but more generally, as the old specialization within the financial system was undermined by the establishment of new national and international financial conglomerates.

"Regulation of financial conglomerates requires a different approach than when the financial system is based upon specialist subsets, as function and institution are no longer synonymous." (Llewellyn, 1989 p. 200.)

During the 1970's, the competitive environment intensified with the increasing number and range of banking institutions, new institutions developed making the banking system less cohesive and therefore more difficult to regulate with informal instruments. The inflow of foreign institutions, not familiar with the traditional informality of the British financial regulation and supervision, also restrained the maintenance of the old regulatory form. The progress of financial innovation, and the

development of new financial markets created more complex conditions in finance, and particularly in banking.

Banks became more profit oriented, therefore more competitive, and thus more aggressive for new diversified businesses. They simply rejected the traditional forms of banking behaviour. Llewellyn (Llewellyn, 1989) sees this change of atmosphere as the immediate cause of the major banking crisis of 1974, when several secondary banks and institutions collapsed. The lifting of the monetary policy constraints in 1971, and the releasing of banks from competitive restraints brought about a climate in which bank lending expanded at a very rapid pace. As in the nineteenth century's financial crises, this was the result of an overreaction from the part of the existing institutions to the massive number of new entrants and to the increase of new profitable lending opportunities. Obviously, this was the failure of an obsolete regulatory and supervisory arrangement.

With the recognition that a more formal and rigorous approach is necessary in the regulatory and supervisory framework because of the fundamentally transformed conditions of banking, the Bank of England was given the special supervisory function in 1974, and in 1979 the Banking Act was introduced. The Act, for the first time in British financial history, described unambiguously the authorization and supervision of all banks.

While on one hand intervention gradually increased during the 1980's, on the other hand, there was a pressure from the financial sector to loosen up these requirements by deregulation, to enable them to adjust to international market trends. There was a belief that in this newly developed international race for faster growth and bigger profit, the most constrained national

institutions would lose their financial intermediation role to those who were less regulated. This was reinforced by the fact that domestic banks faced a growing number of foreign competition, as endorsed by the fact that more than half of all banking institutions in the U.K. were foreign owned, and 59% of all bank assets were denominated in foreign currency in 1989. (Pavel and McElravay 1990, 5)

The concern of losing market share, however, proved to be faulty as the U.K. banking sector kept its leading role in the international market in the 1980's. Domestic banks held foreign banking assets of almost \$900 billions in 1987, up from more than \$400 billions in 1982. (Pavel and McElravay 1990, 4-5)

Domestically, too, commercial banks have performed well in the U.K. During the 1980's, when economic hardship hit most of the Western countries including the U.K., banks managed to achieve a higher than average (average is 9.4%) annual growth rate of assets. (ECC 1989b, 9) (see Chart 1, Appendix A) In addition, such indicators as the rate of return on assets generally point to a high level performance by U.K. banks compared to other countries. In the period of 1980-87, the average return on assets of U.K. banks was 0.8%, the largest among major banks of other countries. (ECC 1989b, 10) This performance is impressive even in light of the fact that U.K. banks can engage in profitable trust business. U.S. banks have the same power and they still lost market shares, and realized less return on assets.

Major evolution came about in the British financial regulatory scene with the Financial Services Act, in 1986. It is designed to guarantee that all parts of the finance industry will be under regulatory and supervisory control. The main target is investor protection. Therefore, it covers all forms of

investments and investment business. It requires anyone operating in the investment business to be authorized, thus automatically formally regulated. The structure of the regulation matrix has therefore changed: self-regulation has diminished. "The ultimate objective of the Act is the establishment of a comprehensive regulatory framework based on the government's legal power to authorize and regulate investment business." (Llewellyn, 1989, p. 209)

4.2.2 FINANCIAL REGULATION IN THE U.S.A.

The U.S. banking system is very different from its Canadian counterpart. While in Canada branch banking is the common structure of the industry, in the U.S., unit banking determines the structure for commercial banking. This difference originated, historically, from the different regulatory approach of the two countries toward depository institutions. Until 1980, U.S. banks were under geographical, product and rate control through the combined effects of the Pepper-McFadden Act of 1927, and the Banking Act (or as it is commonly known the Glass-Steagall Act) of 1933. The former was intended to prevent national banks from getting too much power through geographical restriction which prohibited interstate banking. It created a fragmented industry with as many as 13,700 banks organized into approximately 10,000 corporate entities, 16,000 credit unions and 2,600 savings associations. (various sources) The Glass-Steagall Act was the result of the numerous bank failures in the Great Depression, when one-third of the banks in operation in 1929 failed. Its role was to stabilize banking and prevent failures by controlling excessive competition through rate and product

restrictions.

The industry with relatively free entry before, changed into a system of severely regulated entry, prices, and products. The most important constraints were the prohibition of explicit interest payments on demand deposits; Regulation Q, that controls time and savings deposits; and the separation of commercial and investment banking. The major objective of regulation was to promote the soundness of the system while providing safety to depositors. The Federal Deposit Insurance Corporation (FDIC) was created to insure deposits up to \$60,000. Commercial banks' investment activities were limited and widely separated from those of investment banks. Interest rate regulations included the prohibition of interest payment on demand deposits and ceilings on time and savings deposits. Each state could control branching within its borders helping the conditions for unit banking. This environment prevented the concentration of deposits geographically as well as institutionally.

Hence the U.S. banking structure today is characterized by a large number of commercial banks, 13,722 in all in 1987. Most of the banks, however, are very small; 70% of them have less than \$50 million in assets. Since \$50 million regarded as the minimum amount to achieve scale economies in the U.S. banking industry considering the market size, that means that close to 10,000 U.S. commercial banks fail to reap scale economies. These banks hold less than 16% of total bank deposits of the U.S.A., while the largest banks, which represent 2.5% of the numbers of banks, hold 55% of the deposits. (Heggstad & Shepherd 1986, 304 and Steiner & Teixeira 1990, 13)

The U.S.A. has a dual banking system, which involves federal and state

legislation. A commercial bank may hold a federal or a state charter. If it is the latter, the institution may choose to stay out of the Federal Reserve system. This decision determines its primary regulators. A bank's operational territory is limited to one state federally, unless the state specifically permits interstate branching. States may choose to allow a statewide branching system, or may select to restrict operation to a small geographic area within the state.

In the U.S.A., the present statutory separation of commercial and investment banking has been imposed since 1933, in the form of the Glass-Steagall Act. It limits banks' securities activities :

- 1/ Banks cannot deal in securities on their own behalf or underwrite any issue of securities other than obligations of the U.S. government.
- 2/ Banks cannot be affiliated with any corporation engaged in the underwriting or distribution of securities.
- 3/ The director or an employee of such a corporation cannot serve at the same time as a director or employee of a bank.
- 4/ Corporations engaged in the securities business are not allowed to engage in commercial banking business.

Federal Reserve member commercial banks cannot invest in corporate securities, in real estate not directly related to banking, or in non-financial businesses; neither can they sell or underwrite insurance. In some states, however, state-chartered savings banks and savings and loan associations can make such investments, and can even sell life insurance. U.S. banks can, however, escape these activity restraints in their foreign operations, through which they have become major players in the international securities

markets. "In other words, the Federal Reserve Board has found it necessary, for largely competitive reasons, to allow U.S. banks to do abroad what they cannot do at home, thereby bypassing activity constraints imposed by Glass-Steagall. This regulatory asymmetry between the domestic and foreign operations of U.S. banks has in turn raised doubts about the practicality, in an increasingly global marketplace, of national laws that seek to separate commercial and investment banking." (Dale 1989, 227)

Technological change and international pressures of the markets have led to some degree of deregulation in the U.S.A. since 1979. The first step was the Depository Institutions Deregulation and Monetary Control Act (DIDMCA) in 1980, which eliminated the interest rate ceilings on deposits, and allowed nationwide interest bearing negotiable order of withdrawal (NOW) accounts. The Garn-St.Germain Act of 1982 ensured the development of money-market deposit accounts, and most importantly, authorized interstate and interindustry emergency mergers, breaking with that the first hole in the barriers of separation. Geographical regulation has also been lifted in stages, and interstate branching will be allowed for most banks by 1995. All this deregulation resulted in an increase in competition. Since small banks are unable to keep pace with the major banks, merger activity has increased. The 35 largest banks raised their market share of the industry from 43% in 1980 to 49 % in 1988. (Steiner & Teixeira 1990, 12) The trend is very likely to continue, as the widespread use of securitization of financial assets will favour large players who can efficiently generate funds by pooling liabilities of different risk structure together decreasing their costs. The continuing growth of the necessary systems technology investments motivates banks to spread

their investments over a greater base, inevitably leading to even greater merger pressures.

Although many savings and loan associations (S&L) and other thrift institutions failed during the 1970's and 1980's in the U.S.A., commercial banks experienced very few failures until 1982, an average of six banks a year. Since 1982, however, bank failures have increased. Yet, deregulation does not appear to have played a leading role in this phenomena. The cause was mainly extensive risk-taking on the part of bank managers, due to the incentives of underpriced federal deposit insurance. The number of commercial banks dropped by 487 in the U.S.A. between 1986 and 1987, and the cause was primarily a large number of mergers rather than failures. (Steiner & Teixeira 1990, 13)

The latest U.S. Treasury proposal of 1991 for financial regulatory reform intends to restore the power of banks within the financial industry. The market share of commercial banks has constantly decreased since 1950, when it peaked at 52%. Between 1950 and 1980 this proportion dropped to 37% giving much of the lost power to S&L associations and pension funds. Despite the deregulatory atmosphere in the 1980's, the domestic market share of U.S. commercial banks declined further, to 32% in 1990. (Chicago Fed Letter, 1990) U.S. banks have also been losing ground internationally in terms of assets. The annual rates of growth of their assets between 1980 and 1987 was below the aggregate average of eight countries, and well behind the Italian, U.K., Japanese and Swiss banks. (ECC 1989b, 9) (See Chart 1, Appendix A) Even in their core business, short term corporate lending, banks' share slumped from nearly 80% in 1975 to about 55% in 1989. (Yang et. al. 1991, 73) U.S. banks'

profitability has been declining for two decades. In 1989, the return on equity of the ten largest U.S. financial companies was 12.7%, when banks earned only 0.4% on average. (Yang et. al. 1991, 73)

The combination of regulation and deposit insurance can be blamed for the poor bank performance. Banks have been prohibited from selling many popular financial products, such as mutual funds or insurance, that their nonbank rivals have been allowed to sell. To increase their shrinking profit, banks have invested deposits in high margin - high risk loans such as Third World loans and real estate developments. These bad loans resulted in very low earnings in 1990, and caused hundreds of bank failures which emptied FDIC funds and necessitated a \$70 billion government infusion from taxpayers' money.

The global integration of the world's banking markets has brought strong foreign competition to U.S. banks on the domestic wholesale market. Foreign banks can operate in the U.S. through branches when they are regulated by their home country's authorities, or through bank subsidiaries chartered in the U.S.A. when they are subject to the same regulation as U.S. banks. By 1988, foreign banks accounted for 28% of the wholesale banking business in the U.S.A., exceeding the level of foreign penetration of other mature industries. (Baer 1990, 22) The share of foreign banks in commercial and industrial lending rose from 8.6% in 1980 to 14.4% in 1988. All of this increase is caused by the penetration of U.S. branches of Japanese banks. (Baer 1990, 23) The reason for losing market share to foreign bank branches is the lax regulatory system in other countries compared to the U.S.A. Japanese banks, for instance, are permitted to hold up to a five percent interest in non-

banking firms, thus gaining easier access to capital.

All these events urge a reform in the U.S. banking industry as, without it, banks are in danger of slowly disappearing, and giving up more and more of their business to unregulated or lesser regulated firms. The proposal for regulatory reform suggests a new deposit insurance scheme to stop the abuse of that system. The plan is to eliminate the barriers between sectors of financial services; barriers that, according to many bank officials, pushed U.S. banks behind in size in international competition. By allowing greater ownership links between financial and commercial firms, the proposal assumes greater access to capital. The advantage of a single financial market is recognized by the suggested modification of inter-state banking laws.

4.2.3 THE SEPARATION ISSUE IN JAPAN

Before World War II, Japanese banks had no legal restriction which separated banking from securities activities. In 1948, however, the U.S. as occupying power, sponsored the Securities and Exchange Act. In it, Article 65, which is based on the U.S. Glass-Steagall Act, prohibits banks from underwriting corporate securities. This distinction between commercial and investment banking presently still prevails in Japan, though, it is under pressures from both domestic and international financial participants.

In the 1970's Japan entered the international financial scene, and since then its market share has grown substantially. Today, Japanese banks compete with U.S. firms for the second place in international business, behind the U.K. Yet, domestically, with the widespread securitization process, banks

have lost a substantial share in the credit market as non-financial companies have increasingly relied on direct financing. In the early 1970's banks provided over 80% of all domestic credit in Japan, but by 1984 their share fell to below 60%. Intermediated financing of the corporate sector halved from 85% to only 43% in the same period. (Dale 1989, 230) In Japan, high concentration characterizes the banking sector: of the total 87 commercial banks, 13 so called city banks control 56% of assets.

Banks are trying to regain their lost power domestically by challenging the domestic securities houses in three areas. First, banks are seeking to handle secondary market dealings in foreign bonds in contrast to the current situation, in which they can only deal in domestic public bonds. Second, banks want equal rights to handle commercial paper business. In 1986, overseas securities subsidiaries of Japanese banks were allowed to underwrite and deal in commercial paper issues abroad, although this authorization was denied to foreign branches of Japanese banks. The third sphere of the banks' offence is against the monopoly position of the securities industry in discount brokerage. They argue that brokerage services would be permitted under Article 65 on an agency basis only, as had been arranged in the U.S.A.

The real pressure for a change of regulation comes from the internationalization of banking and securities markets. In this environment, it is increasingly difficult to maintain the separation of the two functions, as Japanese banks can combine these two activities in a third country, and as foreign institutions originating from the universal banking system are participating on Japanese markets. Japanese banks are claiming that if foreign banks are allowed to operate securities business in Japan through their

securities affiliates, they themselves should be permitted to do the same in the domestic market through their own securities subsidiaries abroad. Otherwise foreign banks gain a competitive advantage over Japanese banks both within Japan and internationally. The functional separation of the Japanese financial institutions is also undermined when operating abroad where there is no activity restriction. On a reciprocity basis, therefore, Japanese securities firms can obtain banking licences in countries of universal banking.

Banks' securities activities abroad are limited to locations where the bank has no banking branch. The original reason for this restriction was to strengthen the overseas operations of Japanese security houses. Having achieved this goal, there is no reason anymore to continue this policy, and especially in an international financial environment where Japanese banks and securities firms are trying to undercut each other in third markets, accusing each other of predatory pricing.

The active participation of Japanese banks and securities firms in the globalized financial market, and a behind the scenes agreement of Japanese banks and securities houses to support each other's effort to expand the scope of their activities, has increased the pressure on domestic regulatory authorities to eliminate the legislation separating banking and securities operations. The new regulatory proposal rejects the move to universal banking, but opts to allow banks and securities firms to enter each others' business through overseas subsidiaries which are owned by the firm. "In other words the legal separation of banking and securities business would be eroded by a process of 'round tripping' with banks and securities firms

diversifying into each other's territory by routing business through their overseas operations." (Dale 1989, 233) The plan is to proceed gradually: first allowing the underwriting function to the major banks, but reserving stockbroking to securities houses. Insurance firms are also seeking entry to the securities sector.

In spite of the separation of banking and investment activities, Japanese banks have performed very well during the 1980's. The average annual growth rate of Japanese banks' assets was about 12%, well above the 9.4% average among eight industrialized countries between 1980-87. (See Chart 1, Appendix A) In 1986 and 87, the world's largest bank based on asset size was the Japanese Dai-Ichi Kangyo city bank. (ECC 1989a, 77)

One fact that has made quite an impression in international financial circles is the aggressive marketing attitude of the Japanese banks. These institutions are willing to enter new geographical and product markets, subject to future gains, even if initial profit margins are minimal or less. Indeed, according to measures of bank performance between 1980-87, Japanese banks had the least gross earnings margins, well below the combined average of U.K., U.S., Canadian, and Japanese banks, and less than the Canadian banks. The return on assets was also below average and, at about 0.5%, the same as Canadian banks'. (ECC 1989b, 10) This is explained by the motivation of Japanese shareholders whose priority is the staying power of their bank. No other competitor in the international market is as determined to increase market share as the Japanese institutions "whose shareholders are willing to accept lower profits to gain market share." (ECC 1989a, 76)

4.2.4 BANKING REGULATION IN EUROPE

In shaping the EC financial markets for 1992, a fundamental debate has arisen about the Anglo-Saxon versus universal banking structure and their coexistence within the EC.

Universal banking, as it is practised in Germany, has been traditionally symbolised by the ability of all financial services (now including insurance), to be carried out by one firm, and by the close relationship between banks and commercial companies. The second aspect is not necessarily part of the universal meaning, it is rather a unique German characteristic.

As Germany has seemed to ignore the self-dealing problem and allowed the combination of underwriting and banking, there is concern about the concentration of economic power that universal banking presents. The six largest banks of the 169 commercial banks in Germany control 47% of total assets. While on one hand, universal banking has its advantages, on the other hand, it can pose the problems that make the separation of banking and securities business justifiable, and in particular, the under-development of the German equity markets due to the absence of open markets. Without an active market, banks have taken equity stakes directly into the client company. This, and the strong regulation of the German securities industry can present real barriers to globalization for the German financial services industry, despite the fact that banks have made inroads in the international market.

The country with the longest international financial reputation is Switzerland, which has been on the international scene since the 17th

century. The lack of regulation and restrictions on domestic and international finance ensured a prospering universal banking industry. Coupled with the banking secrecy laws, universal banking made Switzerland an attractive source of capital funds.

The banking industry in Switzerland has become very concentrated with 5 "Grossbanken" controlling 50% of assets. Relative to the size of the economy in which they operate, the largest bank in Switzerland (Union Bank of Switzerland) has the highest assets to GDP ratio (0.734) among the largest banks of fourteen industrialized countries. The performance of Swiss banks has been impressive, and in the period of 1980-87 their average annual asset growth was above the combined average of eight industrialized countries. (ECC 1989a, 76-78) (See Chart 1, Appendix A)

The Swiss securities industry has the same problem as the German securities sector. The Swiss tax laws and the reluctance of the banks to compete internationally in the securities market have resulted in the Swiss securities industry losing its edge.

4.3 THE NEED FOR INTERNATIONAL COORDINATION

As long as banking markets were bounded within national frontiers, there was no need for international regulatory coordination. From the 1960's, as changing technology enabled funds to be transferred at minimal cost between countries, and as a rising number of foreign financial institutions broke into national financial markets, banking became increasingly global in

its scope and organization. This global context is forcing reforms everywhere, towards more open financial structures, widening the access of firms to markets, and breaking down the barriers between markets. There is, however no global rule book; and competing interests collide in competing markets with competing participants controlled and supervised by competing sets of regulators.

New financial innovations can also have a contradictory effect on regulations: they tend to reduce regulatory constraints. Technology has also had a powerful impact on the deregulation process; the application of new technologies widens business and geographical boundaries of financial institutions. Technology accelerates the internationalization of financial systems, thus making their integration necessary. Hence, the fast technological improvement of the 1980's contributed to the trend of similar regulatory systems between countries. If regulations are different in certain countries, opportunity opens to institutions to operate abroad in areas restricted in their home country but not in the host country, encouraging the already considerable international competition. As competition intensifies, financial institutions are induced to take more risks. To avoid unnecessary risks, risk averse firms will gradually shift their operations outside the restricted area and stay within their familiar activities where their expertise lays. They can be competed away on the international field, bringing the realization for a necessary regulatory change to authorities in the home country. Powerful international competitive pressures, thus, can react to national policies forcing structural changes on the restricted system, by activating deregulatory effects. Basically, this phenomenon set in motion the

series of recent regulatory reforms in financial systems where the separation issue had been maintained.

Structural change in the financial system puts pressure on regulatory arrangements. The trend towards business diversification and financial conglomerates requires that regulations must be based either upon institutional or functional criteria as the two are no longer synonymous. In addition to structural changes, the fast pace of financial innovation has created new instruments with different risk characteristics not known before. Many of these risks are yet to be identified and measured. They are the "defensive innovations", created specifically to avoid regulatory constraints. The reaction of regulators has been obvious: they have tried to cover them with the extension of requirements.

The regulatory environment changed substantially in the early 1980's, trying to exploit the advantages of competition on one hand, allowing financial institutions to widen their range of services. On the other hand, to assure adequate protection to investors, a more interventionist era developed, with precise regulation of different financial activities. The number of regulatory and supervisory agencies everywhere increased significantly compared to the 1960's. Their regulatory discipline was based upon functional rather than institutional criteria because of the growing confusion and overlapping among the different types of financial institutions. There were no more clear cut distinctions between institutions.

A growing number of economists, who believe that banks are unique in the financial markets as providers of credit, payments services, and liquid assets, support bank regulation and public subsidies to rescue insolvent banks.

Due to the banks' dominant position in the economy, widespread bank failures can turn a normal business cycle into a slump, causing a major depression. Financial uncertainty generates contagious bank failures across countries because private investors are unable to distinguish between solvent and insolvent firms, causing runs on all banks in the absence of reliable information. According to this theory, bank regulation is necessary to prevent this crisis within a country, and the coordination of different countries' banking regulation is important to suppress the possibility of an unhealthy balance between countries.

The internationalization of banking poses the danger that uncoordinated national regulatory arrangements can encourage banks to enter more permissive financial markets. There is also the problem of giving institutions an equal chance for fair competition through regulatory devices. The setting of comparable regulatory standards and a supervisory mechanism that enables regulators to look at banks' international operations are necessary to establish an efficient international financial market. From the public's point of view, regulators could provide more information to the marketplace.

Yet, there are doubts about the efficiency of international regulation. The argument against is based on the view that depositors are informed enough to be able to distinguish an individual bank crisis or a crisis in the banking system as a whole. Thus, the stability of the international banking system is not in danger from bank runs with or without regulation, while the cost of regulation and supervision is very expensive for taxpayers. Authorities in many countries, however, find that "accepting the inefficiencies of international regulation is preferable to no international

regulation at all." (Weisbrod 1988, 352) It should be recognized, however, that depending on the cause and the magnitude of a crisis, an individual bank failure can endanger the whole system because of two very important factors. First, the widespread linkages among banks can lead to a "domino effect" in the whole industry. Second, even a single bank failure creates a general feeling of uncertainty, thus unsettling the situation.

Financial regulation, in most countries, has three main goals: the safety of the system; consumer protection; and efficiency in financial market. These three regulatory aims are interdependent, and can be counterproductive: if too much competition is allowed to achieve a higher level of efficiency, then system stability is in danger. On the other hand, extensive regulation may reduce competition, increasing therefore the costs for consumers and realizing extra profit for firms, thus reducing market efficiency. The three goals are not equally emphasized in the different segments of the industry. In banking, where the public's deposits are concentrated and where the government's monetary policy is centred, the safety and the soundness of the system and the prevention of runs are the most important. Securities and insurance regulators give more emphasis to the business conduct rules. With the emerging structural change in the financial services industry, regulatory authorities have to learn to work together and adjust to the new financial environment. However, the sets of different regulators are competing with each other, representing various group interests.

There is no global framework for regulation, but there are global issues emerging in the international regulatory reform process.

1./ Activities allowed across financial sectors. The focus has historically been

on the separation of banking and securities activities. The globalization of financial markets has called for changes in the U.S. Glass-Steagall Act, in Japan's Article 65, and in Canada's Bank Act. With the establishment of financial conglomerates and closer financial-commercial links, there is a tendency of shifting towards universal banking. The regulatory question now is how these conglomerates should be structured (through holding companies in Canada and the U.S.A.), and whether firms should be regulated by function or by institution as the two are not the same anymore.

- 2./ Capital requirements. It is very likely that common capital standards will remain as the first step of a more common international regulatory framework. There are two long term concerns included in this issue: first, to ensure that the costs of capital do not provide advantages or disadvantages to different groups of institutions; second, to ensure efficient allocation of bank credit among different risk categories on a risk-based capital system.
- 3./ Access to relatively closed national markets, especially Japanese and Less Developed Countries' markets.
- 4./ Coordination of regulatory authorities. The division of regulatory and supervisory responsibilities between the host and the home country remains a global issue, especially to avoid multiplicity.
- 5./ Future structure of international equity trading with new technology. It is a possibility that stock exchanges will be based totally on computer centres with no particular geographic centre at all, although this implies increasing difficulty for regulatory control.

- 6./ Financial-commercial links. While in Europe banks have been able to buy increasing amount of shares in non-financial companies, in the U.S.A. and in Canada this has been prohibited. In the regulatory reform both countries' authorities suggest the implementation of a closer link between non-financial and financial firms, to inject more capital into the banking sector.
- 7./ Consumer protection. While this is a basic goal of regulation, different rules of business conduct should apply according to the type of the investor.
- 8./ International accounting standards. Attempts to impose international standards must be endorsed by universal accounting rules.

These common issues show how interdependent financial markets have become. International cooperation is a means to reduce the potential for instability in international financial markets, and to improve the effectiveness of macroeconomic policy. Coordination of supervision and information exchange can even out the ground rules to promote fair competition. In 1989, the ECC, however, approached the question cautiously:

"The coordination of supervision and regulation may improve the efficiency of the international financial system - by contributing to its stability, for example - provided, however, that nations avoid 'coordination at any cost'. The adoption of standards at the level of the lowest common denominator could seriously impair the financial system's stability. It is in the ultimate interests of all nations to ensure the best form of coordinated supervision and regulation." (ECC Report 1989a, 105)

4.4 SUMMARY

This chapter discussed different regulatory frameworks of the financial services industry in various countries. It was found that different countries reacted in different ways to changes of the financial markets. Germany has not changed its policy on the principle of separation, while the U.S. and Japan authorities are under constant pressure for regulatory change. In the U.K., where the traditional informal, nonlegislative, and flexible approach to regulation has been overtaken by formal regulatory devices, a shift has occurred toward more financial integration. The pressing question is the harmonization of the different national approaches to financial regulation. The participation of institutions in global financial markets, subject to differing regulatory regimes, creates institutional anomalies and competitive tensions.

economic consequences of the question are introduced through the U.S.

CHAPTER FIVE

THE ROLE OF TECHNOLOGY IN FINANCIAL INTERMEDIATION

5.1 INTRODUCTION

No other industry has changed technologically as much in the last two decades as the financial services industry. The fundamental shift from paper based operation to computer based technique has also caused changes in economic terms. Services have become faster and cheaper, information acquisition has improved in accuracy and in speed, and innovation has developed new financial products. Consequently, the demand for financial services has shifted as consumers have learned the new products and as they have adapted to new market conditions.

This chapter examines the effect of technological improvement on the financial services industry in terms of changing supply and demand. The economic consequences of the question are introduced through the U.S. and Canadian banking sector. Since U.S. financial institutions have been leading the technological revolution in banking, it is useful to discuss the U.S. situation from a Canadian perspective. This section is followed by a discussion of innovation in the financial sector. Innovation is very important in this industry since it has served as a means of overriding regulations. The internationalization of financial markets is a result of improved technology, therefore it is appropriate to elaborate its elements in this part of the thesis.

5.2 ECONOMICS OF TECHNOLOGICAL CHANGE

The evolution of technology in the banking industry and in telecommunication has eliminated most of paper work. It has also accelerated services due to faster data processing and information acquisition. Modern technology is, however, expensive. The total production cost of banking services is higher than it was with traditional instruments, although the unit cost has decreased through increased productivity. The capacity of the supply of banking services has risen considerably and implies the significance of economies of scale.

New technology has also had its effect on the demand for banking services. Consumer preferences have shifted parallel with the new opportunities of modern technology.

5.2.1 SUPPLY OF BANKING SERVICES

Technological changes in office automation and electronic payment systems was, no doubt, a major factor behind the new face of banking activity. Beginning in the mid-1970's and continuing through the 1980's, personal information acquisition and data processing was replaced by a more reliable method of automation.

The implementation of modern technology is very resource demanding. Institutions must carefully consider the timing and the magnitude of their investments in new improved machinery and equipment. If installed too soon, technology can tie up money in terms of

capital expenditures. The amount of the waste of resources that results from such decisions can be very large. They are large in financial and operating terms. On the other hand, lagging behind in technology can cost dearly to the financial institutions in lost market shares and profits, and probably most importantly, in terms of opportunity costs.

Thus, investment decisions in technology have become priorities in the financial services industry. Between 1967 and 1987, equipment spending increased more than twenty fold in Canada, considerably accelerating after 1975. (Handfield-Jones and Glorieux 1988, 1) While total capital expenditure reached close to five times the 1977 level in 1987, spending on equipment multiplied six times in the same period, attaining 17% of total capital expenditure from 14.2% in 1977. (Table 2)

Table 2

CANADIAN FINANCIAL SERVICES INDUSTRY CAPITAL EXPENDITURE

	(1967 - 1987)		
	(\$ millions)		
	<u>1967</u>	<u>1977</u>	<u>1987</u>
Construction	390	1,504	7,194
Machinery & equipment	69	249	1,488
Total	459	1,753	8,682

Source: Handfield-Jones, S. & Glorieux, G. "Adjusting to New Market Realities". Conference Board of Canada Report 31-88, 1988, p.1.

The automation of bank labor increased the noninterest operating cost

devoted to system technology ("system intensiveness") from about 5-10 % ten years ago to 15-20 % of banks' total costs. The expenditure on technology has not shown any tendency to decrease in recent years, although banks have tried to control total cost. Two of the "Big Five" banks in Canada, the Toronto Dominion (TD) Bank and the Bank of Montreal, each spent close to 20 % of their total non-interest expenses for equipment and premises in the last five years. This is the second largest share in the total cost after salaries in the TD bank and has increased by 162.2 % since 1986. (Table 3) In the case of the Bank of Montreal, computer costs represent a high share in the 'premises and equipment' expense, and except for the year of 1989, they have increased in the last five years by 28.1 per cent. (Bank of Montreal Annual Report 1990, 29)

Table 3

TD BANK NON-INTEREST EXPENSES, 1986-1990

<u>Year</u>	<u>Total</u> (mill. \$)	<u>% increase</u>	<u>Premises and equipment</u> (mill.\$)	<u>% increase</u>
1986	988.4	9.2	196.1	n.a.
1987	1,110.3	12.3	215.1	9.7
1988	1,274.3	14.8	246.0	14.4
1989	1,473.2	15.6	283.6	15.3
1990	1591.2	8.0	318.0	12.1

Source: The TD Bank, 135th Annual Report 1990, p.39.

Banking has become a highly automated business that starts to show

the signs of a mature industry with high productivity. This high productivity has been achieved through the implementation of an ever improving electronic network. In the U.S.A., the industry has about 30 times more systems power available than ten years ago. "Yet, banking is not a new industry; it is not experiencing tremendously high growth in the primary demand for its services. Rather, these systems expenditures represent a fundamental change in the way that banking services are being produced and delivered." (Steiner and Teixeira 1990, xii)

The use of new technology, however, has significantly increased fixed costs. In addition, automated teller machines have gained widespread acceptance among customers. The number of automated teller machines in Canada reached 4,526 at the end of January 1987, or a ratio of one machine for every 5,713 inhabitants, a rate that corresponds to the situation in other industrialized countries. (Handfield-Jones and Glorieux, 1988, 3) In 1990, the Bank of Montreal increased the number of its automated banking machines by nearly 25% to a total of 1,163. (Bank of Montreal Annual Report 1990, 1) The "any branch banking" facility, the newly recognized problem of scale economies, and the increased fixed costs still added to the pressure for consolidation in the retail network of Canadian deposit taking institutions. All these effects have resulted in a significant net decrease in the number of branches in recent years. The TD Bank, for instance, reduced its number of branches and sub branches by 6% in the last five years from 964 in 1986 to 908 in 1990. (TD Bank Annual Report 1990, 1)

As fixed costs rose, banks have become more concerned about the volume of their output. The competition for market shares has intensified.

The transformative effects of system technology affected more the U.S. banking industry as it is different in structure than its Canadian counterpart. Based on its individual unit banks, the industry was forced to restructure. Small banks could not afford to keep up with the rate of change of the large banks; their non-interest expense is less than that of large banks.

Large banks increased their non-interest expense at a rate of 14% per year between 1980 and 1988, whereas the small banks expanded theirs less than half of that, at 6.6%, hardly enough to cover inflation. "Non-interest expenses represent control of the industry's vital resources. In turn, control of resources creates opportunities that are no longer rigidly controlled and evenly spread among players. The large banks have rapidly increased their consumption of the people, the facilities, and, especially, the technology that produce banking products and services." (Steiner and Teixeira 1990, 18) This tendency resulted in more industry concentration with a reduced number of banks but with growing power of the remaining banks. Large U.S. banks have substantially increased their domestic market share in banking in the past decade.

As automation has become dominant in the banking industry, spending on systems technology has given the leading edge to many banks. Recognizing the importance of this factor, banks have increased their systems expenses more dramatically than their non-interest expenses as a whole. Large banks led the way again in the U.S.A. with a 20.3% compound annual growth rate between 1980 and 1988, while small banks trailed after them with only 6.7%. The spending on system technology grew from 10% of non-interest expense in 1980 to 15.2% in 1988 and is predicted to reach 20% by 1995. (Steiner

& Teixeira 1990, 21)

The general use of technology to process information has continually gotten more cost-effective as productivity has increased. It has led to a substantial reduction in the unit cost of managing complex financial transactions. The question remains, however, whether this technical improvement has also caused a change in marginal productivity. It is a possibility that marginal productivity, having reached its maximum in the mid-1980's, has started to show diminishing returns, and the recent decrease of employment in the financial sector in the U.S.A. and in Canada is a sign of this change. Modern technology has also encouraged the introduction of more "system dependent" products. Products that are more efficient through technology and contain enormous increases in value. The difficulty with these products is to trace specific cost factors as they are part of a complex system.

Systems technology generally implies certain perspectives of economies of scale. While the paper based banking operation had little to do with scale economies, highly automated lines of business can operate more efficiently on large scale. It is relative efficiency that dictates the survivors and not absolute efficiency anymore. Higher productivity combined with large scale output can support fewer competitors. In Canada, where competition is among large financial institutions, that will mean a further decrease in the number of branches and a consolidation in the line of business. Scale economies will cause a change in the competitive structure of the U.S. banking system reducing the number of competitors to a relatively few banks in certain business lines. Since banking has become a highly disintegrated

business with about 150 different lines of business, competition is focused on a line of business basis with banks selecting the most appropriate products and market services according to their skills, customer base, location, related businesses and other factors.

The restructuring of the banking industry due to the key role of technology and regulatory changes induced the working of economic and competitive forces. Its process caused the operational transformation of banking through the implementation of system technology.

Steiner and Teixeira (Steiner & Teixeira, 1990) distinguish three chronological phases of the operational transformation from paper to electronics. The first stage happens in the back office. It involves mostly comptroller duties and bookkeeping. In the second phase of automation, customers are aware of changes since it occurs in the front office, although, they are not actively involved in it. This period develops the wide-spread use of terminals for data and information processing. The last step of the evolution is when automation gets into the direct customer interface, and that is when the economics of the operation change. The question of "how" to do banking becomes a question of "what" new products to offer through information technology.

Although, it seems that different banks offer different services, extensive product differentiation does not characterize today's market. More than 90% of transactions is movement of funds that can be complicated but is relatively mechanical, and is not the source of competitive differentiation in a bank product. Only about 10% of the industry's system expense is spent on functions that are even potentially distinctive. The real value added is in the

marketing and distribution of the innovated retail products.

The Canadian experience in innovation during the 1970's and 1980's was the result of market factors, such as competition, technological change, and high interest rates, as opposed to the kind of innovation related to deregulation that had occurred in the U.S.A. and elsewhere. In Canada, no prohibition has ever existed on financial institutions paying interest on personal or chequing accounts. In 1979, banks followed the lead of near-banks, and introduced the daily interest savings accounts, which could not be used as a transaction account. It was inevitable then, that there would be created a product that combines the features of both the daily interest savings account and the personal chequing account. Following again the examples of near-banks, competitive pressures led to a gradual spread of this account among banks in 1982.

On the corporate side, new technology permitted by widespread computerization in the banking industry brought the cash management package as a financial product to large companies, and therefore, an important product.

As institutions are becoming larger, they also restructure their business mix entering into the higher yielding consumer loan services instead of the corporate loans. Banks also concentrate on more fee-based business to cover increasing systems expense.

"Are commercial banks unique in financial markets, as they have been considered for the past two hundred years, or are they simply another alternative provider of financial services, which should not have the regulatory attention they currently receive?" (Heggstad and Shepherd 1986, 303) The question is very relevant today, when financial institutions are

difficult to tell apart. Characteristic activities are substituted by a wider range of functions in all institutions homogenizing, therefore, the supply of services.

Historically, banking was a highly integrated business, reinforced and protected by regulation. This public policy secured attractive profit to banks. With technological improvement, with the increasingly easier and cheaper transmission of information caused by technology, near-banks entered the province of the banks, without the banks' regulatory restrictions. Today, financial institutions, as other mature industries that separate their functions and selectively focus on areas with distinctive effectiveness, compete on a disaggregated basis. Technology provides the stage for disaggregation. Yet, competition is not the technology itself, but the application of it. Thus, a more flexible and diversified financial services industry has emerged.

Technology changes industry structure. As fixed costs and minimum efficient scale increase, concentration grows. During the transition period overcapacity can occur decreasing prices, and therefore destroying profit. To avoid that, it is safe to state that the best policy for institutions is to be a fast follower and use appropriate technology rather than to fight for technological leadership.

5.2.2 DEMAND FOR BANKING SERVICES

New technology has also changed the demand for banking services. The change, however, has not primarily been quantitative as the demand for transactions is limited by economic growth. It has rather been a shift in

consumer tastes. Tastes, that having adapted quickly to the new financial environment, have even amplified the demand for new products.

An important feature of changing consumer preferences towards financial services has been the widespread use of securitization. That means, on one hand, the growing importance of direct financing or market intermediation from the corporate side. Internationally, almost 80% of the funds were raised on the securities markets in 1988, a substantial shift from the more than 50% bank loan financing in 1982. (ECC 1989b, 4) On the other hand, securitization represents the increasing utilization of repackaging mortgage, credit-card, or car loans into securities pools through the issuance of asset backed securities. In terms of corporate securities, the bond market grew much faster between the mid-1970's and 1980's than the overall economy in a number of countries. This shift was stimulated by the development of innovative products, and the globalization of financial markets. In the U.S.A., the removal of the interest rate ceiling of banks added to this phenomenon. With bank loan rates moving freely, raising funds through securities has become less costly for corporations than to turn to bank loans.

Another sign of changing consumer preferences is the growing volume of asset backed securitization, especially in the U.S.A., but it has started to spread in other countries as well. Securitization has been a product of innovation, but it reflects a shift in the demand for investment opportunities. A rising number of ultimate savers is willing to hold a pool of mortgage and other bank loans in the form of securities that have higher yield than deposit accounts. Investors are more sophisticated, and through

modern telecommunication, are more informed of risks attached to these forms of investments.

As interest rates have risen, people have economized on balances kept in low interest bearing bank accounts. This has made the means of meeting customers' convenience needs more expensive for banks. The response on the consumers' part has been an expansion in the demand for credit cards, telephone transfer and bill paying services, automated teller machines, and other cost efficient electronic devices. Today, there is no big bank that can exist without some kind of affiliation with a credit card network.

In Canada, demand has shown variations in the last two decades with the changing socioeconomic environment. As real output nearly doubled in Canada between 1967 and 1987, real income per capita rose almost 90 %. (Handfield-Jones & Glorieux 1988, 5) The growth of real income, together with more sophisticated investors, led to an increase in the demand for new financial services. Financial institutions responded to these new demands with renewed innovative forces supported by modern technology that greatly improved the way these services are offered.

The question evidently arises. What kind of financial services will be demanded in the future? The most significant element of determining future demand for financial services, as it has been in the past, is the state of the economy. One conclusion can be drawn from the past: in the tradeoff between yield and nonprice considerations, depositors and investors will increasingly express a preference for yield. Increasing and volatile inflation and volatile interest rates will result in a strong preference for liquidity. For cost saving considerations, it is very likely that retail electronic devices will become even

more popular, and the demand to expand services through them will increase.

5.3 FINANCIAL INNOVATION

Changing conditions in any industry open new opportunities for suppliers to introduce innovative products that are attuned to the new needs of their customers. In the financial services industry, with the emergence of high level computer and telecommunication technology, innovation has also transformed the traditional way these needs are met. In addition, innovation has been a means for heavily controlled and supervised financial institutions to evade regulation and be able to compete with less regulated firms.

"The development of new financial instruments and practices has opened up many opportunities for participants in financial markets, both in the raising of funds and in the management of risks; it has also changed the kinds of risks faced by financial institutions, and it has important consequences for the regulation of financial markets." (ECC Report 1989a, 2)

Financial innovation has also helped multinational firms increase their power by engaging in financial activities, despite the fact that most of them primarily are not financial firms. They possess huge resources, sometimes beyond the budget of several nations, that provide them the power necessary to override national rules as no effective international control exists yet. With the use of innovative products many multinational

firms could transfer funds internationally, evading tax payments.

Since the mid-1970's, many financial instruments and practices have been introduced by financial institutions. They can be categorized into three groups according to their principal role:

- Market broadening instruments which give borrowers access to new sources of funds.
- Risk management instruments which provide the means for both financial institutions and their customers to be able to handle risks due to operating in a globalized market.
- Market arbitraging instruments which facilitate arbitrage between markets, enabling borrowers to raise funds in markets to which they might otherwise not have access. This instrument has played an important role in the internationalization of financial markets.

Most of the new instruments were developed and introduced in the U.S.A. The spread of these instruments in other countries has largely contributed to the recent phenomenon of securitization on the international field.

Market-broadening instruments include note-issuance facilities and other underwritten instruments, Euro-commercial paper and floating-rate notes that are alternatives of bank loans on international markets, and asset-backed securities that provide liquidity to customized financial contracts, like residential mortgages. In spite of being active on international markets, Canadian corporations have not used these instruments extensively. In the mid 1980's, Canadian borrowers accounted for 4% of the traditional instruments on the international markets, but for only 2.6% of Euro-

commercial-paper issues. (ECC Report 1989a, 34) This fact may reflect a lack of knowledge, but it also can mean that financial needs were adequately satisfied through the traditional instruments.

Another form of securitization, the asset-backed securities, involves the pooling of mortgage, personal and commercial loans into a security issue. This instrument could revolutionize the Canadian financial system, but so far, it is not well known and understood. Even though asset-backed securities have been allowed since 1973, their diffusion in the Canadian market originates only from the late 1980's.

Risk management instruments, like forward, futures, and option contracts, were developed to provide tools to manage risks. In Canada, the over-the-counter forward markets for interest rates and foreign exchange rates are active and well run by the chartered banks. Forward contracts are more preferable to corporations because of their ease of understanding, their certainty, and their more availability. They are also considered cheaper instruments than the options and futures contracts.

Market arbitraging instruments and processes permit arbitrage between different markets. Through arbitrage, these instruments also broaden markets and support the management of risks. The basic idea behind arbitrage is that participants can take advantage of price differences between markets in order to make profit.

The most employed instrument is the swap, that is, an exchange of assets, or an exchange of flows of payments related to assets or liabilities between two parties. It serves each party's interests by providing access to a particular market at better terms than the other. The gained advantages are

then shared by both parties.

Many Canadian companies use swaps during their borrowings in foreign currencies. The foreign currencies are immediately swapped back into Canadian dollars to avoid currency exposure and the risks with it. Banks, especially Schedule B banks, are maintaining a very active market in Canadian- and U.S.-dollar swaps.

Many new instruments have been developed in response to specific problems, to satisfy specific needs. Canada has to select innovative instruments, the most effective to its economy and adapt them to its needs. "From Canada's point of view, two groups of instruments are of particular interest: asset-backed securities could inject much-needed liquidity in the mortgage and loan markets and bring much-needed funds to many regions of the country while allowing institutions to diversify; swaps could open new sources of funds for many Canadian borrowers, particularly in international and foreign markets." (ECC Report 1989a, 57)

It is true, that the increased use of these instruments may bring greater risks for participants. Regulators must face this problem, especially the loss of transparency of the financial system in connection of the use of such instruments. There is a danger that this loss of transparency hides important risk increasing interconnections among financial institutions unseen by regulators. However, since the instruments benefit both the users of financial services and the financial institutions, the spread of the use of these instruments will very likely intensify in the international financial markets, causing even more interconnections among individual markets, and requiring an appropriate regulatory framework.

5.4 THE GLOBALIZATION OF FINANCIAL MARKETS

Globalization can be defined in geographic terms as becoming worldwide in scope, and in theoretical terms as becoming universal. In the case of the financial services industry, both definitions are actual, and mean a reduction of barriers to allow free flow of capital and permit all institutions to compete in all markets geographically and functionally. In this thesis, however, the term is used to describe the changing (i.e. enlarging) of the scope of international financial relationships.

Modern technology has brought international integration as a new trend into the financial sphere. International lending and borrowing have increased dramatically, at about 15% annually since 1982, causing a rise in cross-border capital flows, and a substantial foreign penetration in domestic financial markets. The extent of the internationalization can be measured by the cross-border flows of funds. In 1988, funds raised on international bond markets were almost six times as high as in 1980. As Chart 2, Appendix B shows, this rate of increase was substantially higher than that of the domestic bond markets in Canada and the U.S.A. Not only has the volume of flows of funds changed, but so too have the kinds of instruments that have been used. The development of the new instruments of securitized forms of lending has caused a dramatic change in international financial operations, and in the competition between the banking and securities industries.

While prior to the 1960's, banks carried out international activities through correspondent banks in foreign countries, in the 1980's many of them have established a significant network of offshore institutions,

subsidiaries or branches. The increased international competition pressured banks to get a leading edge by creating such establishments, and therefore, to get better acquainted with local needs for successfully penetrating the market. In many countries, these establishments increased their share of the total assets of the domestic banking industry. (Table 4)

TABLE 4

NUMBER OF FOREIGN BANKS (A) OR BANKING OFFICES (B) AND THEIR RELATIVE IMPORTANCE IN SELECTED COUNTRIES, 1960-87

<u>Host country</u>	<u>1960</u>		<u>1980</u>		<u>1985</u>		<u>1987</u>	
	No.	%	No.	%	No.	%	No.	%
Canada (A)	-	-	-	-	57	6.3	58	8.9
Switzerland (A)	8	n.a.	99	11.1	119	12.2	n.a.	n.a.
U.K. (A)	51	6.7	214	55.6	293	62.6	368	61.6
Germany (B)	24	0.5	213	1.9	287	2.4	n.a.	1.9
Japan (B)	34	n.a.	85	3.4	112	3.6	n.a.	n.a.
U.S.A. (B)	n.a.	n.a.	579	8.7	783	12.0	691	12.8

(Relative importance is measured as a proportion of all banking assets.)

Source: ECC, Globalization and Canada's Financial Markets, 1989, pp.5-6.

Nearly half of all foreign banking assets and liabilities are held by banks in the U.K., U.S.A., Japan, and Switzerland. While this is an impressive statistic, it does not mean that each of these countries is truly international in scope. According to the share of foreign assets and liabilities in total banking

assets and liabilities, Switzerland, the U.K., and France can be viewed as internationally active, as roughly half of each country's total banking assets are foreign. In contrast, less than 25% of total banking assets and liabilities of German, Japanese, and U.S. banks are from foreign origin. (Pavel & McElravey 1990, 4-5)

A substantial portion of international banking activity occurs in unregulated offshore markets, commonly known as Euromarkets, which consist of Eurocurrency deposits, Eurobonds, and Euro-commercial paper. Eurocenters have developed mostly where regulation is favourable to offshore markets.

The incentive behind the recent increase in the use of international markets has been linked to two major factors. First, borrowers have been searching for the least costly funds, and for more access to borrowing opportunities. Secondly, there has been a growing desire by holders of wealth to diversify portfolios internationally to reduce risk, and to elude high covariation of returns on assets, which characterizes portfolios with domestic assets only. Thus, the inclusion of international assets in a portfolio helps to reduce risks originating from underlying domestic economic conditions.

The realization of these incentives has been facilitated by constant action-reaction type of changes in regulatory structures in many countries; by rising imbalances among nations and the consequent recycling of funds from surplus to deficit countries; and by the growing number of multinational corporations. The major contribution, however, has been provided by the revolutionary development of telecommunication and computer technology, which has permitted greater availability of information, the development of

innovative financial instruments, and the reduction in transactions costs.

Globalization is a dynamic component of today's financial systems; it is partly a result of structural changes and, at the same time, it can initiate more structural transformation by forcing regulatory changes. As financial services and their regulation are becoming more globally integrated, there is some skepticism concerning the forcing effects of globalization towards deregulation. Some argue that the international financial system is forcing national governments to adjust their policies to the economic objectives of globalization, or face financial threat in the form of capital flight. (Bienefeld, 1990) It is true that, with the present degree of internationalization, it is very questionable if a country can totally separate itself and its policies from those of the countries around it. Today, total economic sovereignty is not attainable, and is probably not even a public policy goal. It is more important for a country's economy that controlling authorities adapt their financial objectives to interacting economic principles, ensuring therefore, a financial system that is - even if it is not more stable - more acceptable to domestic and foreign institutions and customers, and which fits the domestic market into the interrelated international financial markets.

The theories opposing globalization also resist the positive effect of innovation charging that, in the deregulated sector, innovation allows increasingly risky lending through the loss of transparency. In this case innovations serve the purpose of hiding real risk characteristics of the different products by the various pooling, insuring and diversifying processes. According to these arguments the loss of transparency interrupts the efficient operation of the market because it creates instability in the financial system

induced by higher risks and because it does not allow prices to reflect real economic factors.

The two fundamental points of these arguments, thus, express doubts about the real effects of the internationalization of the financial markets, and those of the innovations on efficiency and system stability. It has also been debated that deregulation, or regulation by function, assists instability to spread geographically and functionally, as those barriers that potentially insulate markets disappear. With the internationalization of financial markets and the establishment of diversified financial conglomerates, the possibility that problems can extend from one country to another, and from one sector to another has increased substantially.

There can be no question that the process of globalization has dramatically transformed financial markets and their relationship, and that this has definitely brought some negative consequences. The question is, if whether the adverse consequences outweigh the favourable results of the process. It is true that globalization is an accelerating process that leads to increased uncertainty as national financial systems are becoming more and more interrelated. The advantages, however, are threefold, to consumers, banks and nations: consumers get faster and better services for lower prices as price competition prevails; banks get more freedom in financial activities as the market place broadens; and nations can take advantage of improved investment allocation.

The internationalization of financial services has direct production and income effects. The greater movement of capital provides financial institutions with opportunities for expansion and diversification.

Opportunities that can be expressed in higher risk-adjusted returns. But, at the same time, they face greater competition, which may force them to withdraw from some markets and specialize in services in which they have a comparative advantage. Internationalization lowers the cost of financial services to users as a result of increased competition and as the pool of available savings are larger. Competition, and the greater supply of funds also narrows the spreads between borrowing and lending rates, thus raising real incomes. Globalization helps savers and investors attain their liquidity and intertemporal consumption preferences.

The economy as a whole also benefits from internationalization as the allocation of savings and investment improves. While this means an increase in worldwide efficiency, it might have disturbing impact on income distribution in individual countries. Since the return on capital in countries with a relatively higher (lower) rate of return diminishes (increases) as a result of capital inflow (outflow), while the return on labour increases (decreases), there is a redistribution of income between the suppliers of capital and the suppliers of labour in both the capital exporting and the capital importing countries.

Globalization also influences the autonomy of monetary policy. While in the long run monetary policy is not affected, in the short run, internationalization weakens the impact of monetary policy on the real economy. The easier access to funds through international markets has resulted in less control of fiscal policy. In general, globalization facilitates international power moves, sometimes beyond national interests. It also accelerates the transmission effects of different countries' policies making

financial markets more sensitive to changes.

Do disadvantages or advantages dominate in the assessment of the globalization of financial services? From the view point of economics, greater efficiency, lower costs, and increased opportunities for portfolio management are definitely the benefits of globalization. The diseconomies originating from the globalization process can be controlled by improved supervision, and more efficient - but not necessarily less - regulation.

5.5 SUMMARY

This chapter has observed the changes in the financial services industry caused by the use of improved technology. Revolutionary developments in telecommunication and computer technologies have resulted in a shift in both supply and demand in the banking industry. This shift, however, has been mainly a qualitative transformation as total demand has not shown greater increase for services than permitted by underlying economic factors. Financial innovation has proved to be a means for institutions to evade regulatory control and to broaden operational activity in terms of both the product and geographic markets. As geographic and functional barriers have been eliminated, free capital flows have integrated financial systems into a globalized financial market with greater efficiency and competition, with faster and more cost effective services, and with improved allocation of savings and investment. These changes in the financial services industry have basically been facilitated by technological

development.

United States of America

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CHAPTER SIX

STRUCTURAL CHANGES IN FINANCIAL MARKETS

6.1 INTRODUCTION

The globalization of financial markets, together with technological and regulatory changes, have induced structural transformation in the Canadian financial services industry. The next section will elaborate the impact of this transformation on different segments of the industry. For the purpose of a general overview of the present situation in Canadian financial markets, and of the industry's place in the Canadian economy, first the domestic market will be examined. Emphasis will be put on the evaluation of domestic competition among institutions, especially on the performance of Canadian commercial banks as the main suppliers of financial services. The impact of foreign entry on the Canadian banking market will also be considered in this context.

In today's internationalized financial world, domestic markets do not give a complete picture of industry performance. It is necessary then, to discuss the role of Canadian banks in the international market, and to compare it with other nations' accomplishments. The final section will deal with the Canada-U.S. Free Trade Agreement, since it has been a major factor in shaping the financial systems of both countries in recent years.

6.2 CANADIAN INSTITUTIONS IN DOMESTIC MARKET

As a financially open country, Canada has not been immune from recent international changes. Existing institutions have changed their market strategies, new institutions entered various markets, and foreign entry into the banking sector has been facilitated. All these have caused shifts in powers and market shares.

6.2.1 THE IMPACT OF CHANGES ON THE INDUSTRY

Financial innovations and the globalization of the financial markets have increased the economic significance of the financial services industry. The growth of the industry is reflected by the rapid rise of funds channelled through financial institutions. In Canada, the financial intermediation ratio - the ratio of the assets of financial institutions to total financial assets in the economy - increased from less than 0.28 in 1961 to 0.38 in 1987. (ECC Report 1989a, 2) This tendency was especially strong in the period before the 1982 recession when intermediated financing was the dominant source of funds for the business sector. The factors behind the increasing use of intermediated borrowing was the rapid growth of deposits of the financial institutions which allowed them to offer attractive financing opportunities, while capital markets were adversely affected by the rising inflation.

In 1967, the total Canadian dollar assets held by financial intermediaries amounted to about \$73 billion, of which more than one third was accounted for by chartered banks. (Handfield-Jones & Glorieux 1988, 14)

TABLE 5
TOTAL ASSETS OF SELECTED CANADIAN FINANCIAL
INTERMEDIARIES, 1967-1990

(Average annual rates of growth are in parentheses)

	Value of assets (Millions of dollars)			
	<u>1967</u>	<u>1970</u>	<u>1980</u>	<u>1990 June</u>
Chartered banks (Schedule A)	25,340	33,158 (9.4%)	248,418 (22.3%)	403,676 (5.0%)
Life insurance companies	12,912	15,133 (5.4%)	50,023 (12.4%)	109,639 (8.2%)
Trust companies	4,353	6,564 (14.7%)	38,968 (19.5%)	125,459 (12.4%)
Mortgage loan companies	2,772	3,778 (10.9%)	16,075 (15.6%)	124,897 (22.8%)
Local credit unions & caisses populaires	3,368	4,570 (10.7%)	30,546 (20.9%)	70,158 (8.7%)
Total of selected inst.	48,745	63,203 (9.0%)	384,030 (19.8%)	833,829 (8.1%)

Source: Bank of Canada Review, various issues; Statistics Canada, Financial Institutions: Financial Statistics, Cat. 61-006, 1982 second quarter, 1990 third quarter.

The banks dominated the commercial credit market and supplied about half of the consumer credit, but their operations in the mortgage-lending and

corporate securities business were seriously constrained by regulation.

Life insurance companies were the second largest group, measured by the value of their assets of \$12.9 billion. (Table 5) Their principal investment was in mortgages. In 1967, Canadian life insurance companies, like the banks, were successful and internationally competitive, even though, British and U.S. firms played substantial role in the domestic market.

Trust and loan companies provided mainly mortgage lending services, and from their more than \$7 billion total assets, \$4.5 billion was in the mortgage business. (Handfield-Jones & Glorieux 1988, 14) Credit unions and caisses populaires were primarily consumer oriented, therefore their \$3.4 billion total assets included mostly consumer credit and mortgages. By assets holding, investment dealers do not represent a large group, nevertheless they play very important role in the financial system.

"In retrospect, the Canadian financial system in 1967 was, for its day, a successful, efficient, competitive and safe system. This was the era of the 'four pillars', although that familiar phrase does little justice to the role of institutions other than banks, trust companies, insurance companies and investment dealers. The separation of power and ownership was affirmed in legislation and regulation, and was also based on traditional, generally accepted roles." (Handfield-Jones & Glorieux 1988, 15)

The Canadian financial system has fundamentally changed since 1967. The total assets of financial institutions have risen faster than the country's GNP. Within the industry, the increased demand for intermediation in the 1970's, however, was not equally distributed, and the growth of different segments depended on the sectoral composition of the demand for funds and

on the relative division of powers granted by the regulators to the various types of financial institutions. (See Table 5)

The most dramatic change in the last more than two decades has been the shift in the origin of mortgage financing. After having gained the expanded power for general mortgage lending in 1967, banks emerged as major players in this area, and their holdings of mortgages are more than a third of total mortgages outstanding. (Table 6)

TABLE 6
MORTGAGE CREDIT OUTSTANDING IN CANADA, BY CATEGORY OF
LENDER, AMOUNT AND DISTRIBUTION, 1967-1990

	<u>1967</u>		<u>1990</u>	
	Mill.\$	%	Mill.\$	%
Chartered banks	1,093	6.2	110,168	38.6
Trust & loan companies	4,533	25.6	87,747	30.7
Credit unions & caisses populaires	1,039	5.9	34,630	12.2
Life insurance companies	5,787	32.7	40,054	14.0
Pension funds	724	4.1	8,550	3.0
Other financial inst.	4,527	25.5	4,062	1.5
Total	17,703	100.0	285,211	100.0

Source: Bank of Canada Review, various issues.

Their performance has been even better in the residential mortgage credit

market where banks had over 43% market share in 1990. Trust and mortgage loan companies held their position in mortgage financing mainly by acquiring substantial amounts of non-residential mortgages.

While in 1967 more than 51% and in 1981 close to 55% of the total borrowing by non-financial sectors was raised through intermediation, in 1982 there was a sharp turn towards direct financing, resulting in a close to 98% market share for the securities industry in total borrowing. (Handfield-Jones & Glorieux 1988, 12) This major shift from intermediated financing to securitization was partly associated with the progress in financial innovations across international capital markets which allowed the introduction of highly competitive instruments reducing the total cost of financing. By 1984, the huge imbalance between direct and indirect financing lessened, although, capital markets have remained ever since the main source of raising funds with about two times the amount of intermediated financing. Despite the increasing demand for securitization, the commercial credit market has grown steadily in the past twenty years. Banks have remained the major suppliers of that service with a share of about 70%, but other financial institutions, especially credit unions and caisses populaires, increased their presence in this activity.

The trust and loan companies faced regulatory prohibition of engaging in direct consumer or commercial lending which resulted in banks and credit unions increasing their common market share of the consumer credit business from 62% in 1967 to 80 % by 1986, with the banks leading the process by increasing their part from 47.4% in 1967 to 65.2% by 1986. (Bank of Canada Review, various)

All these shifts in the various sectors of the Canadian financial market have caused changes in relative power among institutions. (Table 7)

TABLE 7
SHARE OF TOTAL ASSETS AMONG FINANCIAL INSTITUTIONS IN
CANADA, 1967-1987

	Percentage		
	<u>1967</u>	<u>1981</u>	<u>1987</u>
Chartered banks	34.3	42.1	35.5
Trust & loan companies	9.6	11.0	11.7
Credit unions & caisses populaires	4.5	6.9	6.7
Life insurance companies	17.6	10.3	11.7
Pension funds	11.0	12.4	13.9
Other private and public	23.0	17.3	20.5
Total	100.0	100.0	100.0

Source: Handfield-Jones & Glorieux 1988, p.18; Statistic Canada, Financial Institutions: Financial Statistics, Cat.61-006, 1988 third quarter.

Banks have kept their leading position throughout the period, but they were not immune from the fundamental change in financing habits in 1982, and from consumer reluctance to increase their liabilities after the 1982 recession. The banks' closest competitors, the trust companies and credit unions, have increased their shares of assets. Life insurance companies lost ground due to a shift in demand towards newly developed pension funds.

In general, deposit-taking institutions have succeeded in overcoming the recessionary setback in the early 1980's, and have increased their share in the domestic market compared to 1967. It is obvious that these institutions have used technological innovation, regulatory change, and shifts in sectoral demand to their advantage. It is also clear that in the increasingly competitive environment, the cost-effective management of an institution has become a critical factor, and price competition has reflected the ability of adjustment. Trust companies and credit unions have used innovative methods to develop new savings instruments with greater flexibility of maturity terms, a smart step considering inflationary effects. Banks have taken advantage of their expanded power by increasing their share of the mortgage market. They have also offered services facilitated by the application of new technology.

The tendency for securitization in the 1980's caused an increase in direct financing. Today, about two thirds of total financing in Canada is arranged through securities issues. Canadians have traditionally made extensive use of foreign capital. The trend has continued and the volume of cross-border capital movements has dramatically increased with the internationalization of financial markets. Relative to the size of the economy, Canadian borrowers raise a significantly larger portion of their new funds on international markets than other industrialized countries, and the share has been growing since the 1960's. (See Chart 3, Appendix C) In 1986, Canadian borrowers raised US\$24 billion in foreign markets.

The more advantageous borrowing abroad has shifted not only the amount raised, but the location of issuance of Canadian securities and the currencies of their denomination. In the period 1963-70, 72.6% of all Canadian

bond issues were placed in Canada, 24.2% in the U.S.A., and only 3.2% was issued in other countries. This has changed in recent years, and the proportions are now 53.2%, 11.2% and 35.6% respectively. Federal crown corporations led the move to foreign markets in the 1970's followed by financial corporations. Almost two third of these institutions' issues between 1981 and 1987 were floated in countries other than Canada and the U.S.A. (ECC Report 1989a, 70)

The important reliance on foreign capital markets retarded the development of the securities industry in Canada. Because of comparative disadvantage, provincial regulatory authorities protected the industry by ownership restrictions and by limiting the ability of other institutions to deal in securities, but self-regulation within the industry has also been important in the context of insider trading and other conflict of interest concerns.

6.2.2 FINANCIAL INSTITUTIONS IN THE ECONOMY

Financial institutions are essential intermediaries between savers and borrowers, and with that service, they represent a fast growing service industry in the international economy. In many countries e.g. U.S.A., Japan, former West Germany and Canada, the assets of financial institutions and the bond market have grown faster than the GNP for at least 10 years. Households, corporations, and governments have increasingly used financial markets to satisfy their borrowing and investing needs, and financial assets have been traded more often.

The behaviour of borrowers and investors, however, has changed over

the past decades and resulted in a reduction in banks' assets share and an increase in bond issues as the direct effect of securitization. The switch in the rank of the two forms of financing has been induced by cost considerations. While governments raise their funds mostly in capital markets, households traditionally borrow through financial intermediaries. The business sector has typically used both, intermediated and direct financing, making it very reactive to changes in cost components. It is the business sector's increased reliance on direct financing due to more favourable cost conditions that has caused an overall shift between the two channels of financing.

The growing importance of direct financing in the mid-1980's is reflected in the rising number of employees in this sector. While the result of business operation of a financial intermediary can be indicated by its assets, securities firms are primarily market intermediaries arranging direct purchase of financial instruments, therefore their activity cannot be measured by the relatively small size of their assets. But this sector experienced the largest increase in employment between 1984 and 1987, with an average annual rate of increase of 19.0% (Table 8). Since 1980, the number of employees of investment companies and securities dealers together more than doubled, from 22.6 thousand to 52.5 in 1990, despite the fact that since 1989, there has been a continuous reduction of employment in the securities industry.

TABLE 8
 EMPLOYMENT IN THE FINANCE, INSURANCE AND REAL ESTATE
 INDUSTRY, 1984-90

(Average annual rate of growth in parentheses)

	<u>1984</u>	<u>1987</u>	<u>1990</u>	Average annual rate of increase 1984-1990 (Per cent)
	(Thousand)			
Banks & other dep- osit-taking inst.	220.9	255.0 (4.9%)	291.0 (4.5%)	4.7
Other credit agencies	18.6	15.9 (-5.1%)	16.8 (1.9%)	-1.7
Securities dealers	14.6	24.6 (19%)	19.2 (-7.9)	4.7
Investment & holding companies	32.3	36.2 (3.9%)	33.3 (-2.8%)	0.5
Insurance carriers	91.4	94.5 (1.1%)	103.3 (3.0%)	2.1
Insurance and real estate agents	158.8	186.6 (5.5%)	191.3 (0.8%)	3.2
Total	536.1	612.8 (4.6%)	654.9 (2.2%)	3.4

Source: Statistics Canada, Employment, Earnings and Hours, Cat. 72-002, various issues.

Is it possible that the demand for these services has declined after 1988? Since direct financing has remained the primary form of raising funds, this is not very likely. The explanation is rather linked to other factors. First, it could be the result of Canadian borrowers' search for less costly source of funds considering the high Canadian interest rates in the last few years. Secondly, there is easier cross-border capital movement caused by the internationalization of financial markets, especially between Canada and the U.S.A. with the enactment of the Free Trade Agreement.

The business sector's move away from intermediated financing has also caused a change in the component of the banks' income that had traditionally originated mainly from the positive spread between lending and borrowing rates. With substantially decreasing amount of lending, commercial banks have increasingly relied on fee income, and attempted to become more involved in securities trading.

6.2.3 COMPETITION IN DOMESTIC MARKET

Individuals, the business sector, and governments turn to the financial sector to raise funds or to invest their surplus resources. In 1987, 62% of the financial assets in Canada were held by households, while corporations owned 24%, and the different levels of governments 14%. On the other hand, households had only an 18% share of the outstanding liabilities, while the corporate sector and the governments were responsible for the remaining part - a much higher portion than their share of assets; 55% and 27% respectively. Total financial assets in Canada amounted to \$1.4 trillion, and

total financial liabilities were \$1.7 trillion that year. (ECC Report 1989a, 21)

Considering these ever increasing amounts, it is not surprising that competition has intensified among individual financial institutions and across groups of institutions, especially in the last two decades. First, there has been competition for deposits among the deposit-taking institutions; then, there was the breakthrough of banks in the mortgage market; and finally, financial intermediaries have competed with the securities industry for financing opportunities.

The quality of financial services and their price charged for customers depend, among other factors, on the degree of competition in financial markets. The concentration level of the market is one of the proxies available to determine the degree of competition. It must be stressed, though, that even when there is high concentration, institutions can follow competitive behaviour if there is a threat of new entries in the market. This seems to be the case currently in Canadian financial markets, where institutions operate in highly concentrated domestic markets, but the growing internationalization provides a continuous threat of competition from foreign sources.

Concentration in the Canadian financial industry is higher than in most other areas. There was some decline in the share of assets controlled by the four largest financial institutions (all of them Schedule A banks) between 1984 and 1987, from 50.4% to 45.4%. (ECC Report 1989a, 24) In spite of this, though, the growth of holding companies in the 1980's resulted in a fall in the number of firms accounting for 80% of total assets from 1984 to 1987. (14 and 16, respectively.)

While asset concentration is a good measure of power, the ability to use this power to control prices, the quantity and the characteristics of services is better expressed by the level of market concentration.

TABLE 9
SELECTED FINANCIAL MARKET CONCENTRATION IN CANADA,
1979-1987

Four largest companies' activity proportion (per cent)

	<u>1979</u>	<u>1984</u>	<u>1987</u>
Mortgages	29.9	32.6	34.9
Domestic deposits	53.8	47.7	45.3
Domestic personal and commercial loans	70.0	62.7	59.4

Number of companies accounting for 80% of market share

	<u>1979</u>	<u>1984</u>	<u>1987</u>
Mortgages	23	20	16
Domestic deposits	9	12	11
Domestic personal and commercial loans	5	7	7

Source: ECC, Globalization and Canada's Financial Markets, 1989, p.24.

The lowest level of concentration among financial markets was in the mortgages market, though, it increased between 1979 and 1987. (Table 9) Since the four largest institutions in 1987 consisted of two banks and two holding companies, one can conclude that the role of holding groups and that of the

chartered banks in this market increased significantly.

Domestic deposit, and personal and commercial loans markets are highly concentrated, but the concentration has continuously declined since 1979. These effects can be attributed to the growth of holding companies and to some merger activity, which increased the number of large firms. On the other hand, institutions that became part of a holding group had been active mostly in the less concentrated mortgages market, thus, the disappearance of their individual activity reduced the number of institutions accounting for a substantial portion of this market.

Overall, these statistical figures have shown a decline in the power of banks, except in the mortgages market. On the other hand, the data have confirmed that recent regulatory changes in the financial services industry facilitated shifts in concentration resulting in the continuous rapid growth of holding companies at the expense of banks.

All these economic changes, reinforced by new technology, regulatory revisions, and a globalized financial market, have, of course, influenced the performance of the various Canadian financial institutions at home and in the international markets.

6.2.3.1 BANKS' PERFORMANCE IN CANADA

Between 1950 and 1964 there was a dramatic change in the position of chartered banks within the overall structure of the Canadian financial system. In 1950, bank assets accounted for 86% of the total assets of private deposit-taking financial institutions, and by 1964 for about 70%. (Green 1974, 5) At that

time, the Porter Commission felt, that this was "largely the result of the banks not offering as competitive, efficient or useful a range of services as they ought compared to other institutions." (Green 1974, 7)

What has happened since then? Have banks improved their economic strategy? Since commercial banks are still the largest group among Canadian financial institutions, their operation must have adjusted to the new environment. This adjustment process has come internally with the use of innovation, as well as externally in the form of regulatory reform.

Commercial banks, true to their name, have kept their leading position in the commercial credit market. Commercial credit held by the banks, however, rose less rapidly than their total assets between 1967 and 1987, despite the fact that this market grew almost tenfold during that period. While in 1967 banks' market share in the commercial credit business was 81.4%, by 1987 it had slipped to less than 70%. (Bank of Canada Review, various) This was caused partly by the shift to direct financing in the post-1981 period, and partly because, realizing increasing opportunities, banks concentrated on mortgage and consumer lending.

Banks have always dominated the market for personal loans. Their market share rose from less than 50% in 1967 to more than 65% in 1988. (Bank of Canada Review, various) The fact that the banks increased their share in the consumer credit market is remarkable, and shows their ability to adjust quickly. It is remarkable, because they achieved it despite the regulatory liberalization of trust and loan companies in 1987 to operate in that field. While the competition increased with the entrance of these new institutions to the market, their conquered market share came at the expense of credit

unions and caisses populaires whose participation decreased from more than 14% to less than 12%. By 1988, one year after entering this market, trust and mortgage loan companies had already an 8.3 % consumer credit market share. (Bank of Canada Review, May 1989)

Regulatory change also helped the banks to improve their services, to expand their power. They made good use of the broadened opportunities which can be illustrated by the fact that while in 1980 their participation in the mortgage business was 17.7%, by 1990 it reached 43.7%, and in June 1991 it was already 44.2%. (Bank of Canada Review, various)

For financial institutions to be able to supply funds, they have to raise funds through deposits. Since the 1970's, depository institutions have closely competed for consumers' savings. These savings have increased more than sevenfold as real output more than doubled in this period. In current dollars, personal income per capita rose from \$2,546 in 1967 to \$18,060 in 1987, a gain of almost 90% once the inflationary effects are discounted. (Handfield-Jones & Glorieux 1988, 5) The increased real income produced a substantial upward trend in financial surpluses of the household sector until the 1982 recession. Source: Bank of Canada Review, various issues. This, together with the urbanization process of this period, the rising general levels of education in Canada, and the increasing sophistication of investors, put pressure on financial institutions to accommodate the increased demand for their services. Increased demand in that case meant not only a quantitative shift but also a change in demand for the quality of financial services which were fulfilled through innovations. Since technological change was accessible to all financial institution and has reduced the cost of providing services, a greater competition was encouraged among individual

institutions and groups of institutions to develop a range of new savings instruments.

TABLE 10
DEPOSIT ACCOUNTS IN CANADA BY CATEGORY OF INSTITUTIONS,
1980 - 1990

	<u>1980</u>		<u>1990</u>	
	Amount (Mill. \$)	Dist. %	Amount (Mill. \$)	Dist. %
Chartered banks	132,513	67.0	294,775	61.7
Trust and mortgage loan companies	40,001	20.3	120,488	25.2
Local credit unions and caisses populaires	25,012	12.7	62,851	13.1
Total	197,526	100.0	478,114	100.0

Source: Bank of Canada Review, various issues.

Households turn to financial institutions for the safekeeping of their funds and for the investing of their surpluses. The number of personal savings accounts has been larger in recent years than the population of Canada: in 1987 there were close to 32 million personal savings accounts. (ECC Report 1989a, 21) Banks have been dominating the market for personal deposits, well ahead of trust and mortgage loan companies, and credit unions. (Table 10)

Deposit accounts have increased substantially in the last ten years, but

banks have failed to capture a growing market share. The trust and loan companies and the credit unions were particularly innovative in developing new savings instruments with flexible maturity terms. This resulted higher market shares for these institutions. As depositors become more sophisticated, they react much faster to changing market conditions, and can accept new products more easily.

On the other hand, banks have inherent advantages. Their large nationwide branch network makes them more accessible to the public. They have also developed an expanded network of automated teller machines to provide differentiated services. The recent changes, however, have reduced the positional security for financial institutions as globalization put more pressure on business conduct, and as product differentiation provided more options for consumers. Competition among deposit-taking institutions will very likely intensify in the future, especially with the new power of banks to own securities dealers. This will allow banks to market their financial services as a package.

6.2.3.2 THE IMPACT OF FOREIGN ENTRY

There are costs and benefits associated with the appearance of foreign institutions in the domestic financial market. Regulatory authorities have to weigh the combined effect of both to make the right decision. In the late 1970's, early 1980's, the pressure of globalization in the financial market reassured regulatory agencies in many countries, including Canada, that the benefits of the establishment of foreign financial firms outweigh the costs.

The impact of foreign institutions, however, must be assessed from various points of view, to obtain the real effect of such a major structural change in an economy.

While the effect of the presence of foreign institutions on domestic financial firms is not unambiguously positive, in many cases, it is the only way to secure access to foreign markets for Canadian institutions. In Canada, foreign banks could capture significant market shares. This might spill over to the international performance of domestic banks. Canadian commercial firms may use the services of the foreign parent company on international markets because of their good relationship with the subsidiaries in Canada.

The impact of foreign bank's entry on domestic market competition depends on the degree of competition before the entry. It can change the structure of the market or the way other banks operate. If foreign banks possess a comparative advantage, competition intensifies in prices and in performance. If the environment had already been competitive, foreign banks can increase efficiency with the introduction of new technique, and new products. In Canada's protected banking market, the former impact dominated in the 1980's, with the spread of foreign bank subsidiaries. In 1991, 57 foreign bank subsidiaries operated in Canada beside 10 domestic chartered banks. They accounted for 9.5% of the total bank assets. (Office of the Superintendent of Financial Institutions 1991, 10) Beside increasing competition, foreign banks have also contributed to the supply of funds for middle-sized borrowers. The portfolio of Canadian banks contained an average of 19% business-loans in the range of \$5 million and \$25 million in 1985, while those of foreign banks held more than 56%. (ECC Report 1989a, 98)

However, foreign bank subsidiaries do not represent serious competition for their Canadian counterparts in the mortgage and the personal loan markets. On the deposit side, they penetrate rather in the large corporation accounts business than in the retail deposit area.

Foreign banks have also brought to Canada new technologies, and new products and provide a system for the gathering and distribution of information on a global basis.

Increased competition could reduce the stability of the domestic financial system. Supervisory authorities must carefully consider the granting of a charter to a foreign institution. The subsidiary status of foreign institutions secures the presence of Canadian supervisory power. However, authorities of the host and parent country face the problem of transparency and the division of responsibility in their supervisory roles.

The entry of foreign institutions could improve the accessibility to financial services of Canadian customers, depending on the distribution network. Since foreign banks tend to open offices in larger cities and in important financial centres, their impact on retail banking service accessibility has not been significant. This is more true in the case of Canada, where the main financial centres are concentrated in the East, and the size of the country prevents customers of other regions from personal contact with institutions other than their local bank branch or trust company.

The maintenance of a strong domestic presence in the financial industry has always been an important issue in Canada. In the past, many segments of the industry have been, and some still are, protected against foreign competition. The objective of domestic control over the financial

sector resulted in prevention of foreign entry by federal legislation in the 1967 Bank Act revisions.

The internationalization of financial markets, however, put pressure on Canadian regulatory authorities to open up the Canadian banking market to foreign firms if Canadian institutions wanted to succeed internationally. "Domestic control" has been replaced by "strong Canadian presence", allowing foreign institutions to establish subsidiaries in Canada.

To date, the small size of foreign bank subsidiaries prevent them from having a significant effect on domestic ownership in this sector. Although, over half of the federally registered life-insurance companies are foreign, Canadian companies dominate the insurance sector. And there is no foreign presence in the trust industry.

While regulatory authorities recognized the importance of competition in the financial industry, it is questionable that regulatory reform with stronger supervision would have resulted in greater competition than the entry of foreign firms. Stability could be improved by retaining the pillar system, the separation of major functions, but at the same time, allowing more competition and accessibility to financial services in the domestic market.

The retail-banking segment is currently not affected by foreign competition. If securitization became more substantial among Canadian instruments, and were made internationally tradable, competition and accessibility could be improved by the existing Canadian banks, bringing in the benefits, but avoiding the costs, of international competition.

With the entry of foreign firms, authorities must be aware of providing

the appropriate environment for fair competition. This involves basically a cautious approach towards lifting the barriers to foreign entry. When foreign institutions enter markets that are subject to different regulations than their home markets, difficulties might arise. Domestic banks can lose market share to their foreign counterparts if they are prevented from participating in activities that are permissible to foreign banks. In Canada, two such problems have arisen. The first is, that until recently, commercial banks could not underwrite securities, thus being denied access to one segment of a profitable business. The other problem concerns the prohibition of Canadian banks from links to commercial firms while foreign institutions are allowed such links. The regulatory reform in 1988 tried to deal with this issue, and made certain changes to avoid this obstacle.

6.3 CANADIAN BANKS IN THE INTERNATIONAL MARKET

The incentive behind the recent wave of internationalization has been, on one hand, the search for new investment opportunities on the part of savers, and search for least costly sources of funds on the part of borrowers. On the other hand, in line with the new portfolio diversification theory, financial institutions have realized the need for portfolio diversification internationally in order to further reduce risk.

The internationalization of financial markets has been facilitated by several underlying factors. Changes in regulatory structures, the rise of multinational corporations, the evolution of information technology, the

introduction of innovative financial instruments, and the reduction of transactions costs as a result of modern telecommunications and computer technology, all played a substantial role. They have also interacted in the process, inducing more suitable adaptation of various factors.

Canadians make extensive use of foreign capital, and they raise a significant part of new funds on international markets. (See Chart 3, Appendix C) Between 1983 and 1988, Canada ranked fifth in the Eurobond and the Note-issuance facilities markets, and third in the international-loan market with 6.1%, 4.4%, and 4.3% of funds raised, respectively. (ECC Report 1989, 67) These data support the theory that for small or medium sized countries, like Canada, international markets are more important relative to the GDP than for countries with larger domestic markets, such as the U.S.A.

Financial institutions of many countries provide services on the international markets. Canadian institutions do not play an important role in this aspect compared to the traditionally domineering countries, such as the U.S.A., Germany, Switzerland. And in the last few years Canadian banks have been losing market shares. The reason for the decline is mainly a relatively reduced participation in the Euromarket activity by Canadian firms.

To a large extent, the loss of market share by Canadian banks in the international market reflects events in the domestic market, where the average annual rate of asset growth of banks between 1980 and 1987 was the lowest among eight industrial countries, with only a 5% annual increase. (See Table 5, p.112; and Chart 1, Appendix A) This slow growth resulted in the largest Canadian bank, the Royal Bank, falling from the 16th place in the world in 1981 to the 57th place in 1987. All the other major Canadian banks

have also lost ground in the international comparison. (Table 11)

TABLE 11
WORLD RANKING OF THE FIVE LARGEST CANADIAN BANKS, 1981
AND 1987

	<u>Rank in 1981</u>	<u>Rank in 1987</u>
Royal Bank of Canada	16	57
CIBC	31	68
Bank of Montreal	35	69
Bank of Nova Scotia	50	80
Toronto-Dominion Bank	59	102

Source: ECC, Globalization and Canada's Financial Markets, 1989, p.76.

The reason behind the slow growth of Canadian banks' assets may well be that the size of available domestic savings has not grown as rapidly after the 1982 recession as in other countries, slipping from 5.4% in 1981 to 3.5% in 1986 as a proportion of the total savings of the major industrialized countries. In Japan, this share rose from 29.3% to 33.3% over the same period. (ECC Report 1989a, 76)

There are some concerns about the domestic market power of Canadian banks. It has been argued that relative to the size of the Canadian economy, banks are more powerful and have a larger share in the economic activity than banks in other countries. The fact is that in nine out of 14

countries examined by the ECC, the ratio of the assets of the country's largest bank to the GDP is greater than that for the Royal Bank.

Institutionally, internal behavioural problems have also contributed to the poor international performance of Canadian banks. It is said that foreign banks are more aggressive in their business conduct. Their pricing strategy is more competitive than that of their Canadian counterpart, who are often unwilling to match their prices to those of their competitors. The distribution and networking systems of institutions are another factor in the international disadvantage of Canadian institutions. They entered the Euromarket too late, when larger, well established French, German, and Swiss banks had already succeeded.

There is also lack of knowledge and expertise in the case of Canadian banks, that until very recently, were prevented by regulation from underwriting issues of corporate securities, and were thus unable to develop the same skills as, for instance, the German banks.

Canadian institutions are not, unfortunately, innovative. They adopt new financial products developed elsewhere, mostly in the U.S.A., rather than create them. With this attitude, they lose the so important leading edge to their competitors.

The decline of Canadian market share in international financial markets is a major concern of the Canadian authorities. First, the opening up of the Canadian market to foreign participants and the changes of retail banking due to new technology might give a greater challenge to Canadian institutions. Canadian banks are not used to intensive competition in their, until recently, very protected domestic market. It is a possibility that, over

time, foreign institutions might acquire increasing market share in Canada. Secondly, the need to serve Canadians abroad is increasingly important. It is very likely that a Canadian institution, having more information on its clients, could better accommodate the special needs of Canadian customers than foreign firms, provided it is well established in international markets.

6.4 CANADA-US FREE TRADE AGREEMENT

There have been arguments that the globalization of financial markets was a major force behind the Canada-U.S. Free Trade Agreement. (Bienefeld 1990, and Loxley 1990) The Canada-U.S. Free Trade Agreement (FTA), signed in December 1987, places U.S. banks in Canada in a different category than other foreign banks. In return, Canadian financial institutions established in the U.S.A. are assured not to be treated by U.S. laws less favourably than domestic institutions.

Canadian banks have been active in the U.S. for a long time while U.S. firms have been able to provide a full range of banking services in Canada after the 1980 Bank Act revision, when foreign entry into banking was permitted. In the U.S. prior to 1978, foreign banks, including Canadian institutions, were permitted to operate interstate while many of their U.S. competitors were constrained to intrastate activities. These privileges, however, were to be subject to review in 1988, and Article 1702 of the FTA preserved these rights for Canadian institutions.

Canadian banks have also become exempted from the Glass-Steagall

Act by being permitted to underwrite and deal in securities of Canadian governments and their agents. At the same time, should there be any amendments to the Glass-Steagall Act with respect to the liberalization of banking regulations, Canadian financial institutions are guaranteed the same treatment as U.S. firms.

For U.S. banks operating in Canada, the Agreement removes the limits imposed by the Bank Act on foreign firms. U.S. applications will continue to be reviewed on a case-by-case basis to ensure that the applicant can make a positive contribution to Canada's financial markets, and that prudential concerns are met. They still have to operate under Schedule B of the act, as subsidiaries, but they are not subject to any constraint concerning their assets and the number of branches. The FTA eliminates the 25% limit on holdings of the capital stock of financial institutions by foreigners, but it maintains the 10% restriction on the foreign ownership of Schedule A banks, thereby ensuring that control of the Canadian financial system remains in Canadian hands.

It is still early to evaluate the effects of the Free Trade Agreement on Canada's financial system, but it is very likely that capital movement will intensify between the two countries. Another very likely result will be a higher convergence of regulation. As to the improvement of domestic market conditions, the FTA's goal has been "to provide more competition among financial institutions with the resultant benefits to consumers. At the same time, control of our financial system will remain in Canadian hands while a new business opportunity has been opened up for our banks in the U.S." (FTA 1988, 250)

6.5 SUMMARY

This chapter has discussed structural changes in the Canadian financial markets due to the underlying technological changes and to the globalization process in the financial sector. Special attention has been given to the evaluation of commercial banks' performance in the last more than two decades in domestic and international markets. While the importance of the financial services industry as a whole has been growing in the Canadian economy, banks have lost their domineering role in the industry. The proportion of their assets and their market shares within the financial sector have declined in the last few years - except of the mortgages market. Banks have faced strong competition from other Canadian financial institutions and newly established foreign bank subsidiaries. The Canada-U.S. Free Trade Agreement provides reciprocity for the two countries' financial institutions, and exempts them from regulation affecting other foreign financial institutions. Competition has also intensified in the international markets, where the participation of Canadian banks has substantially decreased. The relative strength of Canadian banks in the 1980's declined, due mostly to their inability to adapt to a less protective domestic market.

CHAPTER SEVEN
ECONOMIC IMPLICATIONS OF TECHNOLOGICAL AND REGULATORY
CHANGE

7.1 INTRODUCTION

Financial systems that are able to adapt rapidly to the new financial environment and to take advantage of its opportunities, no doubt, will be the financial leaders of the 1990's. The challenge is to discover and learn how to use the new financial instruments while trying to reduce their inherent risks. There is going to be ever increasing competition among financial institutions. Competition, however, increases risk. A balance must be kept between opportunities offered by the new environment on one hand, and solvency and system stability maintained by law and sound corporate management on the other hand.

In Canada, in response to the various forces at work, the financial services industry has begun to organize around a new structure that is markedly different from the "four pillars". The process of change has accelerated in recent years due to recognition by the regulatory authorities that a change in the regulatory framework was inevitable.

The objective of this chapter is to put in Canadian perspective the transition of the financial system and to examine its economic implications for the future. The first part will investigate the changes needed in the regulatory structure, emphasizing the necessity for jurisdictional agreement between the two levels of government, and the need for greater competition in the domestic financial markets. The ownership question concerning the

financial-commercial links will also be discussed. The pressure to improve the use of technology and innovation in Canadian institutions will be enhanced.

7.2 REGULATORY STRUCTURE

The new market realities; long-term social and economic changes, revolutionary technological and institutional developments, and the rapid process of internationalization have had major implications for government policy in the financial services industry.

While in other parts of the world, countries have achieved international cooperation in financial regulation, Canada is still struggling with its two level regulatory and supervisory arrangement. The most important issue for the future of the Canadian financial industry is to put an end to the division of regulatory power and to find a common ground in the regulatory framework between the federal and the provincial governments to establish close cooperation. Only then could the Canadian financial services industry emerge as a strong international player.

7.2.1 JURISDICTIONAL AGREEMENT

If Canada is to meet the challenges of globalization of financial markets, and the spread of financial innovations, it must work out a regulatory structure that is endorsing these new developments.

The existing two-level jurisdiction provides competing regulatory systems in the Canadian financial industry. This competitive regulation increases the costs of financial institutions, and makes fair competition among firms incorporated under different jurisdictions impossible, raising with that concerns about the ability to maintain solvency. The lack of information sharing, and regulatory and supervisory coordination between the various authorities are obstacles in the improvement of efficiency of Canada's financial industry. When the international trend is running toward more coordination of financial regulation, Canada needs to harmonize its various systems of financial regulation and prudential supervision across the country to be able to adapt to the globalization of financial markets.

While Canadian financial institutions do not play a significant role in international markets, they must realize that competition is not limited anymore to these markets, and they soon have to face increasing competition in their home market as well. They cannot ignore foreign competitors, especially those from the U.S.A. with a comparative advantage after the Free Trade Agreement:

The ECC recommended in its 1989 Report that federal and provincial governments work together to support the compatibility of financial regulation throughout Canada. Inconsistencies exist in Canadian financial regulation between different jurisdictions and different categories of institutions that provide similar services but are controlled by different regulatory agencies within the same jurisdiction. Canada's constitutional arrangement does not clarify properly the regulatory control over financial institutions, except commercial banks, and the present political power

struggle between the federal and provincial governments raises barriers to a strong cooperation. But Canada has to overcome this difficulty and harmonize its regulatory structure at every level. Harmonization would mean a basic agreement on principles valid to all provinces. This would then also allow provincial regulatory authorities to finetune the legislation to local needs. This coordination would allow equal competition among institutions everywhere in the country, and it would make supervision more efficient. Solvency would also strengthen, since institutions would soon recognize the presence of a uniform supervision with less loopholes. Excessive risk-taking would surface easier than it does now. Regulatory and supervisory costs would also decline, since many of the now present overlaps could be avoided.

The federal and provincial governments should also coordinate the supervision of all financial institutions. First, different jurisdictions must agree on information sharing on a reciprocity basis. This policy would improve solvency conditions, since information about legal or disciplinary actions taken against any institution would be shared. Information exchange requires that different jurisdictions have confidence in each other and in their supervisory abilities. Some improvement in this area was achieved by an information sharing agreement among all 10 provinces in January 1989.

The most efficient way to achieve these goals would be by the establishment of an independent organization of federal and provincial regulators. The organization would offer a forum for meetings and exchanges of viewpoints while helping to reach agreements. With a consistent regulatory framework and a harmonized supervisory operation, Canadian financial institutions would be more prepared for the challenges of market

globalization and financial innovation, by improved domestic competition while keeping solvency a priority concern.

7.2.2 COMPETITION

Many of the mergers and acquisitions which created large financial holding companies have been, if not induced, at least facilitated by recent changes in domestic regulation.

The establishment of new large financial conglomerates raises the question of whether the degree of competition in the Canadian financial services industry will be reduced. The statistical data point to a somewhat ambiguous answer to this question. Several factors should be considered in this respect. Since entry barriers between the different segments of the industry have been lowered, existing firms will not be able to exercise fully their market power because of the threat by potential competition from new entrants; thus competition should not decrease. A second measure of competition can be the link between profitability and market structure expressed by the rates of return on assets or equity, if one accepts the theory of positive correlation between profitability and concentration. Two of the six largest chartered banks in Canada, the Bank of Montreal and the TD Bank, have had decreasing returns on equity in the last ten years. That also can indicate the presence of stronger competition in the domestic market, supposing that efficiency has not declined in these banks. On the other hand, as has been discussed in Chapter 6, asset concentration has increased measured by the number of institutions accounting for 80% of assets, but the

assets share of the four largest firms has declined. Analyzing market concentration shows that, except for the mortgage market, the degree of market concentration has lessened. In general, an interesting feature of market concentration changes has been that the more highly concentrated markets became less concentrated, while the less concentrated market, the mortgage market, became more concentrated. The ECC pointed out in its 1989 Report that the decline in the degree of market concentration can be short-lived if the development of financial holding companies accelerates. "Should merger and acquisition activity in the financial sector continue, this could lead to a reversal of the recent trends in concentration. But such a reversal would have to be viewed in the context of the continued internationalization of financial activities, especially in the wholesale market." (ECC Report 1989, 25) All these factors indicate that, though the conditions for competition have improved, the outcome is not unambiguous since an opposite effect has been represented by the spread of financial conglomerates.

The traditional relatively high concentration in the Canadian financial markets indicates that competition among Canadian financial institutions must be improved in the domestic market to help them develop the skills necessary for international competition. Regulatory authorities, and the federal government have recognized this demand. Policy goals, however, do not allow the most simple solution to succeed; i.e. the total demolition of the walls between the pillars. It seems, that the four pillars will remain in the Canadian financial system in the future, although the walls between them will not be as high as in the past.

Despite the pillar system, competition could still be increased by other

means. The ECC recommends (ECC 1989a) the removal of remaining barriers to internationalization for a greater benefit to Canadian institutions from recent events of market globalization. The first step should be to eliminate restrictions on foreign investments by Canadian institutions. Nowadays, Canadian institutions often experience difficulty in diversifying their equity portfolios with Canadian equities alone. Based on U.K. and U.S. experiences, the ECC stresses that the elimination of restrictions would not necessarily produce an outflow of Canadian funds, but would give an opportunity to institutions to diversify their portfolios in the most beneficial risk-return combination with less risk taking. The recommendation emphasizes that the "... increased holdings of foreign equities would be at the expense of government bonds and mortgages." (ECC 1989a, 124)

Internationalization means not only Canadian participation in foreign markets, but also the entry of foreign firms into the Canadian market. Foreign financial firms still represent a relatively small portion of the financial services supply in the domestic market and their expansion in scope is constrained by regulatory restrictions. To increase competition, foreign institutions should be allowed to establish subsidiaries in Canada in all segments of the financial industry, subject to the condition that Canadian institutions would be given equal access to their market of origin. It would also be beneficial, if the agreement included the national treatment clause, according to which, foreign institutions operating in a country get the same treatment as the domestic institutions. While foreign entry gives benefits to Canadian investors and borrowers, access to foreign markets provides an opportunity to Canadian institutions to grow and participate in an

international environment. Canada now allows foreign entry into banking, securities business, and the insurance sector, but does not grant national treatment to foreign establishments. Despite the competitive advantages of the growing presence of foreign financial institutions, it is recommended that ownership of the financial services industry remain essentially Canadian.

7.2.3 OWNERSHIP OF FINANCIAL INSTITUTIONS

The poor international performance of Canadian financial institutions in recent years has inflamed the "commercial-financial links" policy debate. There is a view that such links would enable Canadian financial institutions to compete more successfully in international markets. The opponents of these ownership links are more concerned about solvency, which could be reduced by self-dealing.

Commercial-financial links can be categorized into upstream links, which means that a nonfinancial institution holds shares in a financial institution, and downstream links, involving a financial institution holding equities of a nonfinancial corporation. Regulation regarding this issue in Canada today varies by categories of financial institutions. Canadian chartered banks are not permitted to have either upstream or downstream commercial-financial links. Some of the trust companies belong to financial holding companies that are involved in extensive commercial links, but some of them do not have such links. Legislation at both the federal and provincial levels limits downstream links, but there is no restriction on

upstream connections. In the case of life insurance companies, the situation is similar to that of trust companies. If there exist commercial links, they are mainly upstream links since legislation imposes constraints on downstream links. Most of the firms in the securities industry do not have commercial links at all, since constraints on upstream links have just recently been removed by the regulatory reform.

The other issue connected to recent regulatory changes is the concern about the acquisition of investment dealers by banks. The traditional concern is that the strength of banks could be impaired by the inherent riskiness of the securities business. The holding company solution seems to be an effective step against self-dealing and conflict of interest. There have been, however, recommendations to allow each type of financial institution to engage in a broader variety of financial activities within the same corporate entity employing "Chinese Walls" to deal with conflicts of interest. This could be a particularly important option for smaller firms for which the cost of creating a financial holding company is too high. A "Chinese Wall" is a collection of rules and procedures designed to prevent exchange of information between divisions of an institution. It has been employed in many countries successfully, for instance in the U.S.A. where banks are also allowed to operate in the fiduciary business. "Chinese Walls" are very effective in protecting the public interest without imposing excessive constraints on the operations of financial institutions. Heavier reliance on them could enhance competition among financial institutions, could result in broader access to services for customers, and could promote greater efficiency in the Canadian financial services industry. It could also destroy the "four pillars".

7.3 FUTURE OF CANADIAN BANKS

For banks, the most significant regulatory change was that they were granted permission in 1988 to engage in full range of securities activities through the establishment of wholly owned securities subsidiaries.

Following the 1982 recession, with the massive increase of direct financing, a more competitive environment built up within the securities industry, and raised questions about the capital adequacy of Canadian investment firms. There was also pressure from foreign dealers and from domestic institutions to gain access to the lucrative Canadian market by buying into existing firms, but which was limited by ownership regulation. The issue of restructuring was resolved when banks and non-residents gained access to buy into Canadian investment firms. The major Canadian investment firms are now linked with banks, and their association appears to be a natural alliance which will bring a balance to the financial system. If the securitization process continues, which it very likely will considering the cost/ benefits, Canadian banks have protected themselves against any further adverse effect by entering the securities business. By a more aggressive approach to the development of new business financing instruments, innovation can also ease the pressure on banks.

The banks' involvement in the investment business has caused changes in their corporate organization. The banks' hierarchical, bureaucratic organization has been restructured into three operational levels consisting of corporate banking, retail operations and treasury operations. Banks will have to further establish a substantial measure of earnings flexibility, highly

responsive to the achievement of corporate objectives, if they are to become major players in the securities business.

Another major threat for banks has been the widespread emergence and rapid growth of new financial conglomerates or holding groups in the non-bank area as the most efficient way of diversifying operations and offering a wider range of financial services. These groups consist of insurance and trust companies and other financial institutions, including real estate agencies, under common ownership. They offer a wide range of services through branch networks, although, these are less extensive and less developed than those of banks', and the services offered are slightly different from those provided by banks. The economies of scope generated by diversification, however, provide a strong rationale for bringing together these different operations, and create relative advantage and strong competitive pressure against banks.

The new ownership structure has brought a fresh managerial and innovative leadership style to the non-banking area, which has produced profitable new instruments. In contrast, the banks have been occupied with the difficulties they were experiencing in their loans to developing countries, and with the shift in business financing away from bank loans to market financing. The banks needed to widen their spreads to rebuild their equity strength, which made bank loans more expensive. These concerns have prevented banks from concentrating on business development while other deposit-taking institutions won over customers with attractive new products.

Banks are now at a relative disadvantage in context of innovative products, and only recently have they started to catch up with other deposit-

accepting institutions. Perhaps not accidentally, the beginning of this period coincided with the government's decision to allow banks too to form holding companies, and to engage in the securities business through them. It is not enough to own modern technology, it is necessary also to use it to one's advantage to create new products. If the tendency is to continue, banks and other financial institutions will continuously have to increase their expenses on system technology to be able to offer new services and new products to customers.

7.4 TECHNOLOGY AND INNOVATION

In the age of modern technology, innovation is another source of industrial strength. Canadian financial institutions are not participating actively in the process of innovation. Their activity in this area is mostly limited to the follower's role. That is, they introduce a new instrument, usually originating in the U.S.A., after having waited for the results of its market success, and the extent of its market demand. Another obstacle of innovations in Canada is that many statutes do not indicate clearly whether new instruments may or may not be used. New legislation is needed to specify the exact conditions of use of new instruments for each category of institutions, subject to the principle of prudence. Institutions should employ new instruments only when an internal control system is built up, and is able to evaluate the risk factor connected to the introduction of such new products distinguishing between hedging and speculative risk taking.

From the point of view of the customers, it is necessary for them to be informed of every aspect of a new instrument. In recent years, banks have improved their customer services, trained their employees, and enhanced their knowledge about new products in personal banking as well as in the small and medium-sized business financing area. Small firms are not sophisticated enough to overview and understand the role played by new financial instruments. One of such new instrument, and probably the most important for the future of Canadian small and medium-sized businesses is the securitization of business loans. These asset backed securities could make financing less costly, and could contribute to the development of Canada's regions. Another advantage of this product is that it could enable smaller local financial firms, the firms that are more aware of local needs, to obtain loans at the same rate as larger institutions. Securitization could also improve the availability of funds outside financial centres. It could also serve to bring together international and retail markets. In the U.S.A., securitization was introduced in 1970 with the assistance of the federal government. By 1987, 30 per cent of outstanding residential mortgages were pooled into funds of this kind. (Au Courant 1989, 6)

Beside the advantages that internationalization and financial innovation have brought to the Canadian financial market in improved services and a broader range of financial products, they have also increased the risk of insolvency or loss of stability of the Canadian financial system associated with the reduced transparency of financial activity. Regulatory authorities must focus on monitoring risk exposure of firms and propose a capital requirement for all Canadian financial institutions on the basis of risk

involvement. To increase the incentive for prudent business conduct and responsible risk taking, a risk based insurance premium method should be introduced for all segment of the financial services industry.

7.5 SUMMARY

This chapter has introduced an overview of changes that are necessary if Canadian financial institutions want to be efficient and competitive in the domestic and international markets. A new form of regulatory structure is needed to eliminate the existing obstacles: extended power should be given to financial institutions, and ownership rules concerning the financial-commercial links should be reconsidered in the case of banks. Canada's financial system needs a standardized regulatory and supervisory infrastructure through the jurisdictional agreement of the federal and the provincial governments. In the future, if the tendency continues, technology and innovations will play an even bigger role in the financial services industry, and Canadian banks must adapt to that trend to succeed.

CHAPTER EIGHT

CONCLUSION

This thesis has explored the economic implications of banking regulation in Canada, focusing on the issue of functional and ownership separation. The study has been centred around three basic questions, namely:

- The economic role of separation in the banking industry.
- The impact of technological change on the financial services industry and its regulation.
- The effect of regulatory change on the question of separation in the banking industry.

First, an overview of the Canadian financial sector and its role in the economy was introduced, followed by an elaboration of the facts about separation in the banking industry. The review provided a perspective on the topic, and included specific information on the various segments of the Canadian financial services industry.

In the next chapter the regulatory framework of the industry was examined. Beside a general review of the rationale for financial regulation, the unique Canadian regulatory structure was analyzed, providing a basic understanding of the workings of the Canadian financial regulatory system. This analysis highlighted the changes in the principles according to which authorities limit the operations of financial institutions.

Following this, the international aspects of the separation issue was explored. The different approaches to the question by various countries

comparing and contrasting their financial performance were highlighted. The important and increasing role of technology in the financial services industry was also discussed. Chapters Six and Seven concentrated on changes in the financial sector that have already taken place in Canada, and the ones that are very likely to happen in future.

It was found that, over the last two decades, the financial services industry has fundamentally changed everywhere, including Canada. This change was caused by a technological revolution in the industry followed by the accelerating process of globalization of financial markets. While the priority of regulation has remained the preservation of security and stability in the financial industry, the growing competitive pressures and the increasing uncertainty due to globalized financial markets forced an adjustment in the approach of regulatory authorities in many countries. The new regulatory approach, combined with innovative forces, has reshaped the structure of the financial sector, especially in countries where the separation of different financial functions had been maintained.

The Canadian financial system is basically organized according to the so called "four pillars" framework, in which the major financial functions are performed by separate categories of institutions. The original system had been based on separate regulation and separate ownership of the four broad categories of institutions which produced a tight oligopolistic structure with product differentiation or non-price competition. Despite the recent regulatory changes, only one of the two characteristics of the pillar system - the separation of ownership - has been removed through the holding company approach, thereby prolonging the existence of functional separation

in the Canadian financial sector, but creating a looser oligopolistic structure with increased competition, through institutions entering each other's markets. There have also been expansions of in-house powers of some financial institutions, especially those of trust and life insurance companies. The benefits of these changes are threefold. Consumers face more options and better services, though not necessarily lower prices. Institutions, especially banks, have more freedom to participate in different markets, and are thus able to decrease risk by diversifying their activities. And lastly, the economy as a whole benefits from the more effective allocation of resources facilitated by a more efficient financial industry.

It was also mentioned that the separation of functions is under reconsideration in other countries as well, since globalization has induced a need for the coordination of national regulations. The success of German universal banking supports the theory of a less restrictive functional approach towards regulation.

It was further revealed that the whole transition of the banking industry was initiated by the revolutionary developments of computer and telecommunication technologies. This has caused a shift in the supply of services, the products that are offered and the way they are executed, and shifts in the demand for services. Technological evolution has facilitated more cost effective, more efficient, globalized financial markets. On the other hand, it has also increased the expenditure of financial institutions, enhanced the role of economies of scale and has led, therefore, to heightened competition among institutions domestically and internationally.

Examining the performance of Canadian banks in the domestic and

international markets throughout the transition period, it can be concluded that their adaption to the new, more competitive environment has not been ideal: they have lost market share at home and abroad. While other institutions have emerged stronger from the intensified competition, commercial banks have not been able to capture the new opportunities. The only success they have achieved has been in the mortgage market. Abroad, Canadian banks have played a relatively small role in the rapidly growing international market, and they have been losing ground in recent years.

How can the Canadian financial system - and especially the banking system - improve its economic performance? What are the economic implications of recent changes for the future of the banking industry? These are the major questions the industry is facing.

It was concluded that first of all, a jurisdictional agreement would be needed between provincial and federal governments concerning the regulation and supervision of financial institutions. To increase the competitive forces of Canadian financial institutions, domestic markets in every segment of the financial industry should be opened up to foreign firms on a reciprocity basis. This would not only improve competition in Canada, but it would also help Canadian institutions to get access to foreign markets. It is also recommended that restrictions on financial-commercial links be removed to increase capital availability to financial institutions, but at the same time, an adequate supervisory body be established to provide for a secure and stable financial environment.

Finally, it is suggested that a comprehensive set of guidelines be established by regulatory authorities concerning the introduction and the use

of innovative instruments in the financial services industry.

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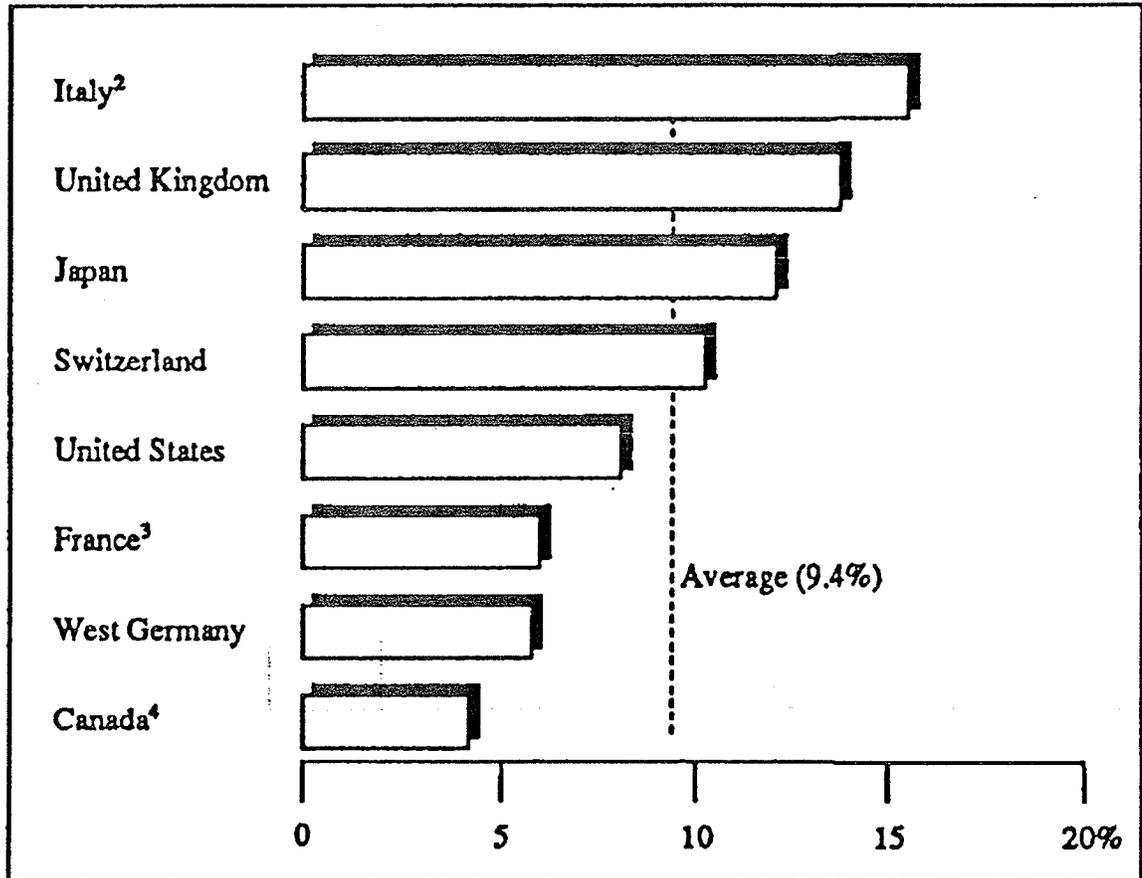
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Appendix A

CHART 1

Average Annual rates of Growth of Nominal Assets of Major Banks in
Selected Countries, 1980 - 1987

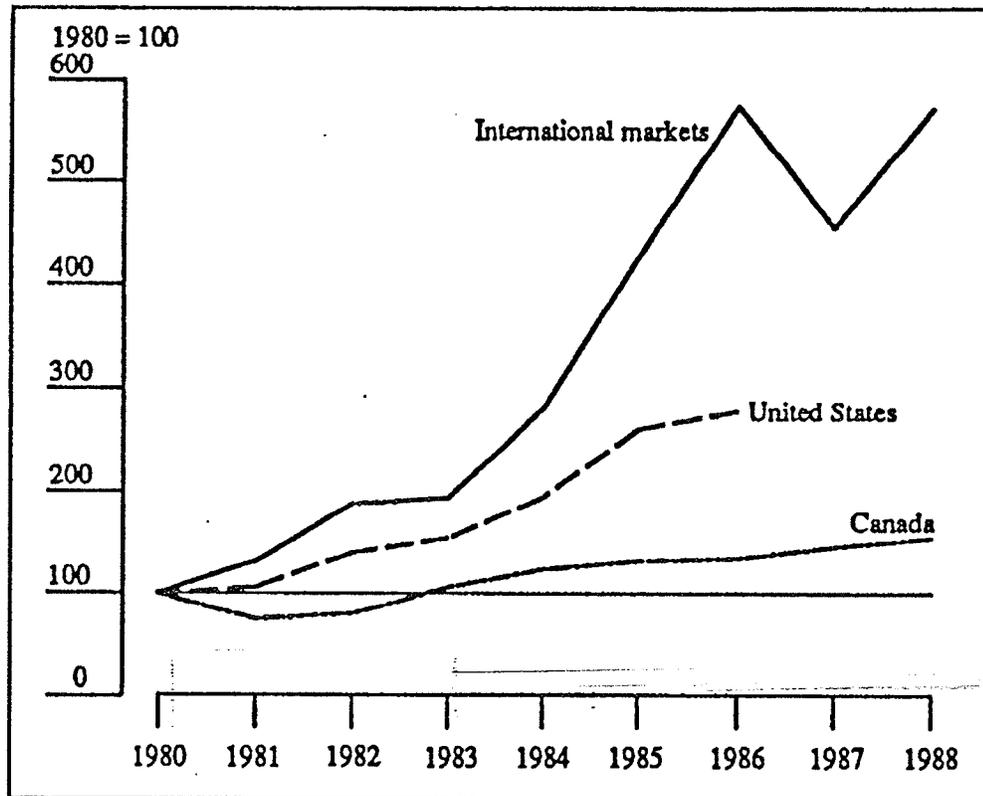


Source: Economic Council of Canada, "A New Frontier: Globalization and Canada's Financial Markets", Summary, Canadian Government Publishing Centre, 1989, p.9.

Appendix B

CHART 2

Growth of Bond Issues in Canada, in the U.S.A., and in International Markets, 1980 - 1988

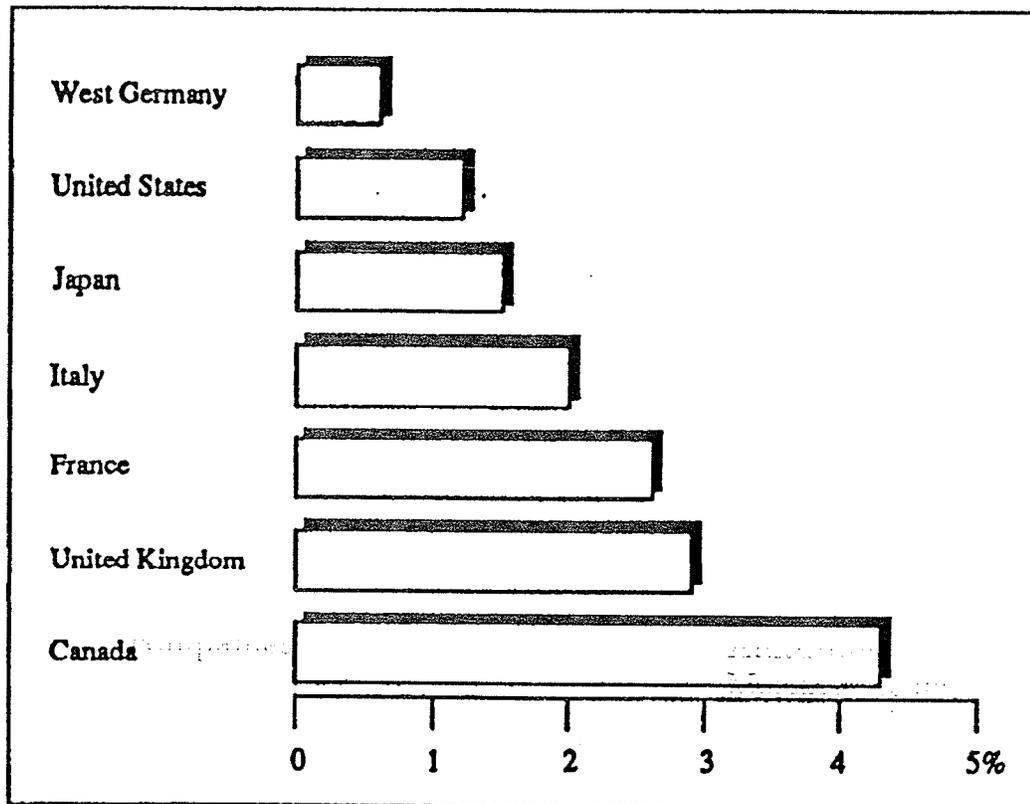


Source: Economic Council of Canada, "A New Frontier: Globalization and Canada's Financial Markets", Summary, Canadian Government Publishing Centre, 1989, p.3.

Appendix C

CHART 3

Funds Raised on International Markets as a Proportion of GDP in Selected Countries, 1982 - 1987



Source: Economic Council of Canada, "A New Frontier: Globalization and Canada's Financial Markets", Summary, Canadian Government Publishing Centre, 1989, p.7.