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The Good, the Bad and the Unnecessary: A Scorecard for Financial Regulations in Canada

Rules and regulations are important in the financial services sector to protect consumers and ensure system stability. However, at some point the costs to firms of remaining in compliance crowd out investments in innovation and productivity. Regulators have an obligation to eliminate unnecessary, duplicative or ineffective rules.

Paul C. Bourque and
Gherardo Gennaro Caracciolo

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by Paul C. Bourque and Gherardo Gennaro Caracciolo

- Canada's regulatory burden has increased significantly over the past decade, resulting in higher compliance costs and decreased competitiveness. This paper evaluates whether Canadian financial regulators employ a sound approach.
- There is a need for a balanced approach that ensures regulations address financial stability and consumer protection while fostering innovation and market efficiency. The analysis includes a review of Canadian rule-development practices and a two-step quantitative and qualitative textual analysis to assess the regulators' approach to regulatory activity.
- Our textual analysis shows a responsive yet situational regulatory approach, emphasizing stability and consumer protection, with less focus on innovation and competition. Our findings suggest that, moving forward, enhancing comprehensive cost-benefit analysis could achieve a more balanced regulatory framework, fostering both stability and innovation for better consumer outcomes.

Introduction

Regulation of financial institutions is critical to a well-functioning economy with good consumer outcomes. Regulators and policymakers put rules in place to minimize undue risk, attempting to avoid scenarios where things go wrong in this critical sector and ensuring we have measures in place when things inevitably do.

But regulation comes with costs. Just a few standouts include: the direct cost of compliance; the indirect cost of compliance such as, major revisions to communications, data collection, storage, reporting systems, staffing and training; and the cost in terms of how much liquidity and capital financial institutions must hold – money that could otherwise be lent into the economy or to finance innovation and growth.

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The pace of regulatory change impacting financial institutions around the world has increased significantly since the Great Financial Crisis (GFC).[1,2] Although reforming the regulatory landscape was indeed necessary and beneficial, the increased costs have been significant. US studies document significant year-over-year increases in compliance costs for banks and investment firms.[3] Regulatory impact analysis of the Retail Distribution Review and Markets in Financial Instruments and Regulations (MiFIR) reforms in the UK shows sharp increases in compliance and indemnity insurance premiums for financial advisor firms (Crews 2023).

Here at home in Canada things are similar, if not worse. Analysis at the C.D. Howe Institute has shown the evolving length of the main regulatory documents affecting the Canadian financial sectors (see Online Appendix A and, more broadly, work done by the Institute's Financial Regulatory Excellence Initiative[4]). This work reports on the word-lengths of the acts under which the main Canadian regulators operate within each financial subsector. It is striking to observe how almost all of them (88 percent) increased consistently over time, strongly implying ever-growing compliance costs for financial firms. A recent Deloitte study looked at the implementation costs for a single set of amendments to the securities registration rules for advisers and dealers. Large firms estimated these amendments would cost, on average, about \$17.9 million to implement with an additional \$13.6 million on an ongoing annual basis (Deloitte 2016).

Other metrics used to measure the cost of regulation to Canadian businesses generally – the increasing percentage of business revenue dedicated to compliance, and compliance costs per employee and as a percentage of GDP – show similar increases.[5] This increase poses a threat to the country's competitiveness, as empirical studies highlight a negative relationship between compliance costs and labour productivity. Data coming from Statistics Canada's Cost of Compliance Survey reveal that a one percent increase in the intensity of regulatory compliance costs leads to a 0.1 percent decline in a firm's labour productivity.[6] It is perhaps no surprise, then, that Canada's position on the World Bank's Ease of Doing Business report has fallen from 4th in 2007 to 22nd in 2019 (Word Bank 2019).

This increasing regulatory burden has long been recognized by financial regulators but, as far as we are aware, there has never been any formal initiative trying to ensure that the increasing volume of regulation is necessary; and that the cost is worth the benefit.[7,8]

1 This increase has been driven by both domestic and international initiatives.

2 It must be noted, however, that there are a few areas still characterized by significant shortcomings, e.g., the standards for credit risk analysis that have seen very little to no development since 2008.

3 https://www.sifma.org/wp-content/uploads/2017/06/costofcompliancesurveyreport1.pdf

4 https://www.cdhowe.org/financial-regulatory-excellence-initiative

5 https://www.cfib-fcei.ca/en/media/news-releases/regulation-costs-canadian-businesses-39-billion-annually-11-billion-which

6 https://ised-isde.canada.ca/site/paperwork-burden-reduction-initiative/en/survey-regulatory-compliance-costs/impact-regulatory-compliance-costs-business-performance-october-2020

7 "https://publications.gc.ca/collections/Collection/F2-172-1-2003E.pdf, https://www.bcsc.bc.ca/-/media/PWS/Resources/Securities_Law/Policies/PolicyBCN/Regulatory_Impact_Analysis.pdf

8 OSC did engage in a major burden reduction effort https://www.osc.ca/sites/default/files/2020-10/20200527_reducing-regulatory-burden-decisions-and-recommendations.pdf. Proportionate regulation – tailored to different businesses – has also been part of the OSC's revised approach. There is a formal Government of Ontario initiative on Red Tape Reduction that has been aimed at reducing the length of regulations and legislation over the years.

This paper analyzes and answers the question of whether Canadian financial regulators' activity follows a sound and structural approach, putting in place rules and regulations that are truly necessary to ensure stability and consumer protection,[9] and without undue harm to competition and innovation. Note that while we acknowledge that regulators may have different mandates, the paper's aim is not to evaluate whether mandates and goals are aligned. The goal of the paper is to determine whether regulations are created using established best principles and how balanced they are in terms of stability and economic dynamism.

We employ two types of analysis. The first is a review of the rule-development practices used by Canadian regulators, while the second is a two-step quantitative and qualitative textual analysis exercise. The first step consists of an international comparison. The performance of the main federal financial sector regulator, the Office of the Superintendent of Financial Institutions (OSFI), is measured using as a benchmark two of its foreign counterparts, the UK's Prudential Regulation Authority (PRA), and the Australian Prudential Regulation Authority (APRA). The PRA has been among the most active in reshaping financial regulatory policies, following UK reforms in setting up their twin peak regulatory model in 2013, consisting of the latter and the Financial Conduct Authority. These reforms have allowed for improvements in avoiding and eliminating unnecessary regulation and red tape.[10] However, acknowledging the institutional differences between OSFI and PRA (which is in fact part of the Bank of England), we include another country for comparison: the APRA. This choice is driven by the significant similarity between the financial landscapes of Canada and Australia.

The second step digs deeper into the Canadian financial landscape, focusing uniquely on federal and provincial regulators. This analysis creates a scorecard to check whether the principles followed by regulators when producing regulations are consistent with those defining efficient and effective regulatory frameworks as used, for example, by the OECD. These include thorough problem identification, cost-benefit analysis, and clear definition of objectives.[11]

We find that the current regulators' approach, despite producing well-designed regulations, tends to lack adherence to general and pre-established principles, specifically with respect to performing and reporting cost-benefit analysis. This leads to a lack of predictability and a more reactive focus. Furthermore, regulators seem to focus almost uniquely on stability and consumer protection, and while critical, is not often linked back to innovation and competition. Our recommendation for the future is to adopt a more balanced approach between safeguarding the financial system and market stakeholders and creating the conditions for innovation and efficiency which, in our view, will be beneficial for both the financial system and the broader economy.

The Role of Regulation and Its Trade-off

The primary aims of financial regulation are to maintain the stability and integrity of the financial system and to protect financial consumers.

9 Namely banking, credit union, investment, and property and casual and life and health insurance consumers.

10 The Queen's Speech 2022: https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/1074113/Lobby_Pack_10_May_2022.pdf, John Glen MP, 'Keynote' (Speech by Economic Secretary to the Treasury, Innovate Finance Global Summit, 4 April 2022) www.gov.uk/government/speeches/keynote-speech-by-john-glen-economic-secretary-to-the-treasury-at-the-innovate-finance-global-summit

11 https://www.oecd.org/gov/regulatory-policybuildinganinstitutionalframeworkforregulatoryimpactanalysisriaguidanceforpolicymakers.htm

These objectives are pursued through two main approaches: prudential regulation and consumer protection regulation.

Prudential regulation involves a set of measures designed to ensure that financial institutions remain solvent and can meet their obligations. This includes enforcing capital adequacy requirements, implementing rigorous internal controls, conducting regular risk assessments, and ensuring that key personnel meet professional standards. Regulators closely monitor these institutions and enforce compliance to prevent anything that could jeopardize the broader financial system. The ultimate goal is to prevent excessive risk-taking that could lead to institutional failures, which in turn could erode public confidence and necessitate government intervention.

On the other hand, financial service conduct regulation (e.g., for capital markets, insurance companies, etc.) is centred around protecting consumers who engage with financial institutions. This form of regulation addresses the power imbalance between sophisticated financial entities and their less-informed clients, particularly retail consumers. It mandates transparency and disclosure of conflicts of interest, ensures that financial products are appropriately described and suitable for the needs of clients, and requires that employees of financial institutions are adequately trained to serve their clients' needs. By imposing these standards, regulators aim to prevent fraud, market abuse, and the provision of misleading advice, thereby safeguarding consumer interests.

In addition to these protective measures, financial regulation should also allow financial institutions to compete effectively and should aim to promote the growth and innovation of financial markets. Effective regulatory frameworks encourage the development of new financial products and services by allowing for competition and reasonable risk-taking. However, overly stringent regulations can stifle innovation, reduce competition, and drive financial activities to less regulated markets.

In short, regulation must be proportionate – not only within sector, but also when thinking internationally. Small, open financial markets, like Canada's,[12] are more susceptible to the negative effects of unnecessary regulation. Moreover, Canada has a large number of financial regulators – 44 to be exact.[13] These numbers suggest the need for federal-provincial coordination across financial markets to avoid the unintended consequences of gaps or overlaps in the regulatory framework. Recommendations for better coordination of systemic risk management[14] are equally applicable to policy development and rule implementation.

In a world where scale is critical, Canadian affiliates of global financial firms must make the case for a Canadian presence. Canada has many advantages: an educated workforce, independent courts, and universal healthcare. However, over the past couple of decades, Canada's GDP growth ranked in the third quartile among advanced economies. Canada's real GDP per capita over the last 10 years grew just 0.8 percent a year on average – its lowest rate of growth since the 1930s

12 For example, the market for investment funds, at about $2.4 trillion in Assets Under Administration (AUM) is dwarfed by the US $38 trillion AUM market to the south. Canada's equities market represents about 2 percent of the value of global equity trading.

13 Canada has 44 federal, provincial and territorial financial regulators: six federal banking and insurance regulators and an additional 38 provincial and territorial securities, insurance, pension and credit union regulators. https://www.canada.ca/en/financial-consumer-agency/corporate/federal-oversight-bodies-regulators.html#toc0

14 See Nicholas Le Pan, *Opportunities for Better Systemic Risk Management in Canada*. Available at: https://www.cdhowe.org/public-policy-research/opportunities-better-systemic-risk-management-canada

(Cross 2023). According to an OECD survey of 32 industrialized countries, Canada is expected to record the lowest level of growth in living standards between 2020 and 2030 as measured in per-person GDP (OECD 2021). A consensus is emerging that Canada's chronically slow economic growth and weak productivity constitute a national crisis. Bank of Canada senior deputy governor Carolyn Rogers called lagging productivity "an emergency," saying "it's time to break the glass."[15] The costs of regulation impose a negative impact on productivity (Tu 2020).[16] If the cost of regulation is too high, market competitiveness is negatively impacted,[17] with small firms feeling the pain disproportionately.[18]

The challenge for regulators is to achieve the best balance between market integrity, consumer protection, and financial stability, and market competitiveness and dynamism, by intervening in the markets only when necessary. When considering whether to intervene, it is not enough that a regulatory initiative appears reasonable. It must be targeted at a well-defined problem with metrics to measure the degree of success or failure. If the regulators cannot describe the problem they are trying to solve with precision, then they cannot know whether the regulatory intervention was or will be successful. In short, every new regulatory initiative must be necessary – and remain necessary – if Canada is to improve the competitiveness of its financial sector.

The Difference between "Unnecessary" Regulation and "Red Tape"

It is important to distinguish between unnecessary regulation and red tape.

Unnecessary regulation is regulation that addresses an unproven but not unreasonable hypothesis about a market problem with a solution that the regulators have not demonstrated will produce a net benefit.[19]

Red tape is regulation that is duplicative or redundant. While both red tape and unnecessary regulation add to the overall regulatory burden, red tape is easily identified. Regulators have been alert to this type of regulatory burden and occasionally address it through red tape reduction initiatives, both government-wide and financial-services-focused.[20]

Red tape reduction initiatives look back to identify rules made redundant by technology, product development, or new entrants or rules that

15 See Senior Deputy Governor Carolyn Rogers, Speech to the Halifax Partnership, March 26, 2024. https://www.bankofcanada.ca/2024/03/time-to-break-the-glass-fixing-canadas-productivity-problem/?#GAtop

16 According to the paper there is a negative association between a firm's regulatory burden and its productivity.

17 https://ised-isde.canada.ca/site/competition-bureau-canada/en/how-we-foster-competition/education-and-outreach/publications/technology-led-innovation-canadian-financial-services-sector

18 https://www.cfib-fcei.ca/en/research-economic-analysis/regulatory-costs-in-canada-and-the-united-states, Hampton (2005). We note that in Ontario FSRA's requirements relating to governance, risk management, capital/liquidity adequacy, etc., are outcomes-focused and applied with proportionality so that they can be scaled to the size/complexity of the institution.

19 We acknowledge that regulators need the capacity to respond to unanticipated or imminent market failure, and that in this case, a reasonable hypothesis might be all that is feasible within the available timeframe. However, when market intervention is required on an urgent basis, there should be a thorough and detailed post-implementation assessment.

20 For example, the OSC https://www.osc.ca/sites/default/files/pdfs/irps/20191119_reducing-regulatory-burden-in-ontario-capital-markets.pdf, and FSRA https://www.fsrao.ca/about-fsra/corporate-reporting/burden-reduction, and OSFI in its recent Annual Risk Outlook https://www.osfi-bsif.gc.ca/en/about-osfi/reports-publications/osfis-annual-risk-outlook-fiscal-year-2024-2025. On the latter, OSFI also says it will "designate a priority set of regulatory expectations to help institutions focus on the right risks. This includes a streamlined guidance release agenda."

duplicate existing rules. A good example of red tape reduction is the elimination of duplicative public company disclosure requirements by consolidating the contents of the Annual Information Form and the Simplified Prospectus.[21]

Unnecessary regulation, on the other hand, is more difficult to identify and rarely rescinded by red tape reduction initiatives. Unnecessary regulation may have a reasonable objective, but the regulators have not demonstrated that the intervention will result in an overall net benefit in promoting market integrity and competition.

The best way to avoid the burden of unnecessary regulation is to avoid introducing it in the first place. This is necessarily a forward-looking exercise and requires the disciplined and consistent use of market failure analysis, cost-benefit analysis, and post-implementation impact analysis in the policy development process.[22]

Towards an Efficient and Effective Regulatory Framework

Once red tape has been identified and swept away, the question remains – how much of the remaining rules are actually necessary? And, equally important, how can we ensure those we create in the future are appropriate?

The purpose of this paper is to create a checklist of criteria necessary for an effective and efficient framework for regulatory intervention in the financial system. We start in this section with the criteria themselves. We then turn to our analysis, at first comparing prudential regulation at home to similar entities abroad, and then applying the checklist to specific subsectors addressing the unique challenges and requirements faced by each regulated entity.

The Checklist

1. Problem Identification

The first necessary step is the identification of a problem – a potential serious financial threat that requires intervention. Problems must be well-defined and supported by data analysis. This should call for an intervention that is proportional to the potential harm and achieves the best balance between stability and competitiveness. This requires a consistently applied, disciplined process to realistically assess the trade-offs inherent in any decision to intervene in the market. Using such an analysis mitigates the risk of creating unnecessary regulations by intervening only to remedy significant weaknesses and flaws that could eventually lead to financial threats. In the absence of these risks, regulatory intervention can only produce net economic costs.[23]

Everything starts with a comprehensive description of the problem and its potential impact on the entire financial landscape. This first step is the most difficult. Necessary regulation cannot be implemented without a proper understanding of the nature and extent of the regulatory problem.

Good problem definition ensures that regulatory intervention is required in the first place and that resources are directed at an important problem that is aligned with the agency's regulatory mandate and priorities.

Crucially, problem definition should not begin with an assumption that another rule is needed. This

21 https://www.osc.ca/en/securities-law/instruments-rules-policies/4/41-101/reducing-regulatory-burden-investment-fund-issuers-phase-2-stage-1-0

22 These three policy development disciplines are sometimes combined in a single process. See for example https://www.oecd.org/gov/regulatory-policy/buildinganinstitutionalframeworkforregulatoryimpactanalysisriaguidanceforpolicymakers.htm. However, there is merit in assessing each one individually to highlight the different objectives and timing.

23 https://spi-romania.eu/admin/filemanager/files/bulgaria/0.3.fsa__a_guide_to_market_failure_and_cba.pdf

mindset directs the analysis away from understanding what the real problem is to a discussion about how a rule could be drafted to solve the problem. This mindset prematurely forecloses consideration of non-rule solutions. Sometimes, better enforcement of the existing rules can send a more timely and less costly compliance message to the industry than implementing new rules.

For capital markets, this whole process takes the form of a thorough market failure analysis. This is a central analytical tool that allows regulators to identify problems in a systematic fashion, therefore developing effective and efficient policy responses.

Former Vice Chair of the BC Securities Commission described market failure as a justification for intervening in capital markets as follows:

> We live in a free market economy. The market forces at work in a competitive free market will usually be effective in promoting behaviours and conditions that will benefit the market, and in penalizing behaviours that harm the market. However, markets do not always do this perfectly, and when they do not, the perception of the market's integrity is put at risk.
>
> As regulators, our job is to intervene in situations where market forces fail to establish conditions favourable to a fair and efficient market. When we are successful, the integrity of our capital markets is not in question. (Aitken 2005.)

Market failure analysis starts by considering potential market failures that might hamper the financial system's good functioning. These failures typically include (but are not limited to) asymmetric information, negative spillovers, market power imbalances and market abuses. Market failure analysis then identifies negative effects resulting from these failures.

For prudential authorities, consistent with their different and more narrow mandate, the process of problem identification is altered. As prudential regulation focuses on safety and soundness of relevant federal financial institutions, the process involves assessing risks to the financial system's stability, such as excessive leverage, liquidity mismatches, or interconnectedness that could lead to systemic risk. Prudential authorities need to identify vulnerabilities that could threaten the resilience of financial institutions and the broader financial system. This includes but is not limited to evaluating the potential impact of economic shocks, stress testing institutions under adverse scenarios, and ensuring that financial institutions have adequate capital and liquidity buffers to withstand such shocks. By identifying and addressing these risks, prudential authorities aim to maintain confidence in the financial system and prevent crises that could have severe economic consequences.

2. Cost-benefit Analysis

A cost-benefit analysis enables staff to assess whether the chosen regulatory solution is optimal, taking as given the existing regulatory landscape.

The Canadian Cabinet Directive on Regulation requires all federal regulators to carry out such an analysis.[24] However, this requirement is very general and it doesn't translate into precise and systematic guidelines that the regulators should follow when carrying out such an analysis.

As a result, among Canadian financial regulators, we struggle to find consistent applications of cost-benefit analysis. OSFI occasionally refers to the practice. Most of the time, however, the actual analysis isn't published in the form of a thorough

24 https://www.canada.ca/en/government/system/laws/developing-improving-federal-regulations/requirements-developing-managing-reviewing-regulations/guidelines-tools/cost-benefit-analysis-guide-regulatory-proposals.html

stand-alone document. Some good examples of cost-benefit analysis come from the CSA,[25] the OSC (the only securities regulator that must do a cost-benefit analysis any time they amend or implement a new rule)[26,27] , and FSRA.[28] Yet, without detailed guidance systematically applied by all the regulators, these remain rare exceptions rather than the rule.

In the UK, the Financial Conduct Authority (FCA) and the Prudential Regulatory Authority (PRA) describe the cost-benefit analysis as being at the heart of their work.[29] In particular, cost-benefit analysis helps the regulators use their rule-making powers appropriately and proportionately.[30,31,32] Similarly, the US Securities and Exchange Commission has provided detailed guidance to staff in applying cost-benefit analysis in the rule-making process.[33]

Providing staff with instruction is necessary but not sufficient to implement a disciplined approach to financial market intervention. The SEC and FCA guidance for conducting cost-benefit analysis has not been fully sufficient to eliminate unnecessary regulation in those jurisdictions.[34] The UK and US markets do, however, have significant scale that helps manage this regulatory burden. The smaller Canadian financial markets do not enjoy this advantage.

Cost-benefit analysis is not determinative of the merits of a regulatory proposal. However, a methodology should be adopted that helps staff identify regulatory initiatives that should be the subject of a cost-benefit analysis, that produce

25 See for example, "Better Disclosure, Lower costs – CBA of Continuous Market Access System" – Office of the Chief Economist BCSC 2002; "Cost-Benefit Analysis on the Introduction of Independent Review Committees for Mutual Funds," Office of the Chief Economist, OSC, January 2004; Executive Compensation Disclosure – Amendments to NI 51-102 Continuous Disclosure Obligations – 2007: CSA Notice of Proposed Amendments to NI 21-101 and NI 23-101 –Appendix B 2008

26 See Section 143.2 of the *Ontario Securities Act*.

27 The published cost-benefit analyses are included in Notices, with no reference to these analyses in the companion policies, which are the key documents where the regulator's approach and line of reasoning are discussed and explained. Furthermore, there is no interprovincial coordination, making it impossible to produce cost-benefit analyses that are consistent across the entire CSA.

28 Financial Services Regulatory Authority of *Ontario Act*, 2016 (s. 22(2)6) requires FSRA to include "a qualitative and quantitative analysis of the anticipated costs and benefits of the proposed rule."

29 Cost benefit analysis must be published together which each regulation. see e.g., https://www.bankofengland.co.uk/-/media/boe/files/prudential-regulation/consultation-paper/2023/december/cp2623app6.pdf

30 https://www.fca.org.uk/publication/corporate/how-analyse-costs-benefits-policies.pdf

31 Consequently, they also place a lot of importance on dynamism. A good example is given by FCA's Project Innovate. Project Innovate is an initiative to help firms looking to introduce innovative financial products and services to the market. It has a dedicated team that helps eligible firms through the authorization process necessary to enter a regulated market, and subsequently for up to a year. More generally, the FCA is also seeking to add more flexibility to its regulatory framework and remove barriers to entry. Project Innovate helps the FCA identify where parts of the regulatory framework may be impeding market development. The aim is to encourage innovation without eroding consumer protection or the integrity of the financial system in the UK.

32 https://www.bankofengland.co.uk/-/media/boe/files/prudential-regulation/consultation-paper/2022/november/cp1622app7.pdf

33 https://www.sec.gov/divisions/riskfin/rsfi_guidance_econ_analy_secrulemaking.pdf

34 In the UK, the FCA competition mandate has generated serial interventions to remedy problems created by previous interventions, and the polarized US political environment incentivizes pell-mell regulation-making before the end of the current administration's mandate.

quantified costs and benefits, and that describe the options considered. The results of the cost-benefit analysis should be made public as part of the policy development consultation process. If the regulator decides to adopt a rule despite evidence that the costs are significantly greater than the benefits, an explanation should be provided.[35]

Cost-benefit analysis is expensive, time-consuming, and requires specialized expertise. Canadian financial markets would benefit from a consistent and coordinated approach to cost-benefit analysis from federal and provincial financial regulators. Combining resources and expertise would enable a harmonized approach to the assessment of the costs and benefits of important rule implementation across all financial services markets. This type of collaboration could be a productive topic for discussion at an expanded Bank of Canada Heads of Agencies (HOA) committee to include not just federal and provincial securities regulators but insurance, pension and credit union regulators as well.[36]

3. Post-Implementation Impact Analysis

Assuming the desired outcomes have been defined in advance, with metrics to measure success or failure, a post-implementation impact analysis will help to decide what works and why. These lessons will pay significant dividends when deciding whether and how to intervene in the future.

Post-implementation impact analysis by financial regulators is rare in Canada and goes beyond pragmatic cost concerns. One of the few instances was undertaken by the CSA to assess the impact of the amendments to NI 31-101, which implemented the Client Relationship Model 2 – Annual Cost and Performance Reports. The regulatory objective of these amendments was to increase investor understanding of fees and returns. Among the anticipated outcomes of the project was improved mutual fund investment decisions as measured by lower fees and better performance.[37]

Different elements of market failure analysis, cost-benefit analysis, and post-implementation impact analysis have been used with varying degrees of success. However, in the aggregate, Canadian financial regulators have not integrated these disciplines across their membership in a way that would deliver a consistent policy development process with predictable results.

These practices take time and rule-making already takes too long. Nevertheless, it is essential that the onus remain on the government to demonstrate that their market intervention is justified.

The only way for regulators to meet this onus is to apply a consistent approach on a case-by-case basis to the decision to intervene in financial markets. While this approach will take time, it should reduce the overall life cycle of rule development and implementation by reducing the number of new rules that are not demonstrably

35 Schwartz (2006.)

36 The HOA provides an informal forum comprising representatives from the Bank of Canada, federal Finance, OSFI and the securities regulators from Alberta, British Columbia, Québec and Ontario. The group meets four times annually to discuss regulatory and related issues concerning financial markets.

37 The analysis had three parts: an investor survey, an investment dealer survey and a comparison of investment fund flows, fees and performance before and after the new annual reports were implemented. The analysis found that the risk-adjusted performance relative to a model benchmark for both mutual funds and ETFs, while remaining negative for the whole study period, improved in the years after the client statements, annual costs and performance reports were implemented. While the CSA does not claim the cost and performance reports caused the changes in performance, this is, nevertheless, a positive finding and confirmed the CSA view that better retail investor disclosure remains an effective regulatory strategy. The analysis, however, could have gone further and included a discussion of the overall impact in terms of the regulatory objectives, whether the approach taken was optimal, and what could be done differently to improve outcomes going forward.

necessary. This, in turn, will improve the competitiveness of the Canadian financial sector.

Textual Analysis of Regulatory Behaviour

We have thus far outlined the features of good rule-making practices necessary for an efficient financial regulatory system. Earlier sections emphasized that a regulator's commitment to a predefined structural approach is key to success. This approach can be summarized in several key steps: identifying potential problems and threats, conducting a thorough and well-defined cost-benefit analyses, and clearly defining intervention objectives.[38]

We now perform a textual analysis exercise with the aim of establishing whether Canadian regulators' activity aligns with this checklist.

Textual analysis dissects written content to quantify the occurrence and significance of specific words or phrases within a document. Our analysis features two steps. First, we take a general perspective. The aim is to understand whether the global approach adopted by the federal regulator, OSFI, is truly structural and based on the adoption of clear rules and a pre-established framework. To achieve this, we need regulators with which to compare. We have chosen to measure OSFI's performance against the UK's PRA and Australia's APRA. The choice of the UK as a comparator is due to its pioneering work in changing and reshaping its financial regulatory policies to avoid unnecessary regulation and eliminate red tape. The heart of the UK's regulatory reforms is, indeed, a commitment to a structural approach.[39] We are, however, aware of the (many) differences between the UK prudential authority and Canada's, and so we also compare OSFI to Australia's APRA, as it is an example of a well-functioning financial regulator with a similar institutional setting, prudential history, and mandate.

In the second step, we delve deeper into the landscape of Canadian financial regulation. Moving from the broad perspective of the first analysis, we shift to a more specific focus, analyzing the approach of a subset of federal and provincial regulators in the creation of specific regulations. Mixing textual and topic analysis[40] tools, we check whether the processes that lead to regulatory changes follow the key steps of the checklist mentioned above.

STEP 1: An International Comparison

Situational Approach and Structural Approach

Our quantitative analysis starts with the definition of two groups of keywords. The first group, which

38 Note that, despite having listed it as one of the 'good practices' in the theoretical section, in our textual analysis we are not including the post-implementation analysis. Checking whether a post-implementation analysis is carried out would, unfortunately, not be revealing because different policies and regulations take different amounts of time to produce tangible and measurable effects, and hence to be evaluated. Any assumption on the correct time-frame would be guesswork. It is, however, worth noting that regulators commit to follow-up surveys and consultations; this represents a good step toward post-implementation analysis and revision.

39 https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/1074113/Lobby_Pack_10_May_2022.pdf, John Glen MP, 'Keynote' (Speech by Economic Secretary to the Treasury, Innovate Finance Global Summit, 4 April 2022) www.gov.uk/government/speeches/keynote-speech-by-john-glen-economic-secretary-to-the-treasury-at-the-innovate-finance-global-summit, Godwin (2021)

40 A quantitative method used to identify the main themes or topics present in a collection of text documents. It involves algorithms that analyze the words and phrases within the text to group similar documents together based on their content. By doing so, topic analysis can help researchers and analysts understand the underlying themes and trends in a large body of text, such as news articles, research papers, or social media posts. This can be particularly useful for organizing and summarizing large datasets, identifying patterns, and gaining insights into the key topics of interest within the text.

we refer to as *situational*, comprises terms that are typical of a circumstantial and case-by-case approach, mostly based on the need to respond to a particular event. This group is composed of words such as 'risk/chance' (without any reference to probabilities or analytical quantification), 'potential', 'contingent'. On the other hand, the second group of keywords, referred to as *structural*, encapsulates a more formal, general, and sound approach to regulation. This group is made of words such as 'efficiency,' 'framework,' 'analysis,' 'measurement.'

Methodology

In order to perform our comparative analysis, we rely on the Term Frequency (TF) statistic. TF refers to the frequency of particular keywords or clusters of words within a text. This statistical technique aids in deciphering the emphasis, tendencies, and patterns embedded within regulatory reports or documents. By quantifying the prevalence of distinct linguistic markers associated with regulatory behaviours, TF analysis offers a quantitative lens through which to comprehend the regulatory approach and compare regulatory strategies employed by different entities.

In our case, the TF statistics reflect the importance of the two groups of terms within the context of a broader collection of documents. We have chosen the most comparable set of documents in which OSFI, PRA, and APRA reveal their approach to regulatory activity: OSFI's Guideline Impact Analysis Statements, PRA's Regulatory Statements, and APRA's Regulation Impact Statements.[41] The computation involves counting the occurrences of these chosen keywords while excluding commonly used stop words and conjunctions to ensure precision and relevance.

Building the groups of keywords, including terms with an elevated similarity index, allows us to capture the nuances of regulatory behaviours more accurately. The resulting TF scores represent the ratio or percentage of how frequently these selected keywords appear in relation to the total number of significant terms present in the document. This normalization process allows for a standardized comparison across documents of varying lengths, providing a clear numerical representation of the emphasis placed on each regulatory behaviour within the reports or regulatory documents. The TF statistic, thus derived, offers a simple and clean analytical tool that allows a precise understanding of the regulators' preferences and inclinations.[42]

Results and Comparative Analysis: OSFI, PRA, and APRA

Our analysis reveals a fascinating contrast between OSFI, PRA and APRA. In OSFI's Guidelines, the emphasis on situational terms constantly exceeds that of the structural terms. In the analyzed documents, 71 percent of the time the TF score for the situational approach is higher than the structural one. This result suggests that OSFI places a stronger emphasis on the immediate context and circumstantial elements. Although this can be taken as a sign of its proactive stance and robust response to sudden changes in the financial landscape, it also signals, as per our analysis, a lack of generality, predictability, and a strong focus on reacting to sudden events rather than on long-term objectives.

Conversely, confirming our theoretical analysis, PRA appears to follow a more balanced approach, assigning greater importance to the structural approach, with 50 percent of the documents having a TF score for the structural terms higher than

41 The sample contains the most recent ones in which the authorities reveal their approach.

42 Despite being an extremely powerful tool, we note that, like any empirical tool, there are limitations. For example, textual analysis is a quantitative tool and might be sometimes unable to identify particularly nuanced meanings and practical applications of terms.

the TF score for the situational ones. PRA seems, therefore, to put a greater emphasis than OSFI on adherence to pre-established regulatory guidelines and frameworks, features that are fundamental for a successful general approach to regulatory activity. Australia's APRA seems to be leaning towards a more structural approach as well, with the TF score for this group of words higher than the situational one in 78 percent of the cases.

STEP 2 – Canadian Regulators' Performance

In this second section, we go a step further, and delve deeper into the specifics of regulatory activity by focusing on the process that leads to individual regulations. We concentrate solely on the landscape of Canadian financial regulation, aiming to assess whether the principles guiding provincial and federal regulators when producing specific regulations align with those of effective and efficient regulatory frameworks. As already mentioned, our theoretical analysis (and existing literature on optimal financial regulation[43]) outlines three key verifiable elements that regulatory activity should always feature:

1. **Problem Identification**: Does the regulation address a clearly defined market inefficiency, risk, or problem within the financial system?
2. **Stating Clear Objectives**: Are the desired outcomes of the regulation explicitly stated and aligned with the identified market failure?
3. **Cost-Benefit Analysis**: Does the document clearly refer to/show consideration of the potential costs and benefits associated with the proposed regulation?

Methodology

To carry out our analysis, we focus on a set of documents whose aim is to disclose the regulators' interpretation and approach when creating specific regulations. For the deposit-taking, insurance, and pensions subsectors, we choose to analyze the Guidelines published by the Financial Services Regulatory Authority of Ontario (FSRAO),[44] *Autorité des marchés financiers* (AMF), and OSFI's Guideline Impact Analysis (and related documents). For the securities industry, we analyze all the CSA's Companion Policies, which are the key documents where the regulator's approach and line of reasoning are discussed and explained.

We perform textual and topic analysis, employing a combination of techniques that allow us to extract key terms, sentences, and logical arguments from all these documents. This involves using natural language processing (NLP) tools to identify and categorize relevant information, such as the definition of different types of market failures (market abuse, asymmetric information, systemic and liquidity risk, etc.), of policy objectives (stability, transparency, efficiency, etc.), and cost-benefit considerations. By analyzing the text, we aim to determine whether each of these regulatory documents satisfies the three criteria outlined earlier. The Scorecard is reported in online Appendix B.

Results

For each document analyzed, the first column of the Scorecard table in online Appendix B indicates whether a problem/potential failure/

43 https://www.oecd.org/finance/financial-markets/44362818.pdf

44 The ones whose goal is to specify the regulator's approach 'APP', to share information 'INF', or deliver an interpretation 'INT'. We note that, like the OSC, FSRAO must perform a cost-benefit analysis, but these are also found in notices and not the guidance they publish, which are, again, the key documents for explaining the regulator's approach.

risk is identified and specifies its category. The second column reports the regulation's goals, and the third column indicates whether cost-benefit considerations are mentioned or taken into account.

The analysis reveals Canadian regulators' consistent practice of identifying risks and market failures before taking action (Column 1). Additionally, the regulations' objectives are clearly articulated and aligned with the identified failures and risks (Column 2). While these behaviours are commendable and consistent with a healthy regulatory system, a notable oversight seems to be the systematic insufficient consideration and/or publication of costs borne by firms in relation to the benefits (Column 3).[45]

Our topic analysis tools allow us to go further and to fully dissect the documents to understand what the regulators' biggest concerns and priorities are. Most regulatory initiatives (approximately 85 percent) primarily target market abuse, stability, transparency, and, ultimately, target improved consumer protection. On the other hand, a much smaller fraction (around 18 percent) explicitly aim to enhance efficiency, promote growth, and take into account the stability vs dynamism trade-off that is typical of any regulatory structure.

Breaking this down at the regulator/subsector level allows us to spot some differences between regulators. The securities subsector seems to be the one in which efficiency is (comparatively) valued the most. Around 20 percent of the CSA's documents analyzed have as the main goal 'simplification and reduction of regulatory burden.' The other regulators seem to be more aligned in focusing on stability, resilience, and consumer protection. In fact, only 20 percent of FSRAO's documents, 11 percent of the AMF's, and 10 percent of OSFI's have as their main objective the efficiency and dynamism of the financial sector (their approach appears to be homogeneous across the different subsectors).

These results reveal a clear imbalance in regulatory priorities, with a stronger focus on mitigating risks rather than fostering long-term sectoral development. This result also seems to be consistent with the findings of the first-step analysis, for OSFI, of a clear preference for a situational regulatory approach.

Conclusion

The financial services industry has been – and will continue to be – closely regulated. This is critical for market integrity. But it is also critical to avoid overregulation of Canada's relatively small financial market.

Unnecessary regulation, unlike red tape, is difficult to spot and even more difficult to undo. A disciplined approach to policy development, employing market failure, cost-benefit, and post-implementation impact analysis, is the first line of defence in curbing the tendency to overregulate.

Our textual analysis of Canadian financial regulations reveals a regulatory approach that is generally situational, responding to specific risks and market failures as they arise. While this approach allows for flexibility and adaptability, it may lack a more structural framework that could provide greater clarity and consistency in regulatory outcomes.

Canadian regulators have largely been successful in identifying potential risks and clearly stating their regulatory objectives, producing regulations that have enhanced financial stability and consumer protection. However, the approach has been weaker in performing and disclosing cost-benefit analyses, and has disproportionately focused on stability and protection, likely at the expense of innovation and competition.

Moving forward, Canadian regulators could benefit from a more comprehensive cost-benefit analysis that considers not only the benefits of

45 Of course, the assumption here is that firms provide these costs to regulators.

regulation in terms of risk mitigation and consumer protection, but also the actual costs and opportunity costs imposed on businesses, consumers, and the broader economy. By striking a better balance between regulatory objectives and compliance costs, Canada can create a more efficient and effective regulatory framework that promotes financial stability alongside innovation and growth, leading to improved consumer outcomes.

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