Intelligence MEMOS

Federal budgets are an annual rite of spring in Ottawa, as is the deluge of advice to the Department of Finance. But budget-making is a yearlong process, and the work is now in progress. Accordingly, the C.D. Howe Institute is presenting a series of Intelligence Memos in the next few weeks, outlining recommendations that we hope will help inform the policy decisions that are being made now.

From: Jeremy M. Kronick

To: The Honourable Bill Morneau, Minister of Finance

Date: November 20, 2018

Re: **IMPROVING THE FINANCIAL SERVICES SECTOR**

Election year budgets are challenging. But that should not stop the necessary policy discussions.

In a recent report, I show that Canada has experienced low aggregate productivity growth rates since the turn of the century – growth rates we cannot attribute to low starting levels. Breaking it down by sector, Canada's financial services sector has lagged many OECD countries.

A variety of factors can contribute to a country and sector's productivity levels and growth rates, but research has repeatedly shown the importance of both regulation and policy. Specifically, in the case of the financial services sector, regulation and policies can foster a competitive environment for the delivery of financial services, and incentivize the efficient allocation of capital. This latter point is crucial in a world where pioneering firms are often cash constrained, and a financial system that more efficiently allocates capital means that early-stage businesses are able to access the necessary investment to boost innovative performance.

Why focus on the financial sector? Quite simply, because it is unique in its ability to boost aggregate productivity through improvements to both its own productivity, and the productivity of other sectors.

So what can the federal government do to remedy lagging financial services productivity?

To start, implement some of the suggestions from the 2017 Competition Bureau study. One suggestion is to base the regulatory burden on the function of the entity and not on the entities themselves. Current regulations are not well tailored to smaller players, such as fintechs, and regulating by function would help close the gap, while preserving consumer protections.

To do this, however, we need to ensure that regulation is proportional to risk. Take payments, for example. There are multiple functions within payments, with differing levels of risk to the system. At the two extremes, consider small retail payments such as buying your daily coffee versus larger interbank settlement payments. The failure of the former function is much less risky to the system than the latter. Regulatory oversight can, therefore, be tailored to the risk of failure the function poses.

Some may argue that the current level of financial sector competition has served the country well, in which case the goal could instead be scaling up fintechs to make better use of the competition we do have. A 2017 Deloitte study shows that as of 2016 the UK fintech market was more than $10 billion, while in the US, New York State alone had a market in excess of $9 billion. Canada's fintech startups, on the other hand, have secured just over $1 billion since 2010.

One of the big hurdles has been the prohibition on banks and insurance companies making a substantial investment in fintechs if these companies perform activities outside of the financial services space – even if financial services remain their core function. The government tabled legislation following Budget 2018 to remove this obstacle, but as of this writing, its impact is unclear. The challenge will be determining how much financial service focus is required to be considered a core function. But revising the *Bank Act* and *Insurance Companies Act* along these lines is critical to help scale up some of Canada's more innovative firms.

The challenges of an election-year budget are many, but in the long-run Canadians will gain from a financial services sector that is competitive, allocates capital efficiently, and is focused on improving productivity.

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