Intelligence MEMOS

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To: Canada's Financial Regulators

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Re: **HOW TO IMPROVE FINANCIAL REGULATION. PRUNING WOULD HELP**

Regulation is an important part of Canada's financial landscape. And to ensure the rules support an efficient and effective financial regulatory framework, regulators need to be "constant gardeners."

Canada has 44 different federal and provincial financial regulators and, as our recent C.D. Howe Institute **analysis** shows, the word count of their various rules and mandates continues to rise significantly year over year. The rules' predominant focus is on risk reduction and consumer protection. Much less attention is paid to market efficiency, innovation and growth – though in the big picture they are at least as important. Our research shows that the balance is almost five-to-one: 85 percent of initiatives primarily target risk and consumer protection, while only 18 percent explicitly foster efficiency and promote growth. The numbers suggest the "balance" may actually be out of balance and that more attention needs to be paid to growth and efficiency.

The constant challenge for the regulatory gardener is to set rules that achieve financial stability, market integrity and consumer protection without stifling competition and innovation. Regulators need to prune constantly, weeding out "unnecessary" rules to ensure regulations are proportionate to the problems they aim to fix.

Unfortunately, Canadian financial regulators have not consistently demonstrated their chosen solutions will produce net benefits for financial markets and consumers. They generally do a good job identifying risks and market failures and using them to justify regulatory objectives. But they often fail to show that the benefits of proposed new regulations exceed their costs.

These costs are well known. They include: the direct and indirect costs to government of developing and enforcing the rules; the cost to financial firms of complying, including with more staff, more training, more data collection, more required reporting and non-superficial changes, sometimes disruptive ones, in internal systems. The benefits of regulation need to be compared to these costs, which can be substantial in terms of foregone opportunities to fund new, innovative enterprises, financial products and markets.

In order to attract investment, small, open financial markets like Canada's must provide a regulatory framework that is streamlined, fosters innovation and ensures market integrity. Canadian affiliates of global financial firms need to be able to make the case for a Canadian presence. Unnecessary rules that hamper growth don't help. Canada has many advantages, but our productivity growth is lowest in the OECD. Increasingly, people need to be persuaded to invest here.

Initiatives to reduce red tape usually look to eliminate rules that have become redundant or irrelevant because of changes in business, technology or markets. Red tape is often easy to identify and from time to time regulators do some weeding.

The bigger problem is unnecessary regulation – rules that address an unproven hypothesis about a market problem. Examples include proposals to regulate financial firms' culture, proposals for open-ended retail investment funds to manage financial stability risk, and proposed amendments to the *Competition Act* that will put the onus on businesses to demonstrate compliance with as yet undefined international standards for environmental claims. These are all regulatory solutions looking for problems. They have significant costs and few identifiable benefits. They are at best unnecessary and may very well be harmful.

How can regulators make sure a regulation's benefits exceed its costs? We propose two strategies that build off each other.

First, adopt good policy development practices, including thorough problem identification, clear definition of objectives in dealing with the problem, and a cost-benefit analysis that demonstrates convincingly a new rule or regulation is the appropriate response.

Second, continually and thoroughly assess whether rule-makers consider the costs to firms and the economy as well as consumer protection and financial stability. In fairness to regulators, this is a question both for them and for the governments that set their mandates.

It's often argued that careful analysis will increase both the cost and time required to develop and implement new rules. But sound cost-benefit analysis may well reduce industry objections and shorten public consultations.

Over-regulation threatens the competitiveness of Canada's financial markets. Our work suggests regulators can and should improve how they assess whether a new rule is necessary and properly balances market integrity and efficiency.

Efficient regulations improve consumer outcomes by delivering enhanced competition, greater product choice and lower prices. By constantly assessing the regulatory balance, the constant regulatory gardener can create a more growth-friendly financial regulatory framework.

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