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*The Financial Services Sector: Past Changes and Future Prospects**

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ABSTRACT

The financial services industry has been undergoing significant change in recent years. This paper analyzes some key developments affecting the industry and examines some important issues facing the industry and its regulators. Changes discussed include the way services are provided, the instruments used to provide services, and the nature of the financial service providers. Factors driving these changes include technological developments, the changing role of competition, and demographically led changes in household portfolios. These changes raise challenges for the financial services industry. Among the most important are determining what services and products to offer as well as the best size for providers. With the evolution in the financial services industry, policymakers and regulators also face challenges: the relative use of disclosure and market discipline versus direct supervision; the potential role of functional regulation; the role of non-regulated financial service providers; changes in the current supervisory process; cross-border transactions; and the impact of new developments on the legislative framework governing financial service providers.

RÉSUMÉ

Le secteur des services financiers traverse depuis quelques années une période de mutation profonde. Les auteurs de l'étude analysent certains des changements clés survenus dans ce secteur ainsi que les défis qu'ont à relever les fournisseurs de services financiers et les organes de réglementation. Le mode de prestation des services financiers, la nature des fournisseurs et les instruments qu'utilisent ces derniers se sont modifiés, par suite notamment des progrès de la technologie, du rôle changeant de la concurrence et des modifications que l'évolution démographique a provoquées dans les portefeuilles des ménages. Tous ces changements

posent des défis aux fournisseurs de services financiers, qui doivent en effet établir quelle gamme de services et produits offrir à la clientèle et quelle est la taille idéale pour réussir. L'évolution du secteur des services financiers recèle aussi de nouveaux défis pour les décideurs publics et les organes de réglementation. Ceux-ci doivent ainsi décider dans quelle mesure recourir à l'obligation d'information et à la discipline de marché ou à la surveillance directe des activités; ils doivent également se pencher sur la réglementation par fonction, le rôle des fournisseurs de services financiers non assujettis à la réglementation, les conséquences des mutations du secteur sur le plan de la surveillance, la question des transactions transfrontières et l'incidence des innovations sur le cadre législatif régissant les fournisseurs de services financiers.

1 INTRODUCTION

The financial services industry has been undergoing significant change in recent years. The rapid pace of this change has left many financial service providers (FSPs)[1] struggling to determine an appropriate strategic direction for the next few years. Many of these FSPs think that they are at a particularly critical juncture and are concerned that a wrong choice could result in their becoming a declining part of the industry. This paper analyses some of the key developments affecting the industry and examines some of the most important issues currently facing the industry and its regulators. It does not attempt to discuss all of the important developments or issues—to do so would require more time and space than is available. While most of the examples in the paper are drawn from the North American context, many of the developments and challenges in the financial services industry in Europe would be similar, although perhaps not identical.

It is important to specify at the outset the nature of the changes that have been occurring. The underlying functions performed by the financial services industry have not changed,[2] although their relative importance probably has altered over time. What has been changing is the way services are provided, the instruments used to provide the services, and the nature of the entities providing these services. Changing customer demands have

1. In this paper, the term "financial service providers" includes both regulated and non-regulated entities that offer financial services; the term "bank" includes all deposit-taking entities; and the term "customers" includes all purchasers of financial services and products regardless of their size (i.e., both individuals and corporate entities).

2. Merton and Bodie (1995, 5) focus on six functions provided by the financial sector:
   - (i) ways of clearing and settling payments to facilitate economic and financial transactions;
   - (ii) mechanisms for the pooling of resources and for subdividing the shares in various enterprises;
   - (iii) ways of transferring economic resources through time, across borders, and across industries;
   - (iv) ways of managing risks;
   - (v) mechanisms for the provision of price information to help co-ordinate decentralized decision-making in various sectors of the economy;
   - (vi) ways of dealing with incentive problems created when one party to a transaction has information that the other party does not have or when one party acts as agent for another.

not been an important factor in driving these changes. Customers have, however, adjusted their behaviour in response to FSP-initiated innovations in services and instruments.

Change in the financial services industry is not new. The nature of FSPs, and the processes that they have developed and used to meet customers' demands for financial service functions, have been undergoing continuous change and this will likely continue. What is most striking about the current period is the pace of change in the industry. The scope of current and potential change in instruments, financial service providers, and types of service provided appears greater now than ever before.

2 KEY FACTORS DRIVING CHANGE IN THE FINANCIAL SERVICES INDUSTRY

A number of factors have driven change in the financial sector: technological developments, the changing role of competition in this sector, and demographically led changes in household portfolios. These factors, while discussed separately below for expository reasons, have interacted in important ways. This interaction makes it more difficult to pinpoint a certain factor or change as *the* cause of a particular development. A factor may have been the necessary condition for a development to occur, but it may not have been sufficient by itself to bring about the outcome. For example, certain technological changes may have facilitated specific outcomes without being the sole causal factor.

2.1 Technological change

The most important factor propelling change has probably been technology. Technological developments in recent years, especially those in information processing, management, and delivery, have led to a number of significant changes in the way FSPs operate. Changing technology has permitted them to offer new services or products or to improve existing ones and hence to satisfy more fully and efficiently customers' demands for the financial service functions. Moreover, technological change is likely to continue to facilitate significant future changes in the nature of services provided and the way they are delivered. This section of the paper focuses on three key developments facilitated by technological change and assesses their implications: backroom efficiencies; new instruments (including electronic money and commerce) and different ways of putting the underlying financial service functions together; and service delivery mechanisms for the household sector.

2.1.1 Backroom efficiencies

Technological developments over the years, particularly in electronic processing of transactions, have enabled financial institutions to increase the efficiency of their backrooms. Initially, these developments allowed the financial services industry to manage the sharp increase in the volume of transactions that was underway without a proportionate increase in costs. More recently, they have led to a merger of some of the backroom operations of large Canadian banks, or to the outsourcing of some of these activities, to take advantage of the potential economies of scale in this area. In one sense, this is not a new development at all; small- and medium-sized FSPs have been doing this for some time.

What is new is that technological change has increased significantly the size of the scale of certain operations at which an FSP must operate to be efficient. Thus, even a large institution can gain significant scale economies by merging certain of its backroom activities with those of other institutions or by completely outsourcing these activities to a third party. Interestingly, a Deloitte & Touche study (1995) of this issue[3] concludes that banks in dif-

3. The Deloitte & Touche study draws an interesting analogy of the financial services industry with other industries. In many other industries, certain processes are contracted out because of the scale efficiencies obtained from their being done by specialist firms. Airlines, for example, have specialist companies clean their aircraft, run their reservation system, etc. In the past, large banks felt that, if they were to provide a product, they had to provide the supporting infrastructure; this view may now be changing.

ferent countries will contract out backroom operations to a different extent. One question is how far this development will go. For example, will FSPs begin to work on common system developments to support internal risk management (e.g., risk modelling, information systems for management) or to develop common industry software to support certain activities (e.g., interfaces to clearing and settlement systems)? In other words, will there be a greater standardization or harmonization of internal processes used to support the delivery of products to the customer at a lower cost or with improved quality?

2.1.2 New instruments and different ways of putting functions together

Six key functions provided by the financial system are noted in the introduction (page 1, footnote 2). Many of these functions traditionally had to be provided as a joint product and could not be disentangled or unbundled. With the recent technological changes, new instruments have been developed that permit the unbundling of these functions, the restructuring of financial components into a variety of new products, and the delivery of the separate services by different entities. For example, a foreign currency bond issue by a Canadian resident used to involve an inseparable link between raising funds and taking on foreign exchange exposure. With the development of the foreign currency swap market, the two elements can now be separated in a very efficient way. Similarly, the use of swap markets or repo markets now allows an investor in a foreign bond to unbundle foreign exchange risk and interest rate risk.

Innovations have also permitted FSPs to unbundle the various financial services incorporated in a given financial asset. For example, in the past, the financial institution making a mortgage loan not only originated the loan and processed the payments over the life of the loan, it also took the loan onto its balance sheet. This meant taking on the credit risk (unless it was a government-guaranteed mortgage) and, in the case of U.S. mortgage lenders, a considerable risk arising from maturity transformation. With the development of securitization, the mortgage originator was able to sell the mortgage to a lender with a longer-term horizon (i.e., to an investor who was willing to assume term risk or to an institution trying to match a longer-term liability). In the United States, where this type of securitization began, certain institutions have come to specialize in the origination of mortgages and the processing of mortgage payments, without holding mortgages on their own balance sheet. The outcome has been that almost 50 per cent of the stock of U.S. mortgages are currently securitized, and the practice is becoming more common in other countries.

The development and spread of a variety of types of derivatives have facilitated the unbundling and potential rebundling of a number of products. New and existing entities were thus able to become involved in parts of the financial services industry in which they were previously not involved. Customers benefited from an improvement in the choice and quality of products and services and from reductions in the costs of certain services.

Another interesting area of development is electronic money and commerce. Technological changes have now made it feasible to develop the stored-value card (SVC). Even more than earlier payment system developments (such as credit cards and debit cards), the SVC provides a very close substitute for bank notes and coins for small-value face-to-face payments, thus offering the possibility of being able to meet consumer demands for such payment services more effectively. There are a number of groups currently involved in developing SVC projects, most notably Mondex, Visa, and Proton. FSPs are jointly developing these products because of network externalities as well as the significant infrastructure costs involved in the development and spread of the SVC technology.

A development in the very early stages, but one that may become more important in the future, is network money or digital cash. This involves funds (i.e., the liability of an issuer) held on computer software that could be used to pay for purchases on the Internet. Thus far, most participants in such schemes have been software companies rather than major financial institutions. It is, however, far from clear whether these schemes, although technically feasible, will find widespread acceptance. While electronic commerce needs facilitating payments mechanisms, there are a number of possibilities available other than digital cash. For medium- to large-sized payments, credit cards are an obvious means of payment, especially if security concerns are dealt with adequately. Moreover, as SVCs spread, they will be usable for small- to medium-sized payments on the Internet. Where digital cash might be helpful would be for payments of a fraction of a cent for transactions that are made frequently, such as access to information on the Internet. However, even here, it is possible that SVCs could be used.

2.1.3 Delivery mechanisms for the household sector

A generation ago, most household transactions were carried out in the bank branch, with the teller taking in deposits, paying out cash, and making bill payments, and with a bank officer making loans based on an assessment of the creditworthiness of the potential borrower.

An important technological breakthrough that changed this pattern was the development and spread of the ABM, which permitted payments of cash to the customer to be carried out without access to a teller.[4] An increasing number of functions gradually became available on the ABM, such as depositing, bill paying, transferring funds between accounts, and even investing in certain types of mutual funds.[5]

4. While initially restricted to the ABMs of one's own bank, systems soon developed that permitted the household to access its account in a network of ABMs regionally, nationally, and then internationally, for a limited range of transactions.

5. Note that earlier technological changes had helped make branches more efficient. For example, large internal computer networks permitted certain routine transactions to be handled more quickly and easily (such as the updating of passbooks or retrieving information related to customers' business). These changes permitted the branch delivery channel to be used more efficiently (i.e., tellers could perform other services with a higher added value for the FSP).

The next step in this process of new modes of delivery was telephone banking. Using a PIN, customers could give instructions to representatives of their financial institution at a call centre, often 24 hours a day. While convenient for some customers, this step required only minimal investment in infrastructure by the bank, since it used existing telephone networks.

The most recent step was the increased use of personal computers for the delivery of financial services. This has allowed owners of PCs (an increasingly large share of the population) to carry out many types of financial transactions interactively from their homes. This service channel has not been limited to traditional bank-type services such as transferring funds between accounts at a given bank or paying bills. New services have been developed that permit the user, for example, to search for the highest interest rate on term deposits offered by banks, to search for the lowest mortgage rate available from lenders, to choose and invest in mutual funds or individual equities, to track the performance of investments, to be sent an e-mail message if there are major developments in the companies in which the user has invested, etc. Moreover, with the development of stored-value cards (SVCs), even the downloading of an equivalent-to-cash on a PC will be possible in the near future.

A further development on the borrowing side has resulted from the spread of credit-scoring techniques to assess the creditworthiness of borrowers. It is now becoming possible to arrange for a loan via computer, thus potentially further weakening the linkage between the branch and the customer.

Many of the services that can be accessed via the home computer are provided directly by FSPs, that is, by some type of financial institution. But non-financial entities, such as software firms, can also act as information providers to the customer, while not providing the basic financial service or product themselves. The role of these entities in the future could be one of the most interesting areas to follow, in particular, the extent to which these entities will want to become more involved with the consumer, going beyond the provision of information, to facilitating the purchase of financial assets or the borrowing of funds, or even to the actual production of these assets and liabilities. Developments in this area could have important ramifications for FSPs such as insurance brokers, discount securities dealers, and even the producers of various types of financial assets and liabilities, as they all strive to “own” the customer. This issue is addressed in more detail in Section 3.2 later in the paper.

2.2 Changing nature of competition in the financial services sector

Another important factor driving change in the financial services sector has been the changing nature of competition, most notably the cross-border movement of FSPs and the growth of non-regulated entities. While these types of expansion were fundamentally driven by perceived opportunities for profit (themselves, in part, consequences of technical innovations), they were also facilitated by government actions to promote greater competition within the financial services sector.

2.2.1 Government actions to promote competition

Many indigenous banking systems in the past developed a cartel-type structure (either nationally, as in Europe, or locally, as in the United States) that generated high intermediation margins in their transactions with their customers. In a number of countries, this was facilitated by competition-limiting measures imposed by the authorities (e.g., restrictions on deposit rates, limitations on entry of foreign FSPs).[6]

6. The competition-limiting measures adopted by governments were often accompanied by requirements that the banks act as instruments of policy in certain areas (e.g., lending on favourable terms to certain sectors of the economy). In addition, to the extent that the cartel-type arrangements enhanced bank profitability, they may have served to increase the safety of depositors.

More recently, policymakers in many countries have increasingly taken the view that additional competition in their country's financial sector would be very beneficial for customers (subject, of course, to maintaining an acceptable level of safety and soundness within this sector) and have been dismantling structures that formerly inhibited competition. In part, this change of view has resulted from the fact that it has become increasingly difficult in any case for countries to protect indigenous FSPs from competition. Customers are finding ways of obtaining these services or products from other producers, either within their own country (from non-regulated entities, for example) or from entities located abroad. In part, this change has resulted from the belief that increased competition in the financial services area can lead to increased productivity growth in the economy as a whole, since financial services are an important input in all sectors.

In Canada, for example, the legal basis for the traditional compartmentalization of the financial sector into specialized sector groupings has disappeared in recent years. The distinction between the separate sectors or pillars had been eroding over the years as each sector started to penetrate the business of other sectors by offering products that competed with their traditional business. However, serious consolidation began to occur only after the legal prohibitions were eliminated in 1987 (permitting other financial institutions to enter the securities business) and in 1992 (permitting the various regulated financial institutions to enter into each other's business through subsidiaries and, to some extent, through their own balance sheet operations). The result thus far has been a very significant involvement of banks in the securities and trust businesses, and the beginnings of a similar movement into life and property and casualty insurance. At the same time, some insurance companies moved into the trust business and into banking. Moreover, the 1980 revision to the Bank Act permitted foreign banks to set up banking subsidiaries, and the Canadian government recently announced its intention to permit foreign banks to branch directly into Canada.

In the United States, the breakdown of the barriers to the penetration of banks into other areas of the financial sector has proceeded largely on the basis of regulatory rulings that have eased the restrictions, rather than on formal legislative change. Thus, for example, Glass-Steagall limitations on banks being involved in the securities business have gradually been attenuated by Federal Reserve Board rulings that permit banks to engage in increasingly large amounts of such business. The Comptroller of the Currency has in recent years given banks under its jurisdiction the right to carry out certain lines of business that had previously been closed to them in the United States. And recent legislative changes first weakened and then eliminated the restrictions on interstate branching, setting off a wave of bank consolidations in the United States. Furthermore, rulings by some state regulators have permitted non-bank financial institutions to engage in many new lines of business. As a result of these changes, the financial landscape of the United States has been altered very significantly in recent years, with the potential for further major change as institutions take increasing advantage of the new possibilities that have been opened to them. If the United States moves in the direction of allowing financial-commercial linkages (as proposed by the Treasury), even more dramatic changes could be in the offing.

This trend towards greater competition in the financial services industry has been reinforced by the inclusion of financial services in world trade negotiations. The focus of these negotiations has been to “level the playing field” for FSPs that wish to sell products or services to residents outside their home country. This has been accomplished by permitting their establishment in foreign countries on terms that permit more effective competition with indigenous FSPs and, more recently, by facilitating the delivery of financial products or services to foreign residents without having to have a physical presence in the foreign country.

2.2.2 Internationalization

In recent years, there has been a significant increase in the internationalization of the financial services industry, defined for purposes of this paper as the spread of FSPs across borders. The internationalization of financial services has involved FSPs in many countries in a two-way movement. That is, in most major countries, domestic FSPs have moved into foreign markets at the same time that foreign FSPs have moved into the domestic markets, increasing competition in both markets. For example, not only have U.S. banks (especially investment banks) been very successful moving into foreign markets, many foreign banks have, at the same time, successfully penetrated U.S. markets. What accounts for this successful two-way movement of large banks?

The historical pattern in the earlier postwar period was for banks to follow their large non-financial customers abroad. They relied on an information asymmetry (namely, their intimate knowledge of their customers' businesses and needs, based on their domestic relationships) to enable them to provide some financial services to such customers abroad as well. But at least initially, they were limited even in this type of business by their lack of a solid base in the foreign country. Indigenous banks, because of their long-standing relationships in and knowledge of local markets, still received the lion's share of the financial business of foreign non-financial firms in their countries. In addition, government policies in many countries severely constrained the ability of foreign banks to compete successfully with domestic banks.

Gradually, however, this began to change. Since each banking system had somewhat different forms of expertise and somewhat different weaknesses, foreign banks were able to find opportunities to expand their operations by focusing on their own areas of expertise. This was especially true where the indigenous banks were, for whatever reason, unable or unwilling to compete in certain areas. For example, U.S. investment banks have long been innovators in the development of new instruments. They also have been in the forefront of developments in the merger and acquisition business (perhaps because mergers and acquisitions are relatively more common in the United States than in other countries). They have been able to offer this expertise successfully to European and Japanese customers. An element of expertise that foreign banks brought to the United States, at least in jurisdictions such as California where such activity was permitted, was their experience in branch banking. Similarly, the development of innovative techniques of service delivery in a domestic market can be exported to foreign markets and can cut into the domain of indigenous institutions.

Another factor that has played an important role in the ability of foreign banks to penetrate domestic markets successfully has been their willingness to compete on both price and non-price terms. The entry of foreign banks into domestic markets has often shaken or broken the prevailing cartel-type arrangements, since the foreign banks had to operate at lower margins than those prevailing in the domestic market in order to gain market share. Gradually, over time, the foreign banks were able to establish themselves as low-cost lenders or high-return borrowers of funds.

This is not to say that the indigenous institutions have lost their home markets. They still retain the major share of the business in those markets. But increasingly, foreign banks are gaining market share as well as forcing the indigenous banks to behave more competitively and more efficiently in their previously protected home market.

While the principal thrust of internationalization in the past was in the wholesale or large-value part of the financial services industry, more recently the emerging trend seems to be increased penetration of foreign banks into domestic retail markets. A key obstacle in the past that prevented foreign banks from breaking into the retail market in a major way was the strongly entrenched position of the indigenous banks in an industry that depended largely on brick-and-mortar branches for services delivery. With the best branch locations already owned by local banks and with explicit or implicit government prohibitions of the takeover of major domestic banks by foreign banks, the indigenous banks in Canada, Europe, and Japan were largely immune to retail competition from foreign banks.

Technological change in the form of remote delivery of certain financial services and products may well provide the means for foreign banks to overcome this obstacle (although this possibility has not yet materialized on a large scale in most places). The spread of telephone banking and the introduction of computer-based delivery of services discussed earlier has made the so-called “virtual bank” a possibility. Of course, domestic banks are also rushing to offer such services to their customers, both as a way of cutting costs and of holding onto their customer base in the face of the new competitive challenges. Nonetheless, the domestic banks are concerned that their costly investment in brick-and-mortar branches, which until now were the principal obstacle to entry for foreign banks, will become an albatross for them,[7] with the new virtual banks (themselves perhaps the subsidiaries or branches of brick-and-mortar banks in other countries) gradually gaining an increasing share of the local retail business. Nonetheless, brand recognition and loyalty to the domestic banks are still formidable obstacles for foreign banks.

While the principal focus of the spread of virtual banking has been on the deposit side, similar developments are occurring (although at a slower pace) on the loan side as well. With the spread of credit-scoring techniques, it has become possible to engage in consumer and even small business lending without having a physical presence in the country or a personal rela-

7. One initiative aimed at reducing the costs of bricks and mortar has been to build mini-branches, providing limited services and opening for fewer hours than traditional branches, in supermarkets and shopping centres.

tionship with the borrower. And perhaps, with video telephones and video conferencing, even larger loans might become more common, since "face-to-face" discussion and negotiation will be possible even at long distances.

2.2.3 The role of non-regulated FSPs

The increased competition to regulated financial institutions provided by non-regulated FSPs has been another important development in recent years. While there has always been a continuum in the provision of financial services, from regulated to less-regulated to non-regulated entities, two developments are challenging traditional regulated financial institutions. First is the entry and spread of non-regulated financial entities into a variety of loan/borrowing areas in which they have managed to compete very effectively with traditional regulated lenders. Second is the potential for entry of non-financial entities, such as software firms and telecommunication companies, into the delivery of payment services and into fund management activities.

Companies like GE Capital (first in the United States and now international) and Newcourt Credit (in Canada and now moving into the United States and Europe) have aimed at becoming highly efficient providers of credit in certain specialized areas, such as the leasing of producer equipment or consumer products. By becoming extremely knowledgeable about the specific areas in which they are engaged, they can offer fast, low-cost service to their customers. Moreover, by specializing in a certain area, they can develop service delivery systems that are customized or tailored to that line of business and hence are more efficient. These services can often be transferred across geographic borders and sometimes can be modified to also meet the needs of related lines of business.

The second type of new competition faced by banks comes from non-regulated non-financial entities (including software companies) in such areas as electronic payments processing and service delivery on the Internet. One big issue here is whether the software providers will create strategic alliances with the financial institutions or whether they will try to provide alternatives to them. In the latter case, they could intermediate between the user and the provider of products and direct the customer to what is perceived to be the most appropriate product. In effect, the customer would be their customer, not that of the bank.

Regulated entities may find regulation an increasing disadvantage in the same way that domestic banks may find brick-and-mortar branches a disadvantage. In the past, government actions that tended to promote or protect cartel-type arrangements of regulated entities may have been of real financial advantage to these entities. Now, however, the regulatory process that protected regulated entities from competition may inhibit these same entities from responding rapidly and effectively to the competitive challenge posed by non-regulated entities. Technological change and, relatedly, governments' increasing willingness to promote customers' interests through increased competition may well mean that regulation no longer shelters regulated entities from full-scale competition. These developments may also have important implications for the objectives of regulation and the processes used to supervise regulated entities, subjects addressed in Section 4 of this paper.

2.3 Changes in household demographic trends

Demographic developments have been largely responsible for the gradual change in the desired asset-liability structure of household portfolios. This change has implications for the areas of growth in the financial sector. As the population of North America, Western Europe, and Japan has aged, and as income levels and wealth have increased, there has been a slow but steady shift away from credit products (such as consumer loans and home mortgages) to wealth-management products (such as pension funds and mutual funds). Moreover, the portfolio shift from deposits to mutual funds has been intensified by the movement to a low-inflation, low-interest-rate environment that has caused many savers to search for higher rates of return than are typically offered by deposits.

These phenomena have had a number of repercussions on the financial market place.[8] First has been the rapid growth of pension funds and other institutions providing wealth-accumulation products for retirement. Second, as household portfolios have grown, the demand for investment advice by households has increased. The provision of this service (along with the commissions that accompany the resulting investment decisions) has become a profitable part of the financial industry offerings. This type of wealth-management advice has been offered by various FSPs as well as by independent agents. While some firms focus on selling the products that they or their affiliates provide, others have taken the brokerage approach, offering the products of other FSPs as well as, perhaps, those of their own firm. And, as mentioned earlier, computer software packages have been developed, enabling households to search out the highest yield assets of a given type. Third, with the shift towards mutual funds, a number of institutions have bought or developed entities that provide such funds to their customers and have reaped a number of benefits from being involved in this business. It has allowed them to tap into a rapidly growing market, with potential for fee growth. It has also allowed deposit-taking institutions to hold onto customers' funds that are shifting out of traditional deposits, albeit in a different form. And, by offering a full-service line of products, these institutions can develop synergies or economies of scope in the delivery process. Most importantly, it has allowed these providers to maintain an ongoing relationship with their customers.

The efforts by all types of institutions to increase their involvement in the wealth-management area reflect not only the demographic changes in

8. See Davis (1996) for worldwide developments.

our society, but also the profitable nature of this type of activity. Much of the net revenue in banking comes from a minority of customers who engage in a significant number of the more profitable types of transactions with their financial institutions and advisers. Some banks seem to believe that they are faced with the choice of gaining a significant share of this type of business, or becoming an entity that offers only plain-vanilla types of transactions (yielding much less revenue per transaction) and that depends on generating large volumes to be profitable. This issue is discussed further in Section 3.2 below.

3 CHALLENGES FACING THE FINANCIAL SERVICES INDUSTRY

The pace and scope of change currently facing the providers of financial services raise a number of challenges. How can FSPs best meet their customers' existing demands for financial services and products and create new and profitable ways of carrying out the underlying financial functions needed by households and businesses? How important is a provider's size in domestic and foreign markets? What is the best way to organize: provide a wide range of products; focus on a few profitable products; produce all products internally; purchase products and services from others but provide the interface with customers? Will governments mandate the provision of certain services or products, or the delivery mechanisms associated with these products? Some of these challenges were noted in the previous section of this paper. This section focuses on two of the most important—how large does an FSP have to be in order to be successful, and how does it determine the range of services and products to provide?

3.1 How important is size?

Current conventional wisdom suggests that a financial institution must be large to prosper in the future environment. This view is based on some or all of the following propositions. First, given technological requirements, it will be extremely expensive in the future to maintain a competitive infrastructure for delivering financial services efficiently and only large institutions can manage these costs. Second, there are economies of scale in some parts of the operation that can be realized only by very large entities. Third, a successful financial institution will have to be large enough to provide all or most types of services to its customers in a sort of financial supermarket, either because of demand or to take advantage of economies of scope (or "synergies"). Fourth, an international presence is essential for success, and only large institutions can compete outside the domestic market. Fifth, large amounts of capital will be necessary to handle the kinds of transactions and provide the kinds of services demanded by some customers in the future. These propositions imply that the successful financial institution of the future will be a very large conglomerate, operating in an international context, and providing all or most types of services to its customers in a technologically advanced way.

These propositions are plausible on the surface but can be challenged to some degree. It appears true that technological changes associated with product delivery will be quite expensive in some cases. However, investment in these new technologies need not necessarily come only from one provider or, for that matter, only from FSPs. The infrastructure for the delivery of some products could be developed jointly with other FSPs, or with other entities such as telephone or cable companies. Also, not all delivery mechanisms will require large investments; telephone banking is an example.

Economies of scale clearly exist in certain parts of the operation of FSPs. However, empirical work thus far has provided no evidence that a bank has to be a mega-institution, rather than just large, to exploit most economies of scale. And, of course, some economies of scale can be exploited by outsourcing or by purchasing certain types of services from specialist institutions, as has happened in other industries and in the back-room operations of banks.

More broadly, one can raise the question of how universal a bank has to be in both services and geography. The conglomeration movement, in financial services as in other industries, is largely based on the importance of economies of scope, or synergies, among its various components. Here, too, there is little evidence thus far that such economies are very large or very important. While some customers of an FSP may want to do all their financial shopping in a single supermarket, others may prefer to shop in separate institutions for different kinds of services. Indeed, some customers may feel more comfortable seeking advice and purchasing services from different firms precisely because they want to avoid relying on a single supplier. Moreover, large institutions are often thought to be less nimble in their responses to change than smaller institutions, raising the issue of how innovative, flexible, and responsive mega-sized, multiple-line institutions would be. The analogy with the non-financial industries, which have gone through waves of conglomeration and divestiture over the years, must at least give one pause before arguing that the future lies with the one-stop-shopping supermarket. What appears to have been the case in some industrial conglomerates was that the diseconomies of scale and scope (or the difficulties of managing and operating a mega-operation with many diverse arms) led to a loss of focus and increased costs. The response was divestiture, with a return to more specialized enterprises and a focus on core business activities.[9]

Another issue that arises in the context of a financial conglomerate is the potential for conflicts of interest. Giving advice in a variety of areas is

9. Of course, part of the perceived synergistic value of the financial supermarket will depend on the regulatory arrangements in place. In Canada, the legal prohibitions preventing banks and other deposit-taking institutions from selling most kinds of insurance on their premises and from sharing information across some business lines certainly reduce the synergies to be gained from common ownership of deposit-taking and insurance entities.

becoming an important activity for FSPs. Do clients want advice, say on mergers and acquisitions, from the same party that stands to gain from handling the associated transactions; or do they want advice from a specialist organization that is indifferent, from a financial perspective, to the outcome of the analysis since it is not involved in the next stage of the process? At least some corporations prefer to have “independent” sources of advice that are totally unconnected to the institutions that will undertake any resulting financial transactions.

Another major element in the argument for the mega-bank is the need for a major international presence. The general consensus is that there will be at most only a small number of truly global banks, offering the full range of services in virtually all major markets.

There is less consensus as to what happens to the rest of the financial institutions. Will they become less-profitable “also-rans,” perhaps even eventually disappearing or being swallowed up by a global bank; or will they be able to continue a profitable existence and compete effectively with the mega-institutions for business in their chosen product niche, in their home market, or globally?

The answer to this question depends largely on the extent of the economies and diseconomies of scale and scope, as was discussed earlier with respect to the domestic financial market. In the mid-1980s, the global mega-institution appeared to be the wave of the future with all else being left in its wake. This view disappeared for a time following the stock market crash of 1987, when a number of institutions with global aspirations cut back on their operations. One might speculate that the current renewed enthusiasm for global mega-institutions is a reflection of the very benign economic environment, with very low credit losses in a number of countries during the most favourable phase of the business cycle.

In the end, however, what counts is profitability, not size. It is far from clear that the global mega-institution will be best at providing the efficient, innovative, and flexible service environment necessary to maintain high profitability.

In summary, while there are many advantages to size, there are some disadvantages. This suggests that the mega-institutions will co-exist with niche players in the future financial system. The conventional wisdom that has mid-sized players disappearing may be correct, since they have neither the strength of the very large nor the flexibility of the small. But even here, if mid-sized institutions can become focused, specialized institutions rather than attempting to be mini-supermarkets, there may well be a positive future in store for them. Thus, the key issue may not be so much the size of FSPs, but rather the nature of the activities they undertake.

3.2 Determining the range of financial services and products

FSPs are also going to have to make some hard choices about the range of products they offer to customers. There are many types of financial products that are standard or commoditized, such as term deposits, consumer loans, and term life insurance. There is little or nothing to distinguish between the product of one firm and that of another, especially when the customer is protected by a deposit insurance or comparable scheme. Pricing becomes virtually the sole characteristic distinguishing the various offerings.

In contrast to the standard products are the customized products that depend on knowledge or relationships. These products include portfolio management, advice on wealth management, complex life insurance products, large-value loans to customers based on a close knowledge of their business as well as ongoing monitoring of developments, complex types of derivatives, and merger and acquisition advice. These are high-margin lines of business where reputation plays an important role.

While provision of standardized products can certainly be profitable, with high volumes offsetting the low margin (e.g., discount brokerage), many large financial institutions apparently see their comparative advantage and future in providing customized products. This is partly because competition forces lower margins over time on both commoditized products and products becoming increasingly commoditized, since access is relatively easy. But the strategic approach that focuses on supplying customized products does involve being on a treadmill to some extent. Today's customized product can become tomorrow's standardized product. Derivatives offer a useful example. Initially, returns were high on all sorts of derivatives. However, over time, as expertise spread, the margin on plain-vanilla derivatives shrank, while the newer, more complex customized instruments, which required expanding the frontiers of knowledge, were able to maintain high margins (at least until they too became commoditized).

Providing customized products requires specialized knowledge and information. Thus, the emphasis shifts to some extent from the financial strength of the institution to the knowledge and expertise of its employees.[10] On the wholesale level, this may account for the high levels of remuneration paid by securities dealers and investment bankers to their top staff. On the retail level, it requires a commitment to the education and training (and sometimes certification) of staff to enable them to provide helpful advice to clients.

There is some evidence to suggest that a relatively small percentage of an FSP's customers provides the bulk of its profits. FSPs will need to decide which customers they wish to shed or, alternatively, how they can deliver

10. Of course, for certain types of products, both capital and expertise are needed.

these less-profitable services in a more cost-effective way. For example, low-margin commoditized products may be more effectively delivered through some sort of discount broker arrangement. This type of decision will have significant implications for the activities of branches. Historically, branches have been associated mainly with the servicing of various transactions, and their success has often been measured in terms of transactions processing. In the future, they will likely become sales centres with success measured in terms of the profitability of services sold. In this kind of environment, many previously free or underpriced services will probably become more expensive, potentially raising sensitive issues of “access” by low-income customers.

An interesting aspect of moving from commoditized to customized products and services is the ability of a financial institution to target those customers needing specific types of service. One way to do this is to use information on the general characteristics of customers likely to need certain services and to compare these characteristics to available information on their own customers. For example, in the area of life insurance, it is well known that the probability of selling a policy to a “cold contact” is much lower than to someone who has been identified as a likely prospect on the basis of age, income, family status, wealth, etc. Thus, by developing and using information in their data banks, financial institutions can pinpoint customers more efficiently for their more lucrative, customized services. One would expect that the control and use of such data will increasingly be a major focal point of relations among entities involved in the provision of financial services. The issue of who “owns” the customer (and information related to that customer’s financial activities) has now become very important for FSPs. For example, it is possible that a software firm providing services to the user of computer banking will be able to turn the customer into their customer rather than the bank’s customer. An analogy can be drawn with the property and casualty insurance business, in which the agent or broker is often the customer’s link with the industry; the customer may have no loyalty to the company, asking his broker simply to search out the best deal. These types of arrangements might also reduce the franchise value of the bank, since its name and reputation would be worth less than before. Alternatively, the financial institution and the software firm may decide on a strategy of partnership in providing financial services.

The ability of financial institutions to access and utilize the data bases potentially available to them will depend in part on the legislative and regulatory arrangements about data privacy prevailing in the relevant jurisdiction. The stricter the rules, the more difficult it will be for financial institutions to be able to realize the synergies associated with cross-selling.

Regardless of the products that an FSP chooses to produce, it will be increasingly important for it to be flexible and focused and able to ensure that all parts of the enterprise are profitable. In some cases, this will be done by the use of divisions or internal groups, each with a mandate to focus on particular areas and to achieve acceptable levels of profitability. Alternatively, controlled subsidiaries could be brought together under a holding company structure. Finally, FSPs may become involved in co-operative or joint venture arrangements for the production of financial services and products. Areas previously thought of as cost or internal service centres, such as cheque processing, are likely to have to sell their services on a profitable basis (both internally and to unrelated parties), or see this activity outsourced. Outsourcing is particularly likely to occur if an activity is scale sensitive.

3.3 Strategic possibilities: a summary

Financial institutions have to decide where to focus their energies and devote their scarce capital and human resources. Many large financial institutions are turning themselves into large financial conglomerates by means of mergers, acquisitions, and strategic alliances, instead of continuing to operate as relatively specialized institutions. Some of the very largest institutions will try to become global financial conglomerates, offering all types of services to all types of customers in all or virtually all major financial centres. There is, however, probably room for only five to ten such global institutions worldwide. The rest will probably have to specialize in certain areas.

Canadian banks will very likely offer all the traditional banking services in Canada, but may choose quite different strategic paths in providing non-banking financial services. Externally, they may also choose to specialize in a niche or niches in which they perceive that they have a comparative advantage, in part for historical reasons, in part because of their strengths in the domestic market. In the domestic market, Canadian banks will face increasing competition from major global banks, from other international banks that see a niche for themselves in the Canadian market (for example, ING in virtual banking, Wells Fargo in small-business lending), and from non-regulated entities like GE Capital and Newcourt that have developed specialized expertise in certain areas of lending. They will also face potential competition from non-regulated entities in attracting funds and in the delivery of payments services.

Their decision on which lines of business to concentrate may implicitly involve a decision whether to focus on customized or commoditized types of products, or, as until now, both. All this will be done in the context of what is perceived by many to be overcapacity in the financial services industry in both international and domestic markets, with considerable uncertainty as to how important size in itself really is (in relation to the need to access economies of scale and scope). Finally, lurking in the background is the possibility of changes in both ownership rules and, more importantly for current business decisions, the possibility of a more liberal framework governing investment in non-financial business.

4 CHALLENGES IN THE REGULATION OF THE FINANCIAL SERVICES SECTOR

The factors driving change in the financial services sector also have important implications for the way in which the sector is regulated. Just as financial institutions are trying to develop their strategic directions, policymakers are grappling with the nature and type of regulation that would function best in the evolving financial landscape, with financial institutions developing into conglomerates, non-regulated firms competing increasingly with regulated financial firms, and international operations becoming ever more important for large financial institutions. From a broader perspective, policymakers also have to worry about such issues as competition, the appropriateness of commercial-financial linkages, and the relative reliance to be placed on disclosure and market discipline as opposed to direct supervision.

This section examines several of the key challenges facing policymakers and regulators: the appropriate use of disclosure and market discipline versus direct supervision; functional regulation; the impact of change on the supervisory process; the possibility of regulated FSPs providing non-regulated services and possible changes in the organizational structures of regulated FSPs; the cross-border provision of financial services; and changes to the legislative framework governing FSPs.

Before turning to these issues, it will be useful to review briefly the reasons why governments have chosen to apply solvency regulation to some types of financial institutions.

One important motivation for the regulation of certain FSPs is concern for the liability holders of the FSPs, especially liability holders of small amounts, where such amounts nevertheless represent a significant portion of the wealth of those holders. In these cases, governments try to establish regulatory frameworks that limit the risks that the FSP can take in order to provide some assurance to small creditors that their investments are reasonably safe. Thus, entities like GE Capital or Newcourt are not regulated for solvency, even though they provide financial services and products that are very similar to those produced by the deposit-taking sector, principally because they do not raise funds from small depositors.

Another important motivation for governments to regulate certain FSPs is their concern about the consequences that the failure of a major entity could have for a large number of borrowers and hence for the economy as a whole, a form of systemic concern. This may be a particularly important consideration if there are many borrowers who do not have readily available alternative sources of funds that they could turn to following the failure of a large FSP.

An essential difference between regulated and non-regulated entities is that, in regulating the former for solvency, governments are using *preventive* measures to reduce the risks and costs to small depositors of the failure of an FSP. This type of regulation is often accompanied by liability insurance (in the form of deposit insurance or insurance on the liabilities of insurance companies or securities dealers) to provide further protection to small creditors. The existence of these insurance programs provides a further impetus for regulation of those FSPs covered by such programs, as governments try to limit their potential costs by trying to reduce the risk of failure of FSPs. In the case of non-regulated FSPs, governments believe that creditors can assess the risks of an FSP failure and can cope with the costs of such an outcome. In such cases, they have created *remedial* mechanisms to permit such creditors to recover as much of their losses as possible after the failure. Often, in the case of non-regulated entities, governments require disclosure of relevant information to help creditors assess the risks they face if they choose to lend to these entities.

One of the disadvantages of regulating for solvency is the creation of moral hazard problems. Liability holders of regulated institutions may conclude that, since the government (or its supervisor) has certified that the entity is “safe,” they do not have to concern themselves with the riskiness of the entity’s activities. These creditors may believe that the government has an implicit guarantee to compensate them if the entity fails. If creditors operate with this belief, institutions will be able to hold riskier portfolios than would otherwise have been the case. This in turn creates the need for governments to require more intensive regulation and supervision. The moral hazard problem is not believed to be significant in the case of non-regulated entities, since creditors have the responsibility for monitoring their riskiness.

4.1 Disclosure/market discipline versus direct supervision

The changes in the nature of the FSPs could have important implications for the relative use of disclosure / market discipline and direct supervision. Governments may come to rely less and less on the traditional forms of direct solvency regulation to protect creditors of FSPs and rely more on market discipline, buttressed by disclosure requirements.

What factors might drive this change? First, there has been a significant improvement in the oversight of payment and other clearing and settlement systems in which systemic risk could be present. Eliminating or significantly reducing systemic risk reduces the total costs to society of individual entity failures, perhaps making it more palatable for governments to increase the reliance on disclosure and market discipline. At the same time, governments would have to be convinced that the mechanisms for dealing with the exit of a firm from the industry were well designed and could meet the needs of creditors and others in the event of failure.

Second, governments might move in this direction if the costs of direct solvency regulation are seen to outweigh the benefits of such regulation. This issue is discussed in greater detail in Section 4.4 below.

A third factor that could drive this type of change would be an increased use of holding companies to permit the separation of activities of FSPs and thus permit the use of different types of regulation. Currently, for example, banks are regulated for solvency, so virtually every activity undertaken by the bank is subject to this type of regulation. Holding companies would permit different activities to be placed in different related entities. Governments could then apply solvency regulation only to those activities that, in their judgment, require such regulation, and use the market discipline / disclosure approach or no preventive regulation for other types of activities. The issues associated with the use of the holding company approach are also discussed in Section 4.4 below.

A fourth factor may be the inability of supervisors or governments to prevent the sale of financial services or products to their residents by FSPs located outside of the country and thus not subject to regulation. These foreign entities will not necessarily have to comply with domestic regulation. Thus the best way to protect consumers may be to use disclosure to ensure that customers of these entities understand the nature of the entities with which they are dealing and whether the domestic regulatory authorities do or do not regulate these entities. This issue is explored further in Section 4.5 below.

A final factor that may push governments to adopt more disclosure / market discipline types of regulation is the increased outsourcing of activities carried on by FSPs. In the past, virtually all aspects of the production of financial services and products of an FSP were located within one entity. Direct supervision for solvency could be applied to the entire entity. Outsourcing opens up the possibility that currently non-regulated entities could have a significant involvement in the production of the services and products sold by regulated FSPs. Governments, for moral hazard reasons, may be reluctant to extend direct supervision to these non-regulated entities and may instead find the notion of increased disclosure to customers much more appealing.

Any opportunity to move FSPs into the disclosure / market discipline type of regulation and out of the current system of regulation and supervision could potentially reduce the financial exposure of governments arising from creditors' perceptions of an implicit guarantee. Of course, this would be true only if government could credibly establish the view that it would not compensate the creditors in the event of a failure of entities subject only to the disclosure / market discipline regime. Concerns for small creditors may, however, limit the extent to which governments can rely on this type of regulation.

4.2 Functional regulation

The functional regulation approach has been suggested as an alternative to the traditional institutional regulation, in a world in which banks are becoming financial conglomerates with large international operations, and other institutions are providing the same or similar financial services as banks.

While many possible models of functional regulation exist, this section focuses on two such models.

The first and more widely discussed model seeks to regulate certain lines of business in the same way, regardless of the nature of the provider. Thus, for example, there could be a payment service regulator that would be responsible for regulating payment services, whether provided by banks, other deposit-taking institutions, regulated non-deposit-taking financial institutions, or traditionally non-regulated entities. Similarly, there could be a regulator for business and household lending. One of the main problems regarding this approach is that a key objective of regulators is to try to minimize the probability of insolvency of financial institutions (since losses to customers typically flow from insolvencies). And insolvency is an institutional, not a functional, phenomenon. The bank fails, not the deposit or lending function. Consequently, while the functional approach has the attraction of treating all players in a similar line of business in the same way, it does not by itself deal with the issue of institutional failure. Nor is one necessarily interested in regulating, say, a telecommunications company peripherally engaged in the supply of payment services in order to minimize its risk of failure. (But functional regulators may wish to set standards in this area that apply to telecommunications companies.)

An alternative model, proposed by the government of Australia following the recently issued Wallis report, has different regulators dealing with the different functions of regulation, not different business line functions. Thus, for example, one regulator would be responsible for market conduct and consumer protection, another for prudential regulation (e.g., solvency regulation of deposit-taking and insurance institutions as well as superannuation funds), and another for financial stability and payment system regulation. This is somewhat closer to the traditional regulatory approach, but it has the added advantage of putting all institutions to be regulated under a single regulator for each regulatory function. Thus, insurance companies, securities dealers, banks, investment banks (or securities dealers), and credit unions would have the same regulator for solvency regulation. Moreover, if an insurance company, for example, engages in banking, its capital requirements for the banking line of business would be the same as those for a bank, or at least would be set by the same regulatory agency.

While attractive in many ways, this model does have the potential for overlap and duplication. Are the functions sufficiently distinct that the regulators will have clearly defined responsibilities? There will also likely be a need for co-ordination of the various regulators, as has been recognized in the Australian government's proposal.

4.3 Possible changes in the supervisory process

In addition to changes in the regulatory structure in response to the factors driving change in the financial sector, the supervisory processes for those entities still subject to solvency regulation might also have to change. For example, with regulated FSPs able to change their risk profiles quite quickly because of innovations in financial instruments, supervisors may become less concerned with the particular state of risk at a given entity at a point of time (and thus may devote fewer resources to determining that particular state of affairs). Instead, supervisors may focus more on the processes followed by FSP management and boards of directors in determining the acceptable level of risk, and on the ways they monitor the FSP’s implementation of their decision. Examples of this type of supervisory approach include the standards of sound business practice introduced recently by CDIC, the “prudent person” approach to investments introduced in the 1992 revisions to Canadian legislation, and the Basle Committee on Banking Supervision’s approach to the use of risk models. While determining the solvency of regulated entities will continue to be an important aspect of a supervisor’s responsibility, increasing emphasis will likely be placed on the procedures that the institution follows to determine acceptable risks.

Just as new products have required FSP staff to upgrade their knowledge and skills, the staff of supervisory bodies have also had to upgrade their knowledge and skills to be able to assess risk models and other techniques used by regulated FSPs to manage risk.

At the domestic level, another possible development is the consolidation of supervisory agencies. Multiple agencies can create significant costs for FSPs and their customers, and in some cases, may not contribute to the safety and soundness of the entities they are regulating. Canada was probably the first major country to move in this regard, and since 1987 there has been one federal supervisor of federally incorporated financial institutions.

(This includes banks, trust and loan companies, life insurance companies, property and casualty insurance companies, and certain pension funds.) The United Kingdom has recently announced what might be called a universal supervisor, with responsibility for all regulated financial institutions carrying out all financial service functions. It is not yet clear how this new agency will deal with the non-financial interests of financial institutions and, perhaps, the financial interests of non-financial entities. Also not clear is whether there will be differing degrees of regulation applied to different types of FSPs or to different functions carried out by FSPs.

This issue also has an international dimension. Just as multiple domestic supervisors may be merged into single entities, it has been proposed that there should be a global supervisory body to deal with internationally active regulated FSPs. While an interesting proposal, significant changes would have to occur in domestic legal arrangements to support such a regime. For example, bankruptcy and contract law are national matters, at least to date. To support a global supervisory body, a legal infrastructure would have to be created with respect to the determination of solvency and the subsequent winding-up of insolvent entities. This does not seem likely in the near future.

What is more likely is a continuation of a variety of actions designed to harmonize supervisory practices (including the sharing of information among supervisors) and associated legal frameworks across borders. For example, the work of the Basle Committee on Banking Supervision is directed towards building common best supervisory practices around the world. Similarly, the G-7 summit process has recently focused on the harmonization of laws and the co-ordination of actions dealing with regulated FSPs. Another example is the European Union (EU), where domestic laws, such as those related to bankruptcy procedures or netting arrangements, have been harmonized across member countries.

4.4 Non-regulated parts of regulated entities and the holding company model

As noted earlier, the combination of technological developments and an increasing acceptance by governments of greater competition in financial markets has led to a greater role for non-regulated entities. The traditionally regulated FSPs have complained that, by virtue of being regulated, they are hampered in their ability to compete with these non-regulated entities. Whether or not this is the case depends on the relative costs and benefits of regulation.

There are a number of costs associated with regulation. These include the costs of the operation of the regulatory agency, which are typically assessed to the industry. They will affect the costs of the industry's products or reduce shareholders' returns, depending on the incidence. Probably more important, however, are the costs of compliance. These could include such things as: the various internal monitoring and control mechanisms required to satisfy the supervisor that the institution is complying with the laws and regulations (including the establishment of firewalls, which may prevent certain synergies from being exploited);[11] the paperwork and complexities of dealing with a number of jurisdictional agencies (11 in Canada in some cases where both federal and provincial regulators need to be satisfied); the costs of dealing with on-site visits of supervisors (more of a problem in the United States than elsewhere because of the greater reliance on on-site supervision in that country); the requirement to get approval (and in some cases delays in receiving that approval) before entering into new lines of business or acquiring or merging with other financial institutions; prohibitions or limitations on getting into some lines of business; minimum capital requirements that may be higher than required by markets; and slow and inflexible regulation.

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11. Many of these control mechanisms would be needed in any event for proper management oversight.

At the same time, there are certain benefits to being regulated, of which the two most important are access to the safety net and "certification" as a sound institution. Creditors of FSPs are given access to some form of compensation arrangement in case of insolvency;[12] banks (but not other forms of FSPs) are given access to lender-of-last-resort facilities at the central bank in case of liquidity problems; and financial institutions are given a "certificate" of soundness from the overseeing regulatory authorities. These translate into three significant cost advantages: the ability to pay lower deposit rates; the ability to hold less liquidity (in the form of low-yielding liquid assets); and, probably, the ability to operate with less capital than otherwise would be the case.[13] In short, there are both costs and benefits to being regulated and it is an empirical issue as to which is larger.

In accounting for the relative growth of non-regulated competitors vis-à-vis regulated institutions in the lending areas, it is difficult to determine the relative importance of their being non-regulated as opposed to their specializing in certain areas, developing greater expertise in these areas, and simply outperforming the regulated FSPs. This relates to the earlier discussion of flexibility and nimbleness, and the capacity of full-service mega-institutions trying to deliver all types of financial services to be equally good in all areas of their business. There is little evidence on which to base a decision between the two hypotheses regarding the growth of the non-regulated financial entities—the benefits of being non-regulated versus the provision of a limited, specialized range of services very efficiently—but the latter hypothesis should certainly not be ruled out.

The development of the holding company (HC) model for regulated financial institutions has been suggested as a way to permit more of the

12. In Canada, smaller depositors at deposit-taking institutions have access to deposit insurance, while creditors of insurance companies and securities dealers have access to legally mandated compensation schemes administered by these sectors of the financial industry.

13. Following the implementation of the Basle accords on minimum capital requirements, this advantage may be less important than in the past.

financial services sector to be non-regulated. Effectively, it would allow regulated financial institutions to engage in a wide variety of business lines by establishing a holding company, along with operating subsidiaries for each of those business lines (somehow defined). Thus, the holding company could have a commercial bank subsidiary, a life insurance subsidiary, a trust company subsidiary, a property and casualty insurance subsidiary, a securities dealer or investment bank subsidiary, a venture capital subsidiary, subsidiaries in other financial areas, and perhaps even subsidiaries in non-financial areas if the financial services industry were permitted to be more closely linked to commercial business.

Proponents of such an approach believe that HC arrangements would facilitate entry of regulated financial entities into other lines of business and permit them to compete more effectively with entirely non-regulated entities. The notion is that each subsidiary could be partly or totally ring-fenced from the others; hence, different levels of regulation could be applied to different parts of the conglomerate. Thus, some subsidiaries (e.g., non-financial business) could be completely non-regulated on the grounds that their operations are not special and their failure would not cause any difficulty for the regulated financial parts of the conglomerate. Similarly, those financial parts of the conglomerate that provide services that are not regulated when offered by other types of entities (e.g., venture capital) might be less closely regulated, provided they could be ring-fenced from the other parts of the conglomerate.[14]

In one variant of this approach, the current banks might be subdivided. A closely regulated "narrow bank," subject to tightly controlled investment powers, would provide payment services; the rest of the current bank would exist in a different subsidiary with little or no regulation and no deposit insurance on its liabilities. This variant appeals to those who

14. This arrangement would also facilitate functional regulation by line of business since the insurance regulator (or the insurance arm of a universal regulator) would deal with the insurance subsidiary, and so forth.

believe that the special nature of a bank derives only from its central position in the payment system. However, the economies of scope may well lead the non-regulated part of the bank to issue types of deposits that can be used for payment purposes, with the same pressures for protection if there were a failure in this part of the bank. Furthermore, such an approach may not address governments' traditional concerns regarding the exposure of small depositors to the risk of financial institution failure.

More broadly, the usefulness of the HC approach depends on whether the regulated part or parts can really be ring-fenced from the non-regulated parts. This would involve strict barriers to any non-arms-length transactions between the two wings as well as restrictions on transactions between the regulated wing and the HC. (Of course, such firewalls reduce the potential synergies from the joint ownership of regulated and non-regulated entities.) Moreover, it assumes that there would be little or no contagion effects on the regulated wing from a failure in the non-regulated wing.

If one believed that these two preconditions could be met, one could leave the HC and the subsidiaries providing non-financial functions totally unregulated. But, in fact, most proponents of this type of scheme would not rely solely on rules restricting the transactions between the two wings and between the regulated wing and the HC. Rather, they wish to have some regulatory oversight over the HC and perhaps some light oversight over, or at least information about, the non-regulated wing. The resulting arrangements would thus rely on a combination of ring-fencing of the regulated wing and some oversight of the HC and non-regulated wing to protect the regulated financial institutions and their customers. However, even light oversight might give rise to moral hazard concerns.

4.5 Cross-border transactions

Policymakers also face the issue of how to deal with transactions by residents with financial entities situated abroad, particularly those carried out on the Internet. These are often referred to as cross-border transactions. Of course, residents of Canada, as well as in a number of other countries, have long been free to transact with any financial institution anywhere. The novelty in transactions through the new technology is the increased likelihood that transactors might not be aware that the foreign financial institution offering financial services over the Internet is not overseen by any domestic regulatory authority and does not have access to the domestic safety net. A resident visiting a financial institution in a foreign country or using the postal system as a means of access to that provider would be aware it is a *foreign* financial institution. However, Internet access is far less clear. There may be little apparent distinction between the offerings of a foreign institution and those of a domestic institution or, even more confusing, a foreign-owned entity operating in the resident's country.

Regulatory authorities do not appear to have the power to regulate a foreign entity operating on the Internet, nor are they likely to be successful in any attempt to bar that entity from operating domestically via the Internet. The alternative approach is to use disclosure and rely on market discipline. That is, the regulator must make it absolutely clear, via public dissemination of information, which financial institutions come under its jurisdiction, as well as the fact that it does not have responsibility for any entity not on that list. The use of its web page would be one means of communicating this information and there may be others. The key point is that residents must be given sufficient information to know that they are in a "caveat emptor" type of situation and that no responsibility accrues to the domestic regulator, the domestic deposit insurer, or the domestic government from any losses arising from their involvement with the foreign entity. Clearly, the development of such types of new delivery channels will provide increased pressure on governments to adopt regulatory structures more dependent on market discipline and information disclosure than has been the case in the past. A good deal of this pressure can be expected to come from domestic regulated entities that will feel that they are subject to "unequal" competition.

4.6 Changes to the legislative framework governing FSPs

The development of new products and delivery mechanisms also has implications for the public and private laws governing the operations of FSPs. Some developments, such as electronic money, were not contemplated by legal drafters decades ago. Thus, the law does not deal adequately with such issues as counterfeiting electronic money, its legal status, or determining the responsibilities of the producers of this type of money. Another simple example comes from securities legislation. In many countries, the legislation still assumes that securities are in physical form and that a securities transaction always involves the physical delivery of a security. This type of legislation can put at risk many developments such as book-entry securities transactions, or the dematerialization of securities, since there may not be a clear legal basis for these developments. Such developments may proceed in any event because of the significant perceived gains in efficiency associated with them. Governments are likely to come under increasing pressure to modernize their laws to deal with domestic developments and to go further and harmonize their laws with those of other major countries to facilitate cross-border transactions and the participation of foreign entities in domestic markets and systems.

5 CONCLUDING REMARKS

As noted at the beginning of this paper, rapid change in the nature of FSPs, the products and services they produce, the manner in which these products and services are delivered, and the way in which FSPs are regulated is expected to be a lasting feature of the financial industry. However, the pace and the scope of change will vary across countries. In part, this will reflect the way regulatory changes have been introduced. In this regard there appear to be at least two types of countries. Countries like Canada have tended to implement regulatory change continuously and gradually, partly because of the requirement to review banking legislation every 10 years or so. Countries like the United States tend to make changes less frequently; consequently, changes tend to be larger and potentially more disruptive. Countries that introduce change gradually and continuously may be in a better position to cope with the unanticipated aspects of changes in the financial sector by being able to respond more quickly than countries where legislative changes occur infrequently. In addition, one is more likely to see innovations in the financial sector driven solely in response to legislative or other regulatory impediments in countries like the United States than in countries where the regulatory structure can be changed more frequently and kept more in tune with market realities.

Finally, given the rapidity of change and the difficulty in predicting future directions in the financial services industry, disclosure and market discipline will likely become a more important source of prudential oversight. A remaining question is the extent to which they can be used in dealing with financial services provided to small and unsophisticated customers.

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