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Improving Financial System Efficiency: The Need for Action

Two years ago, I gave a speech here in Toronto in which I dealt with the theme of efficiency as it relates to the economy in general and to the financial system in particular. Today, I want to return to the theme of financial system efficiency. In doing so, I will draw on material from our latest *Financial System Review* (FSR), published last week.[1] This publication, for those of you not familiar with it, is one way that the Bank contributes to the soundness of the financial system. The FSR reports on developments and trends in financial systems here and abroad, summarizes recent research by Bank staff on financial sector policies, and promotes discussion of how to strengthen our financial system. In short, the goal of the FSR is to improve financial system efficiency and stability.

When I spoke two years ago, I stressed that all of us need to keep in mind the goal of efficiency, and that Canadian financial institutions and markets need to be as efficient as possible. Since that time, the global financial services sector has continued to undergo sweeping changes. The integration of global financial markets is continuing. Exchanges and financial institutions are consolidating, and new financial instruments are constantly being developed. All of this is changing the way that global markets operate, with important implications for the competitiveness and efficiency of Canadian markets and institutions. Today, I want to talk about how Canada has been responding to these developments. In doing so, I hope to underline just how important efficiency is for everybody who is concerned about Canada's long-term economic health.

But before I begin, I should start by saying why financial system efficiency is so important. When a financial system is operating at peak efficiency, investors receive the highest risk-adjusted returns on their investments, and borrowers minimize the costs of raising capital. With an efficient financial system, economic resources are allocated to the most productive investments. Another key reason to promote efficiency in the financial system is the importance of the financial sector to the industrial base. The financial services sector represents more than 6 per cent of Canada's GDP. However, the long-term health of this sector may be at risk unless we all act to increase its efficiency and competitiveness. I'll return to this topic in a few minutes. But the point I want to stress now is that an efficient financial system is crucial for achieving sustained economic growth and prosperity in Canada.

[1] Available at: http://www.bankofcanada.ca/en/fsr/index.html

Efficiency and Macroeconomic Policies

Let's examine how Canada's macroeconomic policies support efficiency. As a central banker, I will start with a brief look at monetary policy; in particular, our policy of inflation targeting. As you may know, last month the Bank and the Federal Government renewed our joint inflation-targeting agreement for another five years, until the end of 2011. Since Canada adopted inflation targeting, we have seen a number of important economic benefits. Inflation has been lower and more stable, and inflation expectations have become well anchored on the 2 per cent target, not just in the short term, but also in the long term. With this low and stable inflation, along with other important policy improvements, the peaks and valleys of the business cycle have become less pronounced, and the economy has shown increased flexibility in adjusting to various types of shocks. Because consumers and businesses have greater certainty about the future purchasing power of their savings and income, borrowers pay a much smaller premium to compensate investors for inflation risk. In short, we have seen lower costs for borrowers, more predictable returns for investors, and a more efficient allocation of resources.

But we should always be looking to see if there are ways to make good performance even better. This is why the Bank is launching a concerted research program to see if our already very successful inflation-targeting framework can be improved. In particular, we want to find answers to two questions. First, what would be the costs and benefits of an inflation target lower than 2 per cent? Second, what would be the costs and benefits of replacing the current inflation target with a longer-term price-level target? We hope to see intensive research on these issues, conducted both inside and outside the Bank, over the next three years. This would give the Bank and the Government of Canada enough time to examine the results and take them into account before the next renewal of our agreement in 2011.

Canada's fiscal policies have been, and will continue to be, important in supporting the efficiency of markets. Governments, both federal and provincial, have worked hard to achieve fiscal balance and are now working to further reduce their ratios of public debt to GDP. Continued progress on this front will support efficiency by allowing investors to remain confident that the proceeds of their investments will not be subjected to excessive taxation in the future. This additional confidence can lead to better allocation of resources.

A well-functioning market for federal debt is also important for Canadian fixed-income markets in supporting the efficient allocation of resources. So the Bank, in its role as fiscal agent for the government, will continue to work with the federal government and with market participants to support liquidity and the smooth functioning of markets for government debt.

Finally, the Bank of Canada supports efficiency through our role in promoting a safe and sound financial system. We do this both through our legislated responsibility to oversee systemically important clearing and settlement systems, and through our responsibility—one that we share with federal and provincial agencies, regulators, and market participants—to actively foster the safety and soundness of the financial system. When everyone is confident that the financial system is safe, there is less need either to keep precautionary resources or to spend on arrangements to guard against the effects of financial instability. Canada's clearing and settlement systems have been judged to be very sound.[2] In addition, they have been designed to operate using a relatively small amount of liquidity compared with systems in other countries. And this frees up resources that can be put to more productive use elsewhere.

Our main goal in this area is to guard against costly financial instability. Recently, there has been discussion in the United States and the European Union about the potential threat to financial stability posed by hedge funds. As my colleague David Longworth pointed out in a recent speech,[3] we at the Bank have looked at the effect of hedge funds on the stability of markets, in particular, markets in Canada. It is important that central banks and others continue to monitor hedge funds for potential systemic risks. But in our judgment, there appears to be no reason to sound the alarm at this time. This is not to say that increased transparency by hedge funds might not improve the efficiency of markets, and that additional disclosure might not increase investor protection. These issues are being examined by securities commissions and others.

So, to sum up the macroeconomic side, the frameworks for our monetary, fiscal, and financial stability policies are second to none in the world, and do their job to support and encourage efficiency. But on their own, sound macroeconomic policies are not enough. Canada also needs microeconomic policies that spur competitiveness and support efficiency. Let me now review a few of these structural issues. I'll begin by talking about financial institutions, then address issues of efficiency in securities markets, enforcement, pension regulation, and fixed-income markets.

Efficiency and Microeconomic Policies

Financial Institutions

When I raised the topic of financial institution efficiency two years ago, I noted that following the 1964 Porter Commission, Canada became a world leader in terms of modernizing regulation. Parliament passed legislation creating a regulatory framework for financial institutions that led to greater competition, lower costs, and improved efficiency. Over the years, with the right policies in place, Canadian financial institutions capitalized on the comparative advantage provided by our regulatory framework to become world leaders in efficiency.

But over roughly the past decade, several countries have greatly improved their regulatory frameworks, eroding our comparative advantage. A number of foreign institutions have become better placed than before to exploit new technologies in order to enhance efficiency, and to offer their clients new instruments and combinations of services. It is in this rapidly-changing environment that our financial institutions must compete. Clearly, if we want our financial institutions to remain a major economic driver

[2] See, for example, the IMF's assessment at http://www.imf.org/external/np/rosc/can/payment.htm

[3] Available at: http://www.bankofcanada.ca/en/speeches/2006/sp06-18.html

in Canada, then we need to make sure that the regulatory framework under which they operate encourages competition and innovation, and does not prevent them from maximizing efficiency. As the Minister of Finance said in his economic update, "Competition drives firms to become more efficient, invest in new technologies, and introduce new products and services that benefit consumers."

This leads to the question of whether our financial institutions are efficient. Some observers have examined our financial services sector as a whole, using the data in the national accounts, and have noted that the productivity of this sector appears to be lower than that of other countries, particularly the United States. For us in Canada, where improving productivity is an increasingly important issue, such an assessment should be a concern. So, at the Bank of Canada, we are looking carefully at this issue. While our work is not complete, we did publish some of the initial findings in the current FSR.[4] At the risk of oversimplifying, I will stress two main findings. The first is that in terms of net operating income per worker and assets per worker, employees of Canadian banks are at least as productive as their counterparts in U.S. banks of comparable size. Canadian banks also do well in some other measures of efficiency. But the second main finding is that, compared with U.S. banks, there are unexploited economies of scale for Canadian banks. This suggests that Canadian banks are less efficient with regard to the scale of their operations and if banks could reap economies of scale, there would be efficiency benefits to flow through to the Canadian economy. Overall, our research concluded that legislative and regulatory changes have benefited efficiency in Canadian financial services. This shows the importance of removing any remaining restrictions that inhibit competition and efficiency, but provide little or no benefit in terms of financial soundness. Our findings are still preliminary, and so far the research has been confined to banks. But as data become available, we plan to complete this research and extend it to other parts of the financial sector.

Securities Markets

Now let me turn to the need to support efficiency through the regulation of securities markets. In the past, I have suggested that Canada would be best served by developing securities regulations that take into account the size and complexity of the firm doing the reporting. The principles of Canada's regulatory framework must apply to all firms, and must be as good as, or better than, those of any other country. But the application of the rules can, and should be tailored appropriately to take into account the size and complexity of the company.

Historically, Canada's public markets have done well in funding smaller companies efficiently. It is important for the future of our markets that this continue. Canada should try to develop a comparative advantage in securities regulation for these smaller firms if it is to remain a market of choice for companies, both Canadian and foreign.

The United Kingdom has made major strides in this area by consolidating its regulatory authorities ten years ago and, more recently, by beginning to implement a principles-

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[4] J. Allen, W. Engert, and Y. Liu. "Are Canadian Banks Efficient? A Canada-U.S. Comparison." *Financial System Review.* (December 2006), p. 61.

based set of rules that simplifies administrative processes for issuers. Authorities in the euro area are moving to unify their regulatory regimes. Even in the United States, Treasury Secretary Henry Paulson has called for a streamlining of U.S. regulatory authorities. Against this backdrop, we in Canada increasingly look as if we are stuck in the middle of the 20th century, and are not positioning ourselves well to compete in the 21st century. For the sake of efficiency, we need a single, uniform framework for securities regulation. Rules need to be applied in a uniform way across the country, and tailored to be appropriate for firms of all sizes, while providing appropriate protection for investors.

The Need for Improved Enforcement

Let me turn now to enforcement. Markets work more efficiently when they operate under clear, transparent, and reasonable rules and principles. But even the best rules won't help if they are not enforced. While we have seen some first steps to strengthen enforcement over the past couple of years, there still is a perception, both in Canada and abroad, that Canadian authorities aren't consistent in their efforts to enforce the rules against insider trading and other offences, nor tough enough in rooting out and punishing fraud.

The Investment Dealers Association's Task Force to Modernize Securities Legislation, chaired by Tom Allen, has recently argued that information should be made more readily available to—and shared more readily by—investigators and prosecutors, and that training for these groups should be improved. A federal-provincial working group was recently formed to address these issues. But we cannot lose any momentum in this area. It's vital that we move quickly and forcefully to strengthen enforcement, so that investors and firms are confident that everyone is playing by the rules.

I recognize that improving enforcement will require considerable effort and extensive co-operation among prosecutors, the police, securities commissions, and industry groups. But we can't lose sight of the fact that this will pay off in the long run. For example, at the Bank, we've put a great deal of effort into co-operating with law-enforcement agencies, and the justice system, to fight counterfeit currency. And while levels of counterfeits are still higher than we would like, we have seen a steady decline in the number of counterfeits detected since the beginning of 2004. Thanks to increased effort and co-operation, we're moving in the right direction.

Pension Regulation

Pension regulation is another important issue for the efficiency of Canada's capital markets. There is a crucial need for a framework that provides the appropriate incentives for employers to establish and maintain pension plans, so that the vast pools of capital in these plans can make their maximum contribution to the efficiency of the Canadian economy.

But our current regulatory framework instead provides a number of disincentives for firms to establish or maintain defined-benefit (DB) pension plans. These disincentives, along with recent low long-term interest rates, have led to increased solvency deficits among many defined-benefit plans. An update on the state of funding of DB pension plans is included in the current FSR.[5] To address some of the problems facing DB plans, the federal and Quebec governments have introduced steps designed to help plan sponsors meet the solvency funding test by obtaining letters of credit. Other jurisdictions are also looking into these issues, including the Ontario Government, which has just launched an expert commission to review pension laws. The measures taken by the federal and Quebec governments will bring significant relief to some DB plans. But these are partial measures, and they do not address the fundamental disincentives faced by organizations sponsoring DB plans. It is important to get these incentives right, so that DB pension plans, which have a long-term investment perspective, can continue to grow.

This long-term perspective fits well with Canada's need to finance the major investments in infrastructure that are essential for future economic growth. This match, between the need for investment in infrastructure and the need for pension funds to find long-term assets, seems perfectly suited to the private-public partnership model, or P3. But this match can't be made if governments do not have an appropriate framework for using P3s when looking at infrastructure improvements. There are still relatively few P3s in Canada, compared with countries that have a well-developed framework for P3 investments. In the June issue of our FSR, we looked at some of the constraints on the use of P3s in Canada.[6]

In summary, if capital markets are to make their maximum contribution to growth and provide financing for needed infrastructure, then action is essential both to reduce the disincentives for pension plan sponsors and to improve the framework governing private investment in public infrastructure.

Efficiency in fixed-income markets

Finally, let me turn to developments specific to Canada's fixed-income markets. There has been progress in improving the efficiency of Canada's fixed-income markets, much of which stems from the decision taken by the federal government in 2005 to eliminate restrictions on the amount of foreign property that can be held in registered retirement and pension plans.

The elimination of the Foreign Property Rule enhanced efficiency in a number of ways. First, it led to the development of the "Maple Bond" market. There is an article on this topic in the current FSR.[7] With the removal of the Foreign Property Rule, foreign borrowers began to issue Maple Bonds, which are denominated in Canadian dollars and sold in the Canadian market. Foreign issuers have found Canadian investors eager for a product that allows them to diversify their fixed-income holdings geographically and by industry, and to earn higher risk-adjusted yields without taking on currency risk. This diversification makes the Canadian bond market more complete, and represents a better allocation of resources, thus increasing efficiency.

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[5] J. Armstrong. "An update on the Funding Status of Defined-Benefit Pension Plans in Canada." *Financial System Review*. (December 2006), p. 43

[6] E. Woodman. "The Market for Financing of Infrastructure Projects through Public- Private Partnerships: Canadian Developments." *Financial System Review.* (June 2006), p. 35.

[7] J. Hately. "The 'Maple Bond' Market." *Financial System Review*. (December 2006), p. 35.

Second, by increasing competition with domestic investments, the development of the Maple Bond market has led to pricing of other domestic corporate bonds that better reflects fundamentals. This improved pricing of risk benefits the Canadian financial system as a whole.

Third, the development of the Maple Bond market has helped to increase trading and narrow spreads in the Canadian-dollar swap market. Since most foreign issuers don't have a natural need for Canadian dollars, the proceeds from the sale of Maple Bonds are typically swapped back into the home currency of the borrower. This additional activity has led to narrower spreads on cross-currency swaps, which also benefits domestic borrowers looking to raise funds abroad. In these three ways, the efficiency of Canadian fixed-income markets has been improved.

Other developments have also served to boost the efficiency of Canada's fixed-income markets. For example, we continue to see the growth of electronic trading systems that improve the functioning of markets, particularly fixed-income markets. It is crucial for any country that these markets function well, especially the markets for its government debt, and initiatives led by the private sector to increase transparency appear to be headed in the right direction for improving efficiency in this area.

Conclusion

Ladies and gentlemen, allow me to conclude. In my speech two years ago, I spoke about how Canada was once a world leader in terms of supporting efficiency. I talked about the 1964 Porter Commission, which came out strongly in favour of greater competition, freer markets, and effective regulation that served to enhance efficiency. Government, regulators, and the Bank of Canada responded positively to that report by acting to promote efficiency, and the private sector took advantage of new opportunities, leading to great benefits for the Canadian economy.

Today, a similar effort is needed. While Canada's macroeconomic policies are second to none in supporting efficiency, our structural policies need work. We need to revisit the spirit of the Porter Commission and build regulatory frameworks that promote competition, innovation, and efficiency. In particular, we need action to support efficiency through the way that we regulate our financial institutions, securities markets, and pension funds. Equally importantly, we need action to improve the way we enforce our regulations.

But improving efficiency is everybody's business. Once policy-makers do their job, it is up to the private sector to respond and take advantage of the opportunities to improve efficiency. The Bank of Canada remains committed to doing its part. If we all promote efficiency, then we all can reap the benefits of a more efficient financial system and a stronger economy in the future.