**CHAPTER 20:**

**Managing Risk:**

**Regulation of the Financial System**

**FOCUS OF THE CHAPTER**

This chapter focuses on the role of **government as regulator** of the financial system. The **need** for and the **guiding principles** of government regulation, key forces influencing changes in the financial system and **regulatory reforms** in Canada, and **various forms of regulation** are discussed in particular.

**Learning Objectives:**

1. Identify the key elements influencing the regulation of the financial system
2. List and describe the dilemmas facing policy makers and regulators today
3. Identify the three dominant themes of regulation today
4. Explain why actual regulation does not fit easily into one classification

**SECTION SUMMARIES**

**Guiding Principles of Government Regulation**

The experience of many countries, including Canada and the United States, shows that the **contagion effect** (the transmission of a financial crisis in one region or country to other regions or countries) is stronger in the financial industry than in other industries. **Market failure** in the financial sector may be caused by dishonesty and attempts to rig financial markets, among other things. Therefore, the **guiding principles of government regulation** in the financial system include the following: a) ensuring the safety of the financial system through prudent requirements of regulation; b) promoting efficiency; c) ensuring competition; and d) promoting social goals. History shows that some of these principles occasionally may conflict with one another.

**Winds of Change: Levelling the Playing Field**

The banks were allowed to be **self-regulating** during the era of free banking in the 19th century, following which government involvement in the financial system grew for various reasons. Events in the last two decades of the 20th century played a major role in shaping the government's role as regulator of the Canadian financial system. These events highlighted the drawbacks of the then-existing types of regulation which constrained different institutions in different ways. At present regulation is designed to ensure that a minimum of prudent controls are imposed on financial institutions (as opposed to controlling virtually every aspect of their operations) with the aim of creating a level playing field.

The **major forces** leading to a **levelling of the playing field** for financial institutions include the following: a) technological changes (such as improvements in computer technology); b) increased globalization and consolidation of the financial industry; c) improvements in payments and settlement systems; d) increased frequency of regulatory reforms; e) clarification of jurisdictional issues; f) demographic changes (such as an aging population); and g) improvements in corporate governance.

***Is Asymmetric Information a Thing of the Past?*** As a result of advancements in information technology and the Internet, information has become widely available and the information cost of financial transactions has been decreased. At the same time, the complexity of financial transactions has grown. The **asymmetric information problem** in financial markets has been reduced, but not completely eliminated.

***Does One Size Fit All?*** The forces of **globalization** and **consolidation** have led to a renewed interest in the centralization (or convergence) of regulation at national and international levels. However, the internationalization and centralization of regulatory activities may involve some costs due to a variety of reasons such as: a) Canada may not have much influence in global reforms (because of the smallness of its financial sector in international terms); b) internationalization of a regulatory framework may conflict with domestic goals; and c) centralization may make regulators less responsive to various constituencies. Therefore, it would seem that one size does not fit all in the context of financial regulation.

***Canada’s Position:*** Some **salient restrictions facing banks** in Canada compared to banks in selected other countries are: a) bank holding companies are permitted in Canada (since 2001); b) universal banking is restricted in Canada; c) competition from foreign banks is very small; and d) the degree of concentration in the Canadian banking industry is relatively high.

In comparison to the United States, Canada still has more restrictions on:

a) the range of activities which the banks are permitted; b) entry; and c) ownership. Restrictions in these three areas present problems for policy makers as they struggle to follow the guiding principles of regulation stated earlier.

**Forms of Regulation**

Governments face three main forms of regulation: **self-regulation**, **institutional regulation**, and **functional regulation**. The existing regulatory framework in Canada is a mixture of all three.

***Self-Regulation:*** Self-regulation (regulation by the institutions themselves) can play an important role in a regulatory framework for a variety of reasons, such as the fact that not every aspect of bank operations can be regulated; regulation of every aspect of the banks' operations is neither desirable nor efficient; the institutions find that self-regulation is in their own best interests; and there are several modern models of corporate governance in which self-regulation can be both effective and successful. However, the principles of prudent regulation and concerns about competitiveness lead to some formal types of intervention by government.

***Institutional Regulation:*** Institutional regulation refers to a set of rules and regulations aimed at institutions or firms (regulating institutions rather than their individual activities). The dominance of the banks and the importance of commercial loans led to the development of institutional regulation in Canada. As a result of institutional regulation, new specialized institutions such as trust companies and insurance companies emerged in the Canadian financial system. The outcome of the separation of functions (under institutional regulation) was the development of the so-called four pillars concept. The institutional form of regulation has become increasingly outdated in the recent past due to various factors such as the growth of world trade and financial wealth; the internationalization of the activities of financial institutions; growth and diversification of the activities of financial institutions; and the entry of traditionally non-financial firms into the financial services markets.

***Functional Regulation:*** Functional regulation refers to the regulation of financial institutions according to the type of activity (or functions) they are engaged in. Banks today have become so complex that they are no longer recognizable in their traditional roles. It has been argued, therefore, that functional regulation is more efficient than institutional regulation. Functional regulation seeks to ensure that the following three aims are met: a) safety and soundness in business practices; b) market conduct conducive to competition; and c) protection of consumers' interests. Additional regulations may be required under functional regulation to prevent undue practices such as **self-dealing** (attempts to tie in the sale of a financial product with another from a different division of the same institution).

**MULTIPLE**-**CHOICE QUESTIONS:**

1. The contagion effect refers to

a) the interregional or international transmission of financial crises.

b) the effect of the volatility of interest rates on the prices of financial assets.

c) the adverse effects of deposit insurance on the financial system.

d) the transmission of crises in the financial sector to the non-financial sector

of the economy.

2. Prudential requirements of government regulation are designed to

a) prevent conflict between monetary and fiscal authorities in the country.

b) prevent conflict between the objectives of principles and agents of firms.

c) ensure the safety of the financial system.

d) prevent bank mergers.

3. In the free-banking era of the 19th century, governments in Canada

a) imposed strict regulations on the banks.

b) allowed banks to be largely self-regulated.

c) followed a model of institutional regulation.

d) followed a model of functional regulation.

4. Which of the following was not a principle concern of government regulation of the financial system in Canada during the last two decades?

a) to encourage competition in the financial industry

b) to keep the foreign value of the Canadian dollar from falling

c) to promote social goals

d) to create a level playing field among the various groups of financial institutions

5. Recent improvements in information technology have

a) increased the transaction costs of financial transactions.

b) reduced information costs and eliminated the problem of asymmetric information.

c) increased participation costs of financial transactions.

d) increased the complexity of financial transactions.

6. Which of the following is a correct statement?

a) Bank holding companies are not permitted in the United States.

b) Universal banking is unrestricted in the United States.

c) Foreign competition is relatively low in the United States compared to Canada.

d) Banking industry concentration is relatively high in the United States compared to Canada.

7. Which of the following is not true about the existing regulatory framework in Canada?

a) There are no barriers on interest rate regulation.

b) There are some restrictions imposed on entry.

c) There are no restrictions imposed on ownership.

d) There are some restrictions on the type of financial activities.

8. Regulation of the financial system according to the type of activities of the financial institutions is called

a) institutional regulation.

b) deregulation.

c) functional regulation.

d) self-regulation.

9. The existing regulatory framework in Canada is

a) one of functional regulation.

b) one of institutional regulation and deregulation.

c) a mixture of self-regulation and functional regulation.

d) a mixture of self-regulation, institutional regulation, and functional regulation.

## PROBLEMS

## 1. What is contagion and why does it make some form of government regulation necessary in the financial system.

## 2. State the guiding principles of government regulation in the financial system.

## 3. What are the major forces leading to a levelling of the playing field for financial institutions in Canada?

## 4. What are some of the key areas of difference between the regulatory frameworks of Canada and the United States

5.Why are demographic changes in the last two decades a force leading to the levelling of the playing field in the Canadian financial sector?

6. How has globalization effected the process of regulatory reform of the financial sector?

7. Having the advances in information technology increased or decreased the importance of financial intermedition? Discuss.

**ANSWER SECTION**

**Answers to multiple-choice questions:**

1. a (see pages 394-395)
2. c (see page 395)
3. b (see page 395)
4. d (see pages 395-396)
5. d (see page 398)
6. b (see page 400)
7. c (see page 400)
8. c (see page 403)
9. d (see page 401-403)

**Answers to problems:**

1. Contagion is a form of an externality in which the unethical or irresponsible behaviour by one party inadvertently affects many others. Some form of government regulation of the financial system is necessary to avoid and reduce the adverse effects of market failure due to factors such as dishonesty in the financial system. The fact that the contagion effect is stronger in the financial industry than in the non-financial industry makes government regulation necessary in the financial system.

2. The guiding principles of government regulation in the financial system are: a) ensuring the safety of the financial system through prudent requirements of regulation; b) promoting efficiency; c) ensuring competition; and d) promoting social goals.

3. Themajor forces leading to a levelling of the playing field for financial institutions in Canada are:

a) technological changes (such as improvements in computer technology);

b) increased globalization and consolidation of the financial industry; c) improvements in payments and settlement systems; d) the increased frequency of regulatory reforms;

e) clarification of jurisdictional issues; and f) demographic changes (such as an aging population).

4. Some of the key areas of difference between the regulatory frameworks of Canada and the United States are as follows: a) bank holding companies are permitted in the US, but in Canada, they are limited and permitted only since 2002; b) universal banking is permitted in the US but not in Canada; and c) foreign ownership of banks is more restricted in Canada.

5. The demographic effect referred to is the aging of the baby-boom generation who are presently approaching retirement. As many of this generation have accumulated significant amounts of financial wealth they are better able to invest directly than indirectly through a financial intermediary. This has generated more competition for traditional banking operations and has encouraged banks to seek new markets.

6. Globalization has forced the financial sector to become more competitive as both borrowers and lenders have increasing opportunities to use foreign markets. It has also motivated banks to want to merge to increase their relative size in global markets.

7. Many of the advances in the financial sector such as derivatives and securitization allow for more direct interaction and less intermediation. On the other hand, however, the increasing complexity of transactions will mean that banks will continue to have an important function.