Mark Carney: Reforming the global financial system

Remarks by Mr Mark Carney, Governor of the Bank of Canada, at a Rendez-vous avec l'Autorité des marchés financiers, Montréal, Québec, 26 October 2009.

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It is a pleasure to be here at this year's Rendez-vous avec l'Autorité des marchés financiers (AMF).

After briefly reviewing the current macrofinancial environment, I intend to concentrate on the G-20 reform agenda. The financial crisis has cost tens of millions of jobs and trillions of dollars in foregone output. Its aftershocks will persist for years. To prevent an even more severe outcome, monetary and fiscal policies have been stretched to their very limits.

In this context, it would be a mistake to underestimate the determination of G-20 leaders to reshape the financial services industry. Last month in Pittsburgh, the leaders of the G-20 endorsed a comprehensive agenda, whose implementation is just beginning. As I will highlight during my remarks, Canada intends to use its presidency of the G-7 next year to advance some of the most important priorities.

Current outlook

Recent indicators point to the start of a global recovery. Economic and financial developments have been somewhat more favourable than the Bank had expected in July, although significant fragilities remain. In Canada, as expected, a recovery in economic activity is also under way, following three consecutive quarters of sharp contraction. This resumption of growth is supported by monetary and fiscal stimulus, increased household wealth, improving financial conditions, higher commodity prices, and stronger business and consumer confidence.

However, heightened volatility and persistent strength in the Canadian dollar are working to slow growth and subdue inflation pressures. The current strength in the dollar is expected, over time, to more than fully offset the favourable developments since July.

Given all these factors, the Bank now projects that, relative to our July *Monetary Policy Report*, the composition of aggregate demand will shift further towards final domestic demand and away from net exports. We now expect growth to average slightly lower over the balance of the projection period. The Bank projects that the Canadian economy will contract by 2.4 per cent this year and then grow by 3.0 per cent in 2010 and 3.3 per cent in 2011. This projected recovery will be somewhat more modest than the average of previous cycles.

Total CPI inflation declined to a trough of -0.9 per cent in the third quarter, reflecting large year-on-year drops in energy prices. Total CPI inflation should rise to 1.0 per cent this quarter, while the core rate of inflation is projected to reach its trough of 1.4 per cent during the same period. Owing to the substantial excess supply that has emerged in the economy, the Bank expects both core and total inflation to return to the 2 per cent target in the third quarter of 2011, one quarter later than we projected in July.

The main upside risks to inflation relate to the possibility of a stronger-than-anticipated recovery in the global economy and more robust Canadian domestic demand.

On the downside, the global recovery could be even more protracted than projected. In addition, a stronger-than-assumed Canadian dollar, driven by global portfolio movements out of U.S.-dollar assets, could act as a significant further drag on growth and put additional downward pressure on inflation.

On Tuesday, the Bank reaffirmed its conditional commitment to maintain its target for the overnight rate at the effective lower bound of 1/4 per cent until the end of June 2010 in order to achieve the inflation target. The Bank retains considerable flexibility in the conduct of monetary policy at low interest rates, consistent with the framework that we outlined in the April MPR.

As I said last week, our focus in the conduct of monetary policy is on achieving the 2 percent inflation target. The exchange rate should be seen in this context. It is an important relative price, which the Bank monitors closely. What ultimately matters is the exchange rate's impact in conjunction with all other domestic and foreign factors on aggregate demand and inflation in Canada. To put it simply, the Bank looks at everything through the prism of achieving our inflation target.

Current macrofinancial environment

As many of you have no doubt noticed, it is currently a very constructive environment for financial institutions. Flow trading and market making have become more attractive and intermediation spreads have increased. Underwriting fees have recovered along with the capital markets; and there are very early signs that an appetite for mergers and acquisitions has returned. Banks are once again being compensated for their basic businesses of providing liquidity and credit. Interestingly, despite the fall in measured volatility, industry VaR, while down from the peak earlier this year, is still above pre-Lehman levels.

What is perhaps less evident is that these returns are largely the product of public policy. While medium-term challenges clearly remain, tail risk has been removed from the economic outlook. The very low policy interest rates and greater-than-usual clarity on policy paths are encouraging investors to return to the markets and to take on greater risk.

Direct support to the industry has been breathtaking, with some industrialized countries committing a remarkable 25 per cent of GDP to support their financial sectors. In effect, there was wartime spending on peacetime calamity. The G-7 commitments of last October temporarily eliminated counterparty risk for major institutions. When this support was combined with an intense flight to quality, large financial institutions benefited disproportionately.

Even in Canada, public funding has been considerable. The $65 billion in Insured Mortgage Purchase Program (IMPP) funding for banks represents 4.3 per cent of GDP. Bank of Canada extraordinary liquidity facilities have been smaller than elsewhere but they still peaked at 3 per cent of GDP. While government guarantees have not been used, it is noteworthy that Canadian bank term funding is running at less than 30 per cent of normal levels, largely as a result of the use of IMPP and the Bank's facilities.

Initially, the crisis has also had a major impact on the competitive environment for financial institutions. Competition globally has been substantially reduced through the combination of the failure of institutions, a decline in cross-border banking and, most importantly, the collapse of most of the shadow banking system. The reduced competitive dynamics could persist for some time, allowing the core of the financial sector to build sufficient capital for the future. Banks around the world would be well advised to take this opportunity to do so.

The G-20 reform agenda

The fundamental objective of the G-20 reforms is to create a resilient, global financial system that efficiently supports worldwide economic growth. The system must be robust to shocks, dampening rather than amplifying their impact on the real economy.

The Bank of Canada strongly believes that our destination should be one where financial institutions and markets play critical – and complementary – roles to support long-term economic prosperity. The financial system will be more stable if market infrastructure is substantially improved, products are more standardized and transparent, and banks are adequately capitalized to fulfill their market-making and credit intermediation roles. Market forces should be left to determine the relative sizes and boundaries of the banking and market sectors. In doing so, markets can discipline banks by furnishing necessary competition.

There are two main approaches to reform:

- First, protect the banks from the economic cycle; in other words, make each bank, individually, more resilient.
- Second, protect the cycle from the banks; that is, make the system as a whole more resilient.

Both are necessary.

Protecting the banks from the cycle

In effect, the objective of the first approach is to create more resilient institutions. This will require more capital, higher liquidity, and better risk management.

In early September, my colleagues and I on the oversight body of the Basel Committee on Banking Supervision (BCBS) met to review a comprehensive set of measures to strengthen the regulation, supervision, and risk management of the banking sector. We agreed on new standards for banking regulation and supervision, which should help reduce the probability and severity of economic and financial stress. These standards were endorsed by G-20 leaders in Pittsburgh.

Specifically, to protect banks from the cycle, we agreed to:

i. Raise the quality, consistency, and transparency of the Tier 1 capital base. Going forward, the predominant form of Tier 1 capital must consist of common shares and retained earnings. Moreover, deductions and prudential filters (such as goodwill and other intangibles, investments in own shares, deferred tax assets, etc.) will be harmonized internationally and generally applied at the level of common equity. Finally, all components of the capital base will be fully disclosed.

ii. Introduce a leverage ratio as a supplementary measure of capital adequacy to the Basel II risk-based framework. To ensure comparability, the details of the leverage ratio will be harmonised internationally, fully adjusting for differences in accounting (such as netting).

These two measures will make international bank capital regulation look more like the existing capital regulations overseen by Canada's Office of the Superintendent of Financial Institutions (OSFI). Other initiatives will be new, even to Canada:[1]

iii. Introduce a framework for countercyclical capital buffers above the minimum requirement. The Bank of Canada is working closely with OSFI and our international counterparts on proposed elements of this framework.

iv. Create a minimum global standard for funding liquidity that includes requirement for a stressed liquidity-coverage ratio, underpinned by a longer-term structuralliquidity

[1] A system-wide, or macroprudential, approach is the shared responsibility of the Department of Finance and all of the federal financial regulatory authorities, including, of course, the Bank of Canada, the Office of the Superintendent of Financial Institutions, and the Canada Deposit Insurance Corporation. Ultimately, it is the Minister of Finance who is responsible for the sound stewardship of the financial system.

ratio. As in other areas, standard setters will need to take a comprehensive approach.

Central banks have real concerns about ratchet effects (large buffers are built beyond the standard), particularly in light of the inherent procyclicality of liquidity (i.e., institutions want more liquidity in bad times so "buffers" cannot be drawn upon).

One potential mitigant would be to ensure that there is a broad range of securities that are liquid in all states of the world. That is tougher than it sounds as anyone who tried to repo quasi-sovereigns throughout the last year knows. I will address some potential solutions to this problem momentarily.

The Bank strongly believes that the standard should not bind in times of systemic crises.

The Basel Committee will issue specific, concrete proposals on these measures by the end of this year. It will carry out an impact assessment in the first half of next year, and calibrate the new requirements by the end of 2010. Implementation will be timed to ensure that the phase-in of these new measures does not impede the recovery of the real economy.

Protecting the cycle from the banks

Protecting the cycle from the banks requires building a system that can withstand the failure of any single financial institution and is buttressed by resilient markets. Today, after a series of extraordinary but necessary measures to keep the system functioning, we are awash in moral hazard. If left unchecked, this will distort private behaviour and inflate public costs.

As a consequence, there is a firm conviction among policy-makers that losses endured in future crises must be borne by the institutions themselves. This means management, shareholders and creditors, rather than taxpayers. This cannot be accomplished overnight. On the contrary, it is a long-term objective that should consistently guide policy choices now and in the future. The following four measures are designed to create a system in which individual financial institutions are less important and markets more important:

i. As is the case in Canada, all regulators should institute staged intervention regimes[2] to detect problems early.

ii. Banks themselves should develop "living wills," or plans to unwind in an orderly fashion if they were to fail. If this process results in simpler organizations, so be it. At a minimum, the exercise will underscore the shared responsibility for financial stability and improve regulators' understanding of firms' business models.

iii. The Basel oversight committee agreed to "reduce the systemic risk associated with the resolution of cross-border banks." Closing down a multinational institution is a horrifically difficult challenge, but without progress in this area, the efficiency of the global system will likely decline, perhaps significantly. For example, viable cross-border resolution is the key to ensure that a financial institution's liquidity continues to be optimally distributed across its international operations.

iv. Finally, the Bank of Canada believes that continuously open markets are essential for a system to be robust to failure. The crisis was clearly exacerbated by the seizure of interbank and repo markets. Good collateral became unfinanceable

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[2] OSFI has developed Guide to Intervention for federally-regulated financial institutions that provide a framework for responding effectively to circumstances that could undermine the financial viability of an institution. It is based on a graduated and progressive set of responses or stages, depending on the institution's situation and degree of weakness perceived. Further information on the staging process can be found at www.osfi-bsif.gc.ca/app/DocRepository/1/eng/practices/supervisory/Guide_Int_e.pdf.

overnight, firms failed, risk aversion skyrocketed, and the global economy plummeted.

Promising avenues to break such (il)liquidity spirals in funding markets include:

- Clearing houses for repo
- Through-the-cycle margining requirements
- Standardizing products
- Ensuring that accounting rules permit effective netting
- Adapting central bank liquidity facilities as necessary

In a similar vein, current efforts to transfer settlement of many over-the-counter derivatives onto clearing houses and potentially the trading of some of them onto exchanges, such as the Montreal Exchange, have the potential to reduce bilateral counterparty risk, increase liquidity, and enhance transparency. As a testament to the seriousness of this initiative, the G-7 – where the vast majority of such transactions occur – has made this a top priority for implementation next year. The Bank of Canada is working with our partners, including the AMF and the federal Department of Finance, to develop a Canadian approach.

Globally, substantial progress has been made in recent months – more than two-thirds of credit default swaps (CDS) and three-quarters of interest rate swaps (IRS) are now eligible for clearing houses. Of course, there is much more work to be done as actual volumes are still a fraction of these levels.

For such initiatives to be fully successful, regulatory capital requirements should reinforce incentives to process standardized products centrally. That is, trading in standardized products should be capital advantaged and limited basis risk should not result in punitive capital charges. Bespoke transactions will continue to have their place, but should be subject to higher capital requirements so that incentives are appropriately aligned.

Securitization needs to be made more sustainable

A more resilient financial system will require a return of private-label securitization. When properly structured, securitization can diversify risk, provide competitive discipline on banks and lower borrowing costs for individuals and businesses. Much more must be done to ensure that these objectives can be achieved.

Securitization has been slow to come back for two reasons. First, some core buyers of senior tranches (structured investment vehicles, Canadian non-bank asset-backed commercial paper (ABCP), balance sheets of large banks) will not return. This alone will shrink the market substantially. Some of this shortfall in financing capacity will be replaced over time with on-balance sheet credit risk, though the prospect of leverage ratios will limit future buying by banks of senior tranches.

Second, the crisis laid bare important structural deficiencies, such as the woefully inadequate disclosure on securitized products. Transparency should be improved so that risk can be identified more effectively and priced more efficiently. For example, the Bank of Canada used its collateral policy to improve the disclosure of bank-sponsored ABCP, creating a standard that should become commonplace. More generally, we advocate publication of models and data underlying securities to move securitization from "black box" to "open source." There are also a host of initiatives for underwriters to have skin in the game (keep similar products or first loss).

The Bank is working with government and industry players to explore the effectiveness of these and other alternatives.

An integrated approach to return risk to the private sector

The financial panic required a bold response. While absolutely necessary, the response has profoundly shifted risk from the private to the public sector. The expedient should not become permanent. Risks must be returned to and, borne by, the private sector. However, this can only happen if banks are resilient and if markets are built on solid foundations.

This will require a set of reforms that are internally consistent and mutually reinforcing. Examples just mentioned include clearing houses for CDS and Basel II treatment of basis risk or new liquidity requirements and the development of continuously open funding markets to aid in liquidity options. Reforms cannot be developed and introduced in a piecemeal fashion; the entire package must be integrated.

Similarly, banks should take an integrated approach to how they deploy their current earnings. In this regard, it may be wise to consider that both the Basel Committee and the G-20 are stressing capital conservation during the transition to a new capital regime. The compensation debate should be seen in this context. Current bumper profits can compensate employees, be returned to shareholders, or increase capital. The clear priority of the public sector is the recapitalization of the financial system to expand credit formation. The transition timetable for a new capital regime referenced at the start of my remarks is in part designed to take advantage of current higher retained earnings. The industry should be in no doubt that capital requirements are going up. Those who pre-fund will be in the best possible position over the medium term.

Moreover, we all agree that bonuses should be tied to long-term performance. In their communiqué, the G-20 leaders urged firms to implement sound compensation practices immediately. The current windfall, dependent as it is on the strongest of safety nets and the policy-driven snap back from the brink, sits uneasily with that principle. Do firms really have a good handle on their medium-term profitability, given the profound regulatory and economic changes on the horizon?

Conclusion: working together for common solutions

To conclude, the financial system must transition from its self-appointed role as the apex of economic activity to once again be the servant of the real economy. Stronger institutions and a system that can withstand failure are necessary conditions. But full realization of this objective also requires a change in attitude.

The Bank of Canada has a strong preference for principles-based regulation and reliance on the judgment of people, rather than blind faith in the security blanket of excess capital. But this approach requires a sensitivity from the industry, which has been absent in recent months. Relief is in danger of giving way to hubris.

Financial institutions need to demonstrate an awareness of their broader responsibilities. Financiers should ask themselves every day how their activities affect systemic risk? And what are they doing to promote economic growth?

As a colleague said during the crisis, there are no atheists in foxholes, and there are no ideologues in financial crises. Policy-makers had to do many unpalatable things to save the economy from the financial system – a financial system that begged for mercy.

We will not remind market participants of the many oaths they swore a year ago; nor do we expect scores of financiers to join religious orders. However, we do expect those fevered battlefield vows to be respected through daily peacetime concern for and contributions to building a better, more resilient financial system – a system that serves the real economy, by replacing those lost jobs and making up for that lost output.