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Remarks by Tiff Macklem,
Senior Deputy Governor, Bank of Canada
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Global Financial Reform: Maintaining the Momentum

Introduction

It is now almost three years since the financial crisis went viral in the autumn of 2008 and threatened a complete meltdown of the global financial system. Thanks to the bold and concerted actions of G-20 nations, the financial system was stabilized and an economic depression avoided. But the fallout was nonetheless severe—the worst global recession since the Great Depression, with almost 28 million jobs lost worldwide. And we continue to struggle with the aftershocks of the crisis.

A central pillar of the policy response to the crisis was a sweeping reform of the financial regulatory and supervisory framework. Launched at the G-20 Leaders Summit in London, the multi-pronged reform agenda included several key elements: enhanced transparency and disclosure; higher prudential and liquidity standards; a new system of macroprudential oversight; credible and effective resolution regimes for large financial institutions; a broader scope for regulation and oversight spanning all systemically important financial institutions, markets and instruments; stronger infrastructure for key financial markets; and measures to promote adherence to international prudential regulatory and supervisory standards.

Our challenge as policy-makers is to strike the right balance. We don't want to undermine efficiency or stifle innovation, but we do want to deter reckless behaviour.

The regulatory reform agenda began, appropriately, at the core of the financial system. In many respects, this was the easy part since we have considerable experience with the regulated sector. As we move beyond the core to consider issues of perimeter and interconnectedness, the intellectual and practical challenges are larger. At the same time, as the desperation of the crisis fades from memories, so will the urgency to tackle these issues. Our collective responsibility is to ensure that our efforts redouble as the going gets tougher.

Since the London Summit, considerable progress has been made along three fronts: standards, tools and enforcement.

Standards

The financial crisis revealed all too starkly that liquidity buffers were glaringly inadequate, and that the banking system as a whole was dangerously undercapitalized and over-leveraged. The new global standards in the Basel III Capital Accord redress this core vulnerability. They substantially increase the loss-bearing capital that financial institutions must hold. They establish new liquidity standards and a limit on leverage. These represent a significant strengthening of the global rules. The combination of greater emphasis on true loss-bearing capital—namely tangible common equity—and increased minimum capital levels has effectively raised the minimum global capital requirement seven times.

Moreover, for the largest and most interconnected global banks, this is being supplemented with additional loss-absorbing capacity. The Group of Governors and Heads of Supervision just agreed on a proposed methodology for assessing systemic importance, the amount of additional required capital, and the timeline over which this will be phased in. These additional measures will further strengthen the resilience of global systemically important banks and create incentives for them to reduce their systemic importance over time.

Tools

The crisis taught us that while regulating on an institution-by-institution basis is important, it is not enough. The risk to the financial system is not equivalent to the average risk to individual firms. This was strikingly illustrated in the crisis, as it was individual institutions' attempts at self-preservation that transmitted and amplified stresses throughout the global system.

Addressing system-wide risks requires new tools, and here, too, there has been considerable progress. The countercyclical capital buffer included in Basel III is a giant step forward. The Bank of Canada played an important role in the development of the buffer, which provides for additional capital to be built up during periods of excessive credit growth in anticipation of a future downturn. This broad macroprudential instrument complements other tools designed to contain financial imbalances in specific markets. These include mortgage loan-to-value ratios and amortization periods, as well as countercyclical margin requirements. What remains is much work on implementation. In particular, how best to combine, sequence and implement these tools, how they will affect financial intermediation, and their implications for other policy instruments, including monetary policy.

Enforcement

New rules are only as good as their application and adherence. Last year in Seoul, G-20 leaders endorsed recommendations to strengthen the mandate, capacity and resourcing of supervisors. They also reviewed the powers required to monitor, identify and address excessive risk-taking, including early intervention. It is imperative that these recommendations are now translated into new standards for supervision and implemented on the ground.

International assessment and review are also being strengthened. Financial Stability Board (FSB) member jurisdictions are living up to their commitments to undergo regular assessments under the IMF's Financial Sector Assessment Program. And under the FSB's new system of international peer reviews, six reviews have now been completed and published. Building a new system of international peer review is a major accomplishment. But heavier lifting lies ahead.

As new, higher standards come into force, ensuring equivalent implementation will become increasingly important. Three critical areas stand out: Basel III, resolution regimes and central clearing for OTC derivatives. We will need rigorous and effective assessment of implementation across all jurisdictions to ensure that they are living up to their commitments. The goal is to create a race to the top in national adherence to international standards.

Agreement on these three elements—higher standards, new tools and strengthened enforcement mechanisms—will substantially enhance financial stability at the core of the system. Agreement in these areas has been hard. But the truly tough work of consistent, rigorous and relentless implementation is just beginning.

Now that we have largely agreed on the reforms to reduce the likelihood of failure at the core of the system, the reform agenda is turning appropriately to two further priorities: expanding the perimeter of oversight and regulation, and reducing contagion and harmful international spillovers.

Expanding the Perimeter of Supervision and Regulation

The existing prudential regulatory framework was designed around banks whose credit-intermediation activities are closely regulated and supervised, as well as backstopped with deposit insurance and central bank liquidity. By contrast, the shadow banking sector is less regulated and does not have access to public liquidity support. However, like the credit-intermediation activities of banks, shadow banking also involves liquidity and maturity transformation, and often with some degree of leverage.

The label “shadow banking” is unfortunate. It is not shadowy. Market-based financing, as it is more appropriately called, provides competition for the banking sector and is an important source of innovation and diversification.

And it is also big. In the United States, market-based financing was roughly twice as large as traditional bank intermediation at the peak of the credit boom and is still about 25 per cent larger today. In several other advanced economies, including Canada, the sector is at least as large as the banking sector.

The crisis highlighted the systemic vulnerabilities market-based financing can pose. The opaque and excessively levered securitization of U.S. mortgages, combined with undue reliance on short-term wholesale funding, greatly intensified the consequences of the U.S. housing collapse.

With the capital and liquidity standards applied to banks set to increase, we can expect to see further incentives for regulatory arbitrage. This has the potential to expand the scope and scale of market-based financing activities.

For all these reasons, the international agenda, under the auspices of the FSB, is turning its attention to the perimeter of regulation and shadow banking or market-based financing. The FSB’s task force on shadow banking is taking a two-pronged approach. The first prong is to cast a wide net to ensure that data gathering and surveillance cover all non-bank credit-intermediation activities where risks might arise. The second prong is narrower in focus. It concentrates on the subset of non-bank credit-intermediation where risks can arise from maturity or liquidity transformation, credit risk transfer, or leverage.

A key characteristic of market-based financing is its diversity, both within and across countries. It involves a wide range of activities with different benefits and risks. At one end of the continuum are government-guaranteed, mortgage-backed securities; at the other end are highly complex, opaque, leveraged securities.

The composition of the sector in terms of instruments varies considerably across jurisdictions, partly in response to the structure and regulation of the domestic banking system. In Canada, for instance, the most prominent market-based financing activities are repurchase agreements (repos). In the United States, government-sponsored enterprises, money market mutual funds and asset-backed securities represent the major components.

The dominant players in the sector also differ from one jurisdiction to another. In Canada and Australia, for example, a much larger proportion of market-based financing is undertaken by regulated financial institutions, compared with the United States.

The diversity across jurisdictions of risk levels, composition and players demonstrates the need for a better understanding of the shape, reach and scale of market-based financing. While we have a much better grasp today of the sector than we did before the crisis, we still have much to learn. We need to understand the complete chain, from origination through to the final sale, with all the links along the way clearly exposed, including the links to the regulated sector. This requires mapping the sector to identify potential problems, inconsistencies and data gaps in the monitoring framework, and to assess the risks to the broader financial system.

In terms of reform, the lowest-hanging fruits have already been harvested. These include enhanced disclosure requirements, the new consolidation accounting standard and minimum risk-retention rules. But much more work is needed to consider the full range of policy options. These include: direct regulation; indirect regulation via links to the regulated sector; targeting specific products and activities; and various macroprudential measures.

As we consider the vulnerabilities posed by market-based financing and the appropriate policy response, it will be important to keep three points front of mind. First, reforms should strike an effective balance between the benefits of market-based financing, including competition, innovation and diversification, and the risks related to regulatory arbitrage and systemic vulnerabilities. Second, given important differences in the structure of market-based financing across countries, the best approach to mitigating systemic risks in this sector is likely to differ across jurisdictions. And third, the best approach will be the one that is adaptable, since changes in regulation and innovation can lead to rapid expansion and mutation of market-based financing activities.

Reducing Contagion and Spillovers

Reducing contagion and spillovers when accidents do happen has two critical elements.

First, resolution. We must be able to resolve institutions, no matter how large, in a way that preserves their remaining value while ensuring the costs are borne by shareholders and uninsured counterparties—and not by taxpayers. The effective resolution of insolvent, globally active banks will require clear rules for cross-border resolution. It will also require new instruments and a range of other powers and tools, including an expanded capacity for bridge banks and clear recovery and resolution plans. Contingent convertible (CoCo) bonds and broader bail-in solutions can also be helpful in providing a kind of pre-packaged priority in bankruptcy.

Resolving firms in crisis is something no one wants to do, but ensuring authorities have a full spectrum of tools and powers is critical if we are to roll back the moral hazard that has distorted incentives for the so-called "too-big-to-fail" financial institutions.

The second element is the need for central counterparties for OTC derivatives combined with trade repositories. Globally, the notional derivatives market is immense. The amount of notional outstanding in OTC derivatives last year was US$618 trillion. In Canada, the Canadian-dollar-denominated OTC derivatives market was about $9 trillion, of which a little over $6 trillion was in interest rate swaps. This is huge for a country with a GDP of Can$1.6 trillion in 2010.

The systemic significance of this market was made all too obvious during the financial crisis. By global standards, Bear Stearns was a mid-sized institution. But its significance as a counterparty in the OTC derivatives market was such that U.S. authorities were required to assist in a transaction to prevent its complete collapse.

To prevent this from happening again, G-20 leaders have agreed that by the end of 2012, all standardized OTC derivatives contracts should be traded on exchanges or electronic trading platforms, where appropriate, and cleared through central counterparties (CCPs). A great deal of work remains if this goal is to be realized.

Central counterparties for OTC derivatives will provide greater certainty of payment, mitigating the harmful spillovers resulting from the failure of a counterparty, as well as increased transparency, thereby reducing contagion and maintaining continuous markets in times of stress. But CCPs also have the potential to create new single points of vulnerability. This calls for the careful design of CCPs, as well as robust regulation and supervision. It will also be important to ensure sufficient access to CCPs to avoid limiting competition. This is of particular concern in countries that are not host to a large global CCP.

There are two potential paths to address these design issues. The first is to promote fair and open access to global CCPs with shared oversight arrangements, so that strong, large and mid-tier derivatives market participants have efficient access to central clearing. The second is to build local CCPs that are better aligned with local risks and local market conditions. A number of jurisdictions are pursuing the local, or onshore option, including Japan, Korea, China, Hong Kong, Singapore and Brazil. Potentially, these local CCPs could be linked globally through risk-controlled interoperability.

Canada is giving serious consideration to an onshore option. This is not to say we are taking the global option off the table, but there are good reasons to consider onshore CCPs. Going local would give regulatory authorities a high degree of oversight and supervision over systemically important market infrastructure. Authorities would also have much more control over the design and implementation of emergency measures, including the provision of emergency liquidity, and influence over a CCP's actions in the event of a member's default.

Regardless of whether global or local CCPs become the path to central clearing, new kinds of interdependencies among jurisdictions will be created. To protect the stability of the financial system, authorities must define shared-oversight arrangements across jurisdictions, the framework and principles for emergency liquidity support to CCPs, and policies for failure resolution.

This work is under way, but much more needs to be achieved, and the details matter.

Conclusion

Since the financial reform agenda was launched at the London Summit, the Pittsburgh, Toronto and Seoul Summits have each marked considerable progress. New standards are now agreed that will significantly enhance the resilience of regulated financial institutions. The easy part is done.

These new rules must now be rigorously implemented in every institution. Supervision and oversight need to be strengthened in all jurisdictions. Scrupulous international assessment must ensure equivalent implementation of these new higher standards.

We must agree on and implement a perimeter of regulation and oversight that encompasses systemically important financial institutions, markets and instruments. And a new system of firewalls needs to be built to prevent the failure of one counterparty in the OTC derivatives market from creating systemically perilous knock-on effects. This will all require considerable energy.

But as we move further from the crisis, we risk losing the sense of urgency that brought us together at the start. This would be a great disservice to our citizens.

The costs of the crisis were enormous. And the lesson from history is that memories in financial markets are short. Without our collective determination, the under appreciation of risk and the build up of vulnerabilities in the system will almost certainly return.

We have within our grasp a new financial landscape with less-frequent and less-severe crises, and with institutions, markets and products that better serve the needs of households and businesses. If we have learned anything from the crisis, this is an opportunity we cannot afford to squander.