Canada needs a Financial Innovation Institute

The answer to overcoming the stifling effect of Super-Regulation in the Financial Sector

Less visible to regulators and governments than the traditional areas of risk management has been the increasing threat posed by inattention to the impact of super-regulation on innovation in financial services. The author suggests that the federal government could put Canada in the forefront of 21st century financial institution leadership by establishing a Financial Innovation Institute.

Richard Remillard

The biggest threat to our financial system today comes from its "super-regulation" by an army of domestic and international officials. The source of that threat, paradoxical as it may seem, is the relentless quest by the regulators to identify and eliminate the currently perceived risks that are viewed as inherent in financial institutions and their activities.

Taking issue with the regulation of the financial services industry is an unpopular stance, as the entire financial services industry has undergone a severe beating in public opinion ever since the near economic meltdown of 2008–9. After all, who can forget the "vampire squid" sobriquet that was hurled at Goldman Sachs for its assumed role in the debacle and which became emblematic of the mistrust towards the financial sector experienced by governments and regulators in addition to the general public? Governments have reacted to the series of unfortunate events that took place in 2008–9 by progressively tightening the web of regulation that entangles the financial services industry that has gone from being merely "highly-regulated" to being "super-regulated".

And, who can argue against the facts? Coming out of the economic near-death experience of 2008–9, which saw financial institution failures in the United States and Europe on a scale unlike anything over the past 70 years, there was not a single bank, insurance company or mortgage guarantor failure in Canada. Of course, these failures internationally have had severe repercussions on a host of economies from Ireland to Spain and Cyprus to say nothing of the United States itself, where the after effects of the shock linger in stubbornly high levels of unemployment and underemployment.

THINKSTOCK

Canada can pat itself on the back for having dodged a couple of very large bullets on this score. Public capital markets (TMX) swooned by 30 percent and financial losses were suffered to those holding one specific product – asset-based commercial paper (ABCP) – where the market seized up. But, the lesson of 2008–9 was that Canada had got it right when it came to the tight supervision and regulation of its financial sector(s).

And so, more of the same would seem to be in order.

At this point, it is worth recalling that regulated financial institutions, such as banks and trust companies, can have multiple layers of oversight and controls over their operations. These include:

- senior management and Boards of Directors;
- internal audit;
- corporate compliance;
- external audit;
- Office of the Superintendent of Financial Institutions;
- FINTRAC;
- Financial Consumer Agency of Canada;
- domestic (e.g., Ontario Securities Commission) and international securities commissions;
- international bank supervisors (Basel).

But, it might be time to step back and not let ourselves get carried away by smug self-satisfaction. To date, the main visible cost of super-regulation has been borne by smaller financial industry players which have quite simply not been able to juggle regulatory reporting requirements and the associated costs, including in management time and attention, with attending to the imperatives of expanding their businesses. While regulators are beginning to recognize that one size doesn't fit all, the process of tweaking the present system has only just begun.

Less visible to regulators and governments than the traditional areas of risk management such as capital adequacy, liquidity, operational risk, credit risk, outsourcing and related party transactions and the like have been the increasing threat posed by inattention to the impact of super-regulation on innovation in financial services.

Innovation in financial services has several meanings. These include new technologies (e.g., ATMs), new products (options) and new processes (on-line banking). Too often, particularly in government circles in recent years, financial innovation has been associated with the tax-driven creations of smart Bay Street lawyers – income trusts spring to mind here.

Looking back to the past, the smaller financial institutions had developed a reputation for driving a considerable part of the innovation in Canada's financial sector as they sought for ways to more effectively compete against established, more well-known players. The level playing field of regulation has had an unequal impact on the smaller, more nimble firms who have had to contend with a regulatory compliance burden that has been robbing them of their ability to focus on bringing innovative experiments to the industry. However, the smaller firms are simply the 'canaries in the mineshaft' for what has befallen them is about to land on the largest firms in the industry as well.

The challenge today is much more than the hobbling of the smaller firms that have disproportionately been Canada's financial innovators. We live in an era of rapid-fire, discontinuous, disruptive, business-model destroying change. Business cemeteries are littered with the corpses of former titans felled either by their clinging to an old way of doing things or to old products that no longer met customers' needs or by backing the wrong new technologies. Remember the Encyclopedia Britannica.

In successfully adapting to today's world, corporate survivors, large and small alike, will need to continually re-invent themselves, turn themselves upside down and inside out. This is precisely what has been happening in the technology industry where the world has watched Google battle Apple battle Facebook battle Microsoft for winner-take-all supremacy.

This ferocious competition is now spreading out from the technology industry to all industries, including financial services, with the prospect of Facebank, Bitcoin and Crowdfunding quickly emerging. The lesson of the technology wars is that trailblazers may win or lose but followers, or late-adopters, never win. This lesson is coming to the world's financial industry and is coming fast.

In short, all successful firms will need to take the risks that come with experimentation and early adoption of the newest technologies, processes and products. However, the financial super-regulation system is expressly designed to frustrate such risk-taking by lengthy approvals, by constant second-guessing and by instilling in financial institutions themselves a culture of deep aversion to anything that challenges the status quo. The result is: shorter-term gain for longer-term pain. Without a full-bore

"All successful firms will need to take the risks that come with experimentation and early adoption of the newest technologies, processes and products."

commitment to financial innovation, the revolutions when they come will be more gut wrenching and jarring than they otherwise need to be. That being said, it is important to recognize upfront that hand-in-hand with innovation comes uncertainty and with uncertainty comes winners and losers.

We need to ask ourselves:

- How innovative is Canada's financial system today?
- Is Canada's financial sector as innovative as it could be or as innovative as it needs to be?
- What steps can we take to restore financial sector innovation to its rightful place?

The place to start might be to look back four years when, in the wake of the economic crisis, the federal and Ontario governments in partnership with the private sector set up the Global Risk Institute in Financial Services. So, too, should the federal government today play a catalytic role in setting up a world-class Financial Innovation Institute whose mandate would be to identify, back and promote the adoption of the "new" and put Canada in the forefront of 21st century financial institution leadership. This Financial Innovation Institute would play to two strengths in Canada today – a financial system that is second to none and a commitment to innovation, including the technological variety which has grown by leaps and bounds in recent years.

Richard Remillard *is President of Remillard Consulting Group (RCG), an Ottawa-based firm that was re-activated in 2014. RCG, whose clients have included OSFI and several Canadian and international banks, specializes in financial sector public policy solutions. Remillard previously served as Executive-Director of Canada's Venture Capital and Private Equity Association, Vice-President with the Canadian Bankers Association, Special Assistant to the Minister of Finance, and as a manager with the Bank of Montreal. He has sat on several Boards, including MRS Trust, the Sierra Club of Canada Foundation, and the Rideau Club. He has degrees from McGill University and the London School of Economics and Political Science.*