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Financial System Efficiency: Getting the Regulatory Framework Right

I am happy to have the opportunity today to follow up on a speech I gave here in Toronto last December. In that speech, I talked about the need for Canada to improve its financial system efficiency. Today, I want to focus my remarks on how regulation can, and must, contribute to that important goal. When I talk about an efficient financial system, I mean a system that helps to allocate scarce economic resources to the most productive uses. By making our financial system more efficient, we can help generate sustained economic growth and prosperity.

The Bank of Canada has been contributing to the goal of an efficient financial system in a number of ways. The Bank's monetary policy aims to keep inflation low, stable, and predictable. By doing so, we enhance Canadians' confidence in the value of their money, thus reducing the need for people to spend resources either anticipating or coping with inflation. We also contribute to efficiency through our role as overseer of major payments, securities, and foreign exchange clearing and settlement systems, and by providing liquidity in times of financial stress. By reducing risks to the safety and stability of the financial system, we increase certainty about the robustness of the system, thus supporting efficiency. Our semi-annual *Financial System Review* promotes awareness of financial system issues, looks at developments and trends in the system, and addresses issues that affect its safety, soundness, and efficiency. As well, the Bank works actively with market participants and regulators to develop and promote an efficient financial system. And we conduct research that helps inform the decisions of policy-makers in terms of promoting this goal.

Today, what I want to talk about is how policy-makers can support efficiency by getting the regulatory framework right. I will start with some brief remarks about regulation in general. I'll then discuss how our regulatory framework can support financial system efficiency, and how we can best make sure that our framework is an effective one. I'll conclude with a look at some current issues in financial system regulation and the various ways in which the Bank is involved in them.

How Regulation Can Promote Financial System Efficiency

Let me start with a basic premise. For any market economy to operate efficiently and achieve an optimal allocation of resources, there needs to be a solid legal and regulatory framework. Basic legal concepts, such as property rights, the rule of law, and the honouring of contracts, must be in place in order for market forces to work and to generate wealth.

Once this is done, policy-makers have a number of overlapping motivations for further regulation. I'll spend much of my time today talking about the promotion of efficiency. But regulators also act to improve the safety and stability of the financial system, and to protect investors and savers.

Let me set out three principles that policy-makers should apply in deciding when regulation is appropriate. First, regulation is appropriate to correct a market failure or, to put it in economic jargon, to deal with "externalities." The second principle is that regulation must be effective. Even when a market failure is recognized, regulators should act only if there is a reasonable chance that they will actually address the failure in question. The third principle is that the benefits of a particular regulation must be greater than the costs it imposes. In trying to solve one problem, regulators must avoid causing even greater problems.

With these principles in mind, let me now describe three ways in which regulators can enhance the efficiency of the financial system. The first is to **promote competition** in domestic and international markets. Competition unleashes the forces that drive financial institutions and markets to become more innovative and efficient. That doesn't mean that regulators should "just get out of the way." Appropriate regulation can enhance competition. For example, an important goal of the Competition Bureau is to prevent firms from unfairly restricting competition.

Canada became a world leader in promoting competition in financial markets when it adopted many of the recommendations of the Porter Commission of the 1960s. At a time when policy-makers worldwide favoured extensive government controls on economic activity, particularly within the financial system, Porter broke new ground by coming out strongly in favour of enhancing efficiency through the promotion of competition and freer markets.

Competition is enhanced by expanding the scope of a given market. One way to do this is to have our markets and institutions compete with those in other countries and to have foreign enterprises compete in our markets. Therefore, regulation needs to take international considerations and developments into account. I'll have more to say on this point in a few minutes. For now, the point I want to stress is that competition leads to greater efficiency.

A second way that good financial system regulation can promote efficiency is by working to **correct "information asymmetries"** that sometimes occur, and that can lead to market failures and a suboptimal allocation of funds. Most often, these failures arise when there are significant differences in the quantity or quality of relevant information available to market participants.

Regulation should be designed so that investors are able to adequately gauge the risks and potential returns of an investment. To be clear, I'm not saying that the goal of regulation should be full disclosure of all information. Rather, the aim should be to reduce information asymmetries to the point that the benefits of disclosure still outweigh the costs of compliance. In that way, regulation can lead to a more efficient financial system.

The third way that financial system regulation can support efficiency is to **promote overall financial stability**, which essentially means limiting systemic risk. The idea that regulation can support efficiency at the same time as it promotes stability may strike some as counterintuitive. But these objectives are not mutually exclusive. If the regulation is carried out in the right way, enhancing stability can lead to increased efficiency through the saving of resources that would otherwise be dedicated to guarding against systemic risk.

Let me elaborate. I noted earlier that the Bank's monetary policy supports efficiency by increasing certainty about the future value of money. This reduces the need for Canadians to spend resources on activities intended to protect them from inflation. Similarly, enhancing the safety of the financial system reduces the need for Canadians to unnecessarily spend resources to guard against the risk of a financial crisis.

Policy-makers are more likely to successfully promote both stability and efficiency if they bring market players into the picture when addressing a particular issue. Canada's Large Value Transfer System (LVTS) provides a good example of how systemic risk can be mitigated in the most efficient way. The LVTS processes Canada's large-value or time-critical payments. It gives participants the certainty that once a payment has been processed, the transaction will settle on the same day, regardless of what might later happen to any of the participants. This certainty enhances efficiency on its own. But, in addition, the design of the LVTS minimizes the amount of collateral that each institution needs to pledge to the system, compared with the gross settlement systems used in other countries. This reduction in collateral frees up resources that can then be put to more efficient uses elsewhere.

Building an Effective Framework

That's a look at three ways in which a sound regulatory framework can improve the efficiency of the financial system—by promoting competition, by reducing information asymmetries where practical, and by reducing systemic risk. But to further our goal of improving efficiency, it is also important that our regulatory framework be effective. What makes a framework effective? I would highlight three factors.

First, our regulations should provide incentives that encourage markets to reinforce and reward the right behaviour. These incentives should be sufficient to motivate market participants without the constant intervention of regulators or the imposition of detailed rules that dictate to firms not just what must be done, but how it must be done. The right incentives can help regulators achieve their goals without imposing process costs that outweigh the benefits of the regulation.

Second, to achieve an effective regulatory framework, we need to take international developments into account. Countries can gain a comparative advantage by developing a superior regulatory framework. For our financial markets and institutions to be internationally competitive, our regulatory framework needs to be—and needs to be seen to be—as good as, if not better, than that of other countries.

But at the same time, Canadian rules and their application should be tailored to our domestic needs and should reflect domestic realities. This tension between domestic and international considerations leads to some challenges for Canadian policy-makers. A case in point is the Sarbanes-Oxley law. Canadian policy-makers embrace the general principles behind this legislation in terms of promoting good governance and financial practices. But the extreme level of detail in the application of its rules, as well as its focus on process instead of outcomes, creates costs for many of our firms that likely exceed the benefits to the system. Large Canadian corporations that want access to U.S. capital markets have no choice—they must follow both the spirit and the letter of Sarbanes-Oxley. But Canadian regulators are right to take a made-in-Canada approach that accommodates the needs of Canadian issuers and investors.

Let me be clear. The goal is not to mimic U.S. regulations, despite that market's size and proximity. The <u>principles</u> behind our regulations must be as good as, or better than, those of other countries. But we must apply those principles in a way that develops a comparative advantage for our firms and our markets.

Finally, and very importantly, an effective regulatory framework is one where the rules are enforced and are perceived to be enforced. Even the most coherent and efficient regulatory framework won't be effective unless it is followed. Participants must be appropriately monitored. And when the rules are broken, offenders must be prosecuted, and adequate penalties must be strictly applied. A framework with strong monitoring, prosecution, and application of penalties provides the incentives for firms to follow the rules, and this adds to the framework's credibility. When everyone is playing by the rules—and everyone is confident that others have the incentives to do the same—then markets operate with greater efficiency.

I've said before that regulation should be designed to enhance confidence and support trust in markets and institutions. Let me talk about one issue as an example. Canadian-listed firms can sometimes have a lower market valuation than similar firms listed in the United States. Why? Bank of Canada research has pointed to concerns about governance as a possible cause. And one of the main concerns appears to be a perception that Canadian enforcement of insider-trading laws is not as strong as it could be. We are continuing our research to better understand the root of this perception.

The key point here is that to improve the effectiveness of our regulatory framework, investors must have confidence that they will be treated fairly. To repeat: we must have, and be perceived to have, proper enforcement in Canada.

Current Issues in Financial System Regulation

That's a look at how a sound regulatory framework can improve the efficiency of the financial system. Now let's turn to some current issues, a number of which the Bank of Canada has some involvement in.

The Bank has been active in terms of research and commentary on developments aimed at improving efficiency. We have worked alongside the private sector to improve the safety and efficiency of clearing, payment, and settlement systems. For example, we've recently worked with various groups to make sure that participants are continuing to pursue more robust business-continuity plans, especially from a system-wide perspective. By increasing the degree of certainty that critical systems will be operational in times of disruption, the development of appropriate business-continuity plans can improve the overall efficiency of the financial system.

With respect to fixed-income markets, the Bank is also playing a role in helping to develop regulations regarding transparency and alternative trading systems. We are promoting innovations such as electronic trading systems, because they provide opportunities to reduce transactions costs and increase transparency to appropriate levels. This will increase liquidity and lead to better-functioning markets. And through our research, our commentary, and, in some cases, our direct involvement, we contribute to the design of rules and codes of conduct that improve the functioning of both fixed-income and foreign exchange markets.

Of course, one ongoing issue in the financial system is the question of consolidation among financial institutions. In my speech here in Toronto last December, I noted that Canada is facing a difficult policy challenge as we try to keep up with other countries that have enthusiastically adopted the competition-based regulatory philosophy espoused by the Porter Commission. We need to strive for a policy framework that continues to provide incentives for innovation and efficiency by encouraging competition. At the same time, we need to consider how to allow our financial institutions the scope to improve efficiency through economies of scale.

Recent research at the Bank of Canada that examined economies of scale in banking concluded that there could be untapped efficiency gains for Canadian financial institutions. The benefits from these efficiency gains could flow across the economy, through lower-cost business and retail lending. But there are other relevant public policy questions here as well, including foreign ownership and concerns about the concentration of market power among very few players. Striking a balance between these interests is not a simple task. But in terms of competition, we should keep in mind that the level of competition can be maintained or enhanced by new entrants in the marketplace or by the threat of new entrants.

Another issue that is being hotly debated relates to the ideal structure for securities regulators in Canada. What I said about this issue last year remains true today. Efficiency dictates that Canada should have uniform securities laws and regulations based on principles that apply to everyone.

But the question is how to apply these rules in a tiered way to take into account the differing needs of issuers. For example, one tier could apply to large, complex firms that want access to international capital markets. Rules for these firms would be similar to those that are applied in New York or London. At the other end of the spectrum, another tier could apply to small, speculative resource firms that have historically relied on Canadian equity markets for financing. A third tier in the middle could apply to the bulk of Canadian "mid-cap" firms, which choose to access only Canadian capital markets, and which very often are smaller and less complex than U.S. "mid-cap" firms.

These different tiers of firms exist in all major provincial jurisdictions. And investors in every jurisdiction have similar needs. So the key point is that, while the application of rules needs to take into account the size and complexity of firms, there is no need for different rules to be applied based on the province or territory of the issuer or investor.

Conclusion

In closing, let me say that I hope you've found my comments to be topical. Many important decisions about our regulatory framework are currently being considered, and these will profoundly affect the Canadian economy. In making those decisions, it is very important that policy-makers keep in mind the goal of efficiency. They can support this goal by promoting competition, by correcting market imperfections where practical, and by promoting financial stability through reduced systemic risk.

But it is even more important to remember why the goal of efficiency must be followed. Ultimately, policy-makers must strive to provide the best possible environment for achieving optimal allocation of economic resources. This is how policy-makers and regulators of the financial system can best serve the public and contribute to sustainable economic growth and prosperity in Canada.