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Remarks by David Dodge
Governor of the Bank of Canada
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Financial System Efficiency: A Canadian Imperative

Good afternoon. It is a privilege for me to address this joint meeting of the Empire and Canadian clubs, and I thank you for the opportunity to do so.

I am particularly pleased to speak to you today because this is a bit of a red-letter day on the Bank of Canada's calendar. Today, we released the latest edition of our semi-annual *Financial System Review* (*FSR*). This publication, which is only a couple of years old, examines issues that relate to Canada's financial system. Each edition of the *FSR* takes a look at recent developments and trends in the financial system, as well as issues that have an impact on its efficiency, safety, and soundness. This is because the overall role of the Bank in the financial system area is to promote its safety, soundness, and efficiency. Today's edition contains a number of articles that focus on the promotion of financial system efficiency and stability. And it is the issue of financial system efficiency that I will talk about today.

I will begin with a brief discussion of how the Bank of Canada contributes to the efficiency of the financial system at the macroeconomic level. Then, I will spend most of my time discussing how we can improve efficiency in Canadian financial institutions and markets; that is, the microeconomic aspects of efficiency.

But before I do that, I should start by defining what I mean by "financial system" and "efficiency." Then, I will explain why it is so critically important for Canada to improve in this area.

When I talk about the "financial system," I am referring to financial institutions and markets, the infrastructure, laws, and regulations that govern and support their operations, and the macroeconomic framework within which they operate. My message for you is that improving the efficiency of Canada's financial system is imperative.

But what is an efficient financial system? In economic terms, an efficient financial system is one that helps to allocate scarce economic resources to the most productive uses, in a cost-effective way. The ultimate goal is to have Canada's financial institutions and markets match investors and their savings with appropriate, productive investments. Put more directly, if Canadians want sustainable economic growth and prosperity, our financial system must function as efficiently as possible.

Let me explain why efficiency is so important. With an efficient system, investors can get the highest risk-adjusted returns on their investments and borrowers can minimize the costs of raising capital. Inefficiencies can drive a wedge between what borrowers pay and what investors receive. I'll give you some examples of how inefficiencies can interfere with the saving and investment process that is so crucial to economic growth. If adequate information isn't available, potential investors can't tell whether a particular investment fits with their tolerance for risk. If financing costs are too high because of inefficiencies, borrowers won't be able to secure the funds they need to expand. If competition isn't encouraged, the various players in the financial system won't have the right incentives to innovate. This is why it's so critical for the financial system to work efficiently.

Efficiency and the Bank of Canada

I would now like to spend a few minutes on the Bank of Canada's role in promoting an efficient financial system. In order to have such a system, we need above all a supportive framework of macroeconomic policies that minimize uncertainty and enhance confidence about the future value of money. This includes prudent fiscal policies, which are the responsibility of ministers of finance. It also includes effective monetary policy, which is the Bank of Canada's responsibility.

We achieve effective monetary policy through our system of inflation targeting. One of the key benefits of this regime is that inflation expectations have become well anchored on the 2 per cent target, not just in the short term, but also in the long term. As a result, borrowers now pay a much smaller premium to compensate investors for inflation risk. This is particularly important at the long end of the yield curve. Reduced uncertainty has led to lower costs for borrowers and to a more efficient allocation of resources.

The promotion of a safe and sound financial system that reduces uncertainties and systemic risk can also contribute to efficiency. We work in partnership with federal and provincial agencies, regulators, and market participants in this area, in order to actively foster the safety and soundness of the financial system. We also have a number of unique responsibilities. It is our role, for example, to oversee those payment, clearing, and settlement systems that could pose systemic risk. These systems have been designed to provide certainty that large-value payments or securities transactions will settle in real time. In addition, they have been designed to operate using a relatively small amount of liquidity compared with systems in other countries. This frees up resources that can be put to more productive use elsewhere. The Bank of Canada is also the "lender of last resort"—the ultimate provider of liquidity to the financial system. Indeed, we've just concluded a review of that role, and the details can be found in the *FSR* that we released today.

There is also an international element to our efforts. The Bank of Canada works with partners in other countries on initiatives to strengthen the international financial system. The goal is to minimize the risk of a financial crisis in one part of the world spreading across borders. But that's a topic for a whole other speech.

So to summarize, Canada's macroeconomic and prudential policies generally do the job they are supposed to do in supporting efficiency. But let me be clear—we are not complacent; we are always looking for ways to improve. Continuous improvement is essential.

Efficiency in Financial Institutions and Markets

Now, I want to talk more specifically about the microeconomic aspects of efficiency in financial institutions and markets, including the promotion of competition and the provision of an appropriate legal and regulatory framework. Competition drives innovation and efficiency gains. And an appropriate legal and regulatory framework gives all investors fair access to necessary information, while minimizing the costs of raising capital.

The evidence shows that Canada's financial institutions and markets have generally been efficient when compared with those in other countries. But over the past decade, markets and financial institutions elsewhere have become—and are becoming—more efficient. To stay competitive in this environment, Canada's financial system must also constantly increase its efficiency. If we don't make this effort, the Canadian economy will suffer. The status quo won't cut it.

So what should our priorities be? I'll talk about financial institutions first and then about financial markets.

Efficiency and Financial Institutions

In terms of financial institutions, a quick look backward may show us the way forward. I want to go back 40 years, to 1964, and recall the Royal Commission on Banking and Finance, otherwise known as the Porter Commission. The Porter Commission was well ahead of its time, with groundbreaking analysis and policy recommendations. In the post-World War II environment, where extensive government controls on the economy were still thought desirable, Porter came out strongly in favour of greater competition, freer markets, and effective regulation that served to enhance efficiency.

In the wake of the Porter Commission, Canada revised its financial legislation in some crucial ways. Canadian banks responded to the new competitive environment by innovating and enhancing efficiency. Canadian institutions became world leaders, as financial institutions in many other countries were still operating under more restrictive and less-efficient regulatory regimes. Over the next three decades, Canada continued to lead the world. Successive revisions of legislation covering financial institutions encouraged greater cross-pillar competition in some areas, leading to lower costs and improved efficiency. But over the past decade, other countries have caught up and are forging ahead.

During this time, two trends changed the global environment for financial institutions. First, with the expansion of world trade, national markets became truly global. Financial institutions had to find ways to provide enhanced services to customers worldwide. Second, other countries—particularly the United States and the United Kingdom—began to align their regulatory frameworks with the competitive philosophy of the Porter Commission. The regulatory barriers that had held back competition, both geographically and among different types of institutions, began to fall rapidly.

Out of this more open and competitive environment came consolidation—not just among institutions but across pillars and jurisdictions. As a result, foreign institutions were better placed to exploit new technologies in order to enhance efficiency, and to offer new instruments and combinations of services to their clients. These two trends have led to great benefits for consumers worldwide, and they are continuing.

In these circumstances, Canada faces a difficult policy challenge. How can we enhance our policy framework to provide greater incentives for innovation by encouraging competition while, at the same time, giving our institutions the scope to improve efficiency? This is the challenge for Canadians in considering mergers, both within and across pillars, and the removal of barriers to foreign competition.

The questions about the best ways to enhance competition—to balance incentives for efficiency with other legitimate public policy concerns—are complex. And I don't have simple answers. But efficiency must be at the heart of the debate. Because, in the end, an efficient financial system is key for the future—not just of the institutions, but of the Canadian economy as a whole.

Financial Market Efficiency

Let me now turn to financial markets. When it comes to the competitiveness of global financial markets, size, depth, and liquidity do matter. So Canadian financial markets—whether equity, fixed-income, derivatives, or foreign-exchange—have an inherent disadvantage compared with those in New York or London. To compensate, Canadian financial markets have to be relatively even more efficient.

So what can Canada do to improve the efficiency of its markets? One area that has received a lot of attention, not just in Canada but in many other countries, is securities regulation. The key issue is to reduce what economists call "information asymmetries" by as much as is practical. What that means is that our regulatory framework should aim—in general—at having market prices reflect all relevant information, and that all parties to a transaction should have fair access to that information. We can enhance efficiency by reducing information asymmetries up to the point where the cost of additional compliance would outweigh the benefits.

Following events such as Enron, Parmalat, and Livent, it became clear that investors were not always receiving sufficient and accurate information. Corporate scandals prompted many an investor to say: "There oughta be a law!"—a law to make publicly traded companies disclose all information. But in the rush to write laws and regulations, too much attention has been paid to detailed rules that govern *how* companies disclose information, rather than focusing on *what* they disclose. We have seen a large increase in the costs of providing information—particularly in the United States—without *commensurate* progress towards improving the relevance of the information being disclosed.

The concept of relevant disclosure is particularly important for a country like Canada, where public companies range in size from the very small to the large and multinational. The precise nature of what constitutes relevant information differs depending on the size and complexity of the firm. Corporate disclosure regulations should recognize this. For large, complex firms, more complex rules are required in order for investors to receive appropriate information. But for smaller firms, less-complex disclosure regulations—and lower costs of compliance—may result in the best cost-benefit balance. The Canadian Securities Administrators recognized this point in putting forward new proposals for guidelines for corporate governance that are based on a firm's size.

There is another consideration, and that is the need for some companies to have access to global capital markets. Firms that want to list on international exchanges will have to follow the disclosure rules that apply in those markets. And large Canadian firms that want to raise capital abroad need regulations here that are recognized as meeting international standards. But smaller, less-complex firms—which make up the vast majority of publicly listed companies in Canada—may not want to raise capital abroad. So it may not make sense for Canadian regulators to force these smaller firms to comply with the kinds of detailed rules that would be appropriate for large firms.

Let me be clear. The *principles* at the heart of Canada's regulatory framework must be as good as, or better than, those of any other country. But keep in mind that companies considered to be mid-sized in terms of capitalization in Canada would be regarded as micro-capitalized by international standards. Historically, Canada's public markets have done very well in funding these smaller companies efficiently. This should continue in the future. So it is clear to me that our regulatory framework should take into account differing levels of size and complexity when establishing rules for disclosure.

The rule requiring CEOs to sign-off on their financial statements is a case in point. The principle behind the rule is to try to make sure that investors have sufficient and accurate information. Holding the CEO accountable is a good way to go about this. The principle can work equally well for large and small firms. But we need to be careful. For very large and complex organizations, setting out some detailed rules in terms of procedures may be helpful. However, we do not need a whole raft of complex rules that tell the CEOs of smaller firms what procedures they must follow before they can put their signatures on their financial statements. We need to be careful not to write rules that govern only the inputs that come before the CEO sign-off. Rather, we need to focus on getting the output right, so that the document that the CEO signs actually gives investors sufficient and accurate information.

Efficiency dictates that Canada should have uniform securities laws and regulations, based on principles that apply to everyone. Some have taken this idea further and advocated for a single, pan-Canadian securities regulator. I'm not here today to weigh in on that debate. But I do want to stress that, whatever the structure of the regulator, we must strive for efficiency in regulation—the best regulation, at the lowest cost.

Now let me talk briefly about another important information issue, and that is the issue of price transparency in markets. Here, I am referring to timely, public disclosure of transaction details, such as price and volume. It is not difficult to see how this information leads to better resource allocation.

The appropriate level of transparency may vary from market to market. Generally, the more liquid the market, the higher the level of transparency it can support. However, the world is moving to greater transparency in all markets through the spread of technology. The Bank of Canada is conducting research and working with market participants and regulators on ways to increase transparency in Canadian markets, with due regard for liquidity, equitable access, and fair play. Together with price transparency, these are the ingredients that help to create efficient, well-functioning markets.

It is important that we get transparency and regulation right. But we also need to devote the appropriate time and effort to making the most of whatever rules we write, including existing ones. This means focusing on a range of smaller initiatives that can enhance efficiency. For example, provincial and territorial legislatures need to make the Uniform Securities Transfer Act a priority. Such an act would provide a sounder legal basis for the holding and transfer of rights in securities that are held in book-entry form, and would replace the current patchwork of legal rules in this area. Another initiative is the Canadian Capital Markets Association's focus on trade-matching to support progress towards straight-through processing.

There's one more area where it is absolutely critical for Canada to continue to improve, and that is enforcement. There is a widely held perception that Canadian authorities aren't tough enough in punishing fraud and enforcing insider-trading and other rules. That's why it is encouraging to see that steps to toughen enforcement are being taken, by provincial securities commissions, by the Investment Dealers Association, by law-enforcement agencies, and by the federal government. These kinds of steps to improve enforcement must continue.

Conclusion

Let me conclude. To improve the economic and financial welfare of Canadians, we need an efficient financial system. The Bank of Canada has been contributing to this goal by enhancing Canadians' confidence about the value of their money and by reducing risks to the safety and stability of the financial system. Our *Financial System Review* is part of this effort.

But the effort must extend far beyond the central bank. I've raised some issues today that I think are critical to enhancing the efficiency of our financial system. None of these issues are new. They have been studied and analyzed thoroughly. But while Canada has been studying and analyzing, the rest of the world has been acting. It's time for us to act, too. We have to get on with the job of improving efficiency. The future health of our economy and the prosperity of Canadians depend on it.

See also: Press Release

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