David Dodge: Research in financial services and public policy - filling the gaps

Remarks by Mr David Dodge, Governor of the Bank of Canada, to the Conference on Financial Services and Public Policy, Schulich School of Business at York University, Toronto, Ontario, 22 April 2004.

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Good evening, ladies and gentlemen. It gives me great pleasure to open this important conference on research in financial services and public policy. In his invitation to this event, my former colleague, Fred Gorbet, referred to the need for “highly focused academic research in Canada on the linkages between public policy and financial services.” I certainly concur with this assessment, and so I am happy to be a participant here today.

For five years, the research program here at Schulich has helped to support and nurture a Canadian academic community focused on financial services. In doing so, the program has encouraged researchers to fill the gaps in our knowledge and help policy-makers and regulators to do a better job. After five years, it's useful to think back and recall the motivations for establishing this program in the first place.

It goes without saying that the economy works better when a country's financial services sector is as sound and as efficient as possible. And the importance of promoting soundness and efficiency was certainly highlighted by the events of the late 1990s. Five years ago, the global economy was emerging from the Asian and Russian financial crises, and the near-collapse of Long-Term Capital Management. During these events, we saw that financial markets are a key channel through which crises can spread. And among the countries most affected, we saw that one common element was a weak banking system. So one clear lesson to be learned was that the strength of a country's financial system is crucial. This is particularly true in times of stress, because a strong financial system gives an economy a better chance of making necessary adjustments, before a stressful economic situation turns into a full-blown crisis.

It may be tempting to look at today's relatively benign economic and financial environment and conclude that the urgent need to strengthen financial systems has passed - tempting, but wrong. Now is precisely the time to get the work done, when there is considerable liquidity in the global system, and interest rates and spreads around the world are low. Because, at some point down the road, there will be less liquidity, and interest rates and spreads will be higher. So if we wait, the task will only become more difficult. It may be a cliché to say that we should fix the roof when the sun is shining, but the point is valid.

During the past five years, other events have also underlined the importance of the research you are doing here at Schulich. Following the collapse of Enron, and in the wake of other scandals, we have heard a great deal about corporate governance, transparency, and accountability. As businesses and policy-makers address these issues, we all need to understand how current rules are affecting the efficiency and stability of the financial sector, and how any proposed new rules will do so in the future. Regulators must always keep in mind that their actions may have unintended consequences, thus making the solution worse than the problem they were trying to correct.

The Bank of Canada has been a source of funding for the research program at Schulich since its inception. It is fair to ask why the Bank cares so much about financial services and public policy research. Our interest stems from our mandate to further the economic and financial welfare of Canada. There are several ways that we do this, and the work that you do here has relevance for all of our roles.

The most high-profile way that we promote the economic well-being of Canadians is, of course, through the conduct of monetary policy. We know that the financial sector and financial markets are at the heart of the transmission mechanism for monetary policy. And we know that monetary policy is more effective when markets function well. So it is absolutely critical that the Bank understand the financial sector and the markets as thoroughly as possible.

We also promote Canada's economic well-being through our role as lender of last resort. We have a mandate to oversee those payment, clearing, and settlement systems that have the potential to pose systemic risk. And we have a less formal, but still important, role in providing advice to the Department of Finance on financial sector policies. In all of these areas, it is clear that we have a strong interest in promoting sound institutions, efficient financial markets, and well-functioning systems to support them.

Of course, financial markets and institutions play a critical role in the economy by serving borrowers and savers, and by bringing about the efficient allocation of credit. But the financial sector itself is an important contributor to economic growth. So policy-makers also have an interest in providing a framework that will allow our financial institutions and markets to compete in an increasingly globalized world. With global standards evolving rapidly, Canada must be at the forefront in terms of efficiency and soundness.

One thing that the Bank can do is to help policy-makers and financial service providers have the best available research at their disposal. Indeed, in our most recent medium-term plan, the conduct and promotion of leading-edge research was identified as one of the Bank's strategic priorities. Of course, the Bank does a significant amount of research in-house. We have established an ambitious research program for 2004 and beyond. It includes such topics as how to improve our economic modelling, how regulatory initiatives and frameworks can help or hinder financial markets and institutions, and an investigation into the effects of various types of asymmetric information on capital markets.

We are proud of the work that we do. But we recognize that we can't do it all ourselves. There will always be large gaps in our research program. And we recognize that our research, and the research that is being carried out in universities, can be mutually strengthened through collaboration. And so we promote good research by actively collaborating with academics and seeking out partnerships. Finally, we try to inform others of what we are doing by publishing working papers and summarizing our work in our semi-annual *Financial System Review*. And we post a summary of our research program on the Bank's Web site annually.

We also know that good research requires good data. There is a widespread need for better data on the Canadian financial system, and the Bank has begun to seek out data sources through its Financial System Database Project. We know that pulling together more complete sources of data about financial institutions, financial markets, and payment, clearing, and settlement systems, will not be simple. Indeed, it will be a complex and costly project, and one where collaboration with external partners will be necessary, and enormously helpful. If we co-operate and build the databases properly, we can all share in the benefits. This is a priority for the Bank, and I would be happy to hear your suggestions on the best way to proceed with this ambitious project.

That is an explanation of why we care about your work. Now let me take the opportunity - given this audience - to expand upon some of the areas where we at the Bank of Canada would like to see more research done. I will organize my remarks by talking about the three areas I have already mentioned: financial institutions; financial markets; and payment, clearing, and settlement systems. Within each area, I will raise a number of questions. What I want to do is to stimulate ideas, in the hope that some of you may be inspired to continue to probe into these issues.

Where research is needed

Financial Institutions. Over the past 15 years or so, regulators and policy-makers have been working hard to improve the soundness of financial institutions. Clearly, this is important and necessary work. But in carrying it out, we must always strive for a balance. That balance is between maintaining and strengthening the key elements of regulation and supervision that promote appropriate risk management, and the necessity to promote efficiency by keeping compliance costs to a minimum.

So the question that can be asked is, How do regulators best encourage good risk management without unduly discouraging risk taking and without stifling innovation? Rather than putting the emphasis on compliance with a vast number of detailed rules, it seems to me that the goal of the regulator should be to encourage financial institutions to identify and measure the true nature of the risks being taken, and to see that methods are being developed to mitigate these risks. Policy-makers and regulators do not want to discourage appropriate risk taking to the point where incentives are created for appropriate risk-taking activities to move outside the regulated financial system.

Given the development of a wide range of new financial instruments and the exponential growth in their use, the need to find this regulatory balance is becoming more and more acute. It is certainly true that through these instruments, banks have become better able to manage risk by shifting some risks to others. But as banks do this, the question arises, Where do these risks ultimately reside? And are the bearers of these risks able to manage potential losses in times of economic stress, so that the financial system is ultimately more stable?

The evolution in accounting standards also has many implications for financial institutions and markets. Does compliance with some of our accounting rules lead to large swings in reported earnings that do not reflect the true economic state of a firm? If we are to use fair-value accounting, how do we ensure that both assets and liabilities are correctly and equally marked to market? And we need to understand how particular elements of accounting rules can affect the risk-taking behaviour of financial institutions and investors.

The issue of the right regulatory balance can also be looked at in relation to questions about the most efficient structure of financial institutions. This relates to the powers of institutions to do business, the types of business lines that can be offered by a single institution, and the corporate structures of institutions. As we approach the quinquennial review of the Bank Act in 2006, now is the time for researchers to be making their contributions to these areas.

Financial Markets. Let me now turn to financial markets. This is one area where considerable research has already been done, particularly in equity markets, and we now know more about how markets work than we did in the past. However, markets are constantly evolving, driven by technological and other forces. Given this, policy-makers and regulators should always be asking a basic question, while providing reasonable protection against inappropriate conduct and minimizing systemic risk, are we still allowing sufficient incentives for markets to innovate, develop, and become more efficient?

Let me give you some concrete examples. Are there inefficiencies in the way that our markets provide financing for Canadian firms? Specifically, is there something about the structure of our markets that leads non-investment-grade issuers to go abroad for their long-term debt financing? Or are our banks remarkably efficient in providing longer-term capital through their corporate loan business? Or are other instruments, such as income trusts, providing a substitute mechanism?

To begin to answer those questions, we need to have answers to even more basic questions, such as, What determines the cost of capital, and how does the cost of capital in Canada compare with that in other countries? Exactly how do Canadian firms access capital? And are there particular market impediments here in Canada that small and medium-sized issuers are facing? Again, we know much more than we used to in these areas, but our knowledge is still far from complete.

One particular cost-of-capital issue that we have been investigating is related to the so-called “Canadian discount” - the fact that firms listed only on Canadian exchanges tend to have lower price-to-earnings ratios than comparable U.S. firms or Canadian firms listed on U.S. exchanges. This increases the cost of raising equity capital and may interfere with the ability of Canadian financial markets to provide the most efficient match between issuers and investors. Whether the source of the discount is a matter of perception or something more substantial, we need to understand the forces that are causing it.

If policy-makers are to find the best ways to promote market efficiency, they need a better understanding of market microstructure. They need answers to questions such as, How do transparency and liquidity affect the cost of capital? How do different structures affect the optimal rules for transparency and liquidity in each market? Is the Canadian situation unique? And what lessons can be learned from the experiences of other countries? The Bank recently held a workshop on these and related topics, with input from many financial market participants. A summary of this workshop will appear in our next *Financial System Review*. Market microstructure will continue to be an important area of research at the Bank and, I hope, in the Canadian academic community as well.

Payment, Clearing, and Settlement Systems. So far, I've talked about issues related to the architecture of the financial system. But as researchers, it is also important to pay attention to the plumbing - the critical infrastructure that supports the activities of institutions and markets. So let me ask a few questions regarding payment, clearing, and settlement systems. As I mentioned, the Bank of Canada is responsible for the oversight of those systems that have the potential to pose systemic risk. Of course, financial service providers are major participants in these systems.

At the Bank, one major research project involves efforts to model payment, clearing, and settlement systems so as to better understand how they work. Further research into the best oversight processes for these systems is also a priority.

While the Bank's objective is to see that risks are minimized, we need to do so in ways that do not unduly inhibit the development of even more efficient systems. Do any current practices create unnecessary inefficiencies? What issues are raised by the current drive towards straight-through processing? How can cross-border clearing and settlement be improved, particularly where the ownership of securities and the posting of collateral are involved?

Conclusion

As you can see, there are still many questions that need to be answered. There are still gaps in our knowledge, and the need to fill these gaps is pressing. You, as academics and researchers, can do your part so that policy-makers, supervisors, and institutions are all better informed and more productive.

As I said earlier, Canada's economic health depends on a strong financial services sector. So your work is crucial, not just for the Bank of Canada, but for all Canadians. I hope that I have been able to convince you that there are many research topics that are not only inherently interesting for academics, but relevant for public policy. I look forward to you filling the gaps in our knowledge.