Mark Carney: The G-20's core agenda to reduce systemic risk

Remarks by Mr Mark Carney, Governor of the Bank of Canada, at the International Organization of Securities Commissions (IOSCO) meeting, Montreal, 10 June 2010.

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Introduction

It is a pleasure to be here at this important meeting. It comes at a critical time, as we all work to repair a global financial system that has failed our citizens.

Given this failure, the G-20's agenda to reshape the global financial system is comprehensive and radical. The coming weeks and months will be pivotal to its success. The time for debate and discussion is drawing to a close. Policymakers now need to decide and to implement.

Recent tensions in Europe have underscored this urgency. Market volatility over the past couple of months has reflected both macroeconomic forces and heightened regulatory uncertainty. A flurry of tangential proposals has sown confusion about the focus and intent of regulatory reform. Could taxation and regulatory fiat really address Too-Big-to-Fail? Are markets part of the problem or part of the solution?

This past weekend in Busan, South Korea, G-20 finance ministers and central bank governors refocused on the core reform agenda of capital, resolution, and market infrastructure. Later this month in Toronto, G-20 leaders can be expected to harden that resolve.

Today, I would like to focus on the G-20's core agenda, whose objective is to create a more resilient, global financial system. I will begin by discussing the nature of systemic risk and then move to the three principal strategies to mitigate it:

- increasing the resiliency of financial institutions;
- enhancing the robustness of financial markets; and
- reducing the interconnectedness between institutions and between institutions and markets.

IOSCO is an important contributor to the G-20 process. We share a common purpose. Reducing systemic risk is at the heart of the IOSCO principles. Your ongoing efforts to enhance investor protection and market integrity will also serve to build a more resilient financial system.

Systemic risk

Systemic risk is the probability that the financial system will not function as needed to support economic activity. Mitigating systemic risk is challenging because it requires identifying the essential elements of a complex, modern financial system. What is essential changes as the system evolves.[1] In reducing some aspects of systemic risk, policy-makers will undoubtedly increase others. As a consequence, we will need to remain vigilant in the years that follow the initial burst of reform.

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[1] O. de Bandt and P. Hartmann, "Systemic risks in banking," in Financial Crisis, Contagion and the Lender of Last Resort, edited by C. Goodhart and G. Illing, (Oxford: Oxford University Press, 2002). (http://www.olivierdebandt.com/publications_en.html).

A fully risk-proofed system is neither attainable nor desirable. The point is not to pile up so much capital in our institutions that they are never heard from again, either as a source of instability or of growth. The challenge is to get the balance between resiliency and efficiency right.

The global financial crisis exposed the fallacy of composition that strong individual financial institutions collectively ensure the safety and soundness of the system as a whole. Even the most vigilant, microprudential regulatory regime can be overwhelmed by systemic risks. As a consequence, policy-makers now recognise that systemic risk is the product of the resiliency of financial institutions, the robustness of systemically-important markets; and the interconnectedness between institutions and markets.

At its heart, the resilience of markets and institutions is a function of solvency and liquidity.[2] As evident in the recent crisis, uncertainty about the solvency of financial institutions causes markets to become illiquid, and illiquid markets can cause otherwise solvent institutions to become insolvent.

However, while solvency and liquidity are related, the responsibility for each ultimately falls to different agents.[3]

The risk of insolvency should, fundamentally, be a private concern, just as the return is appropriated by private agents. It is the job of regulation to ensure that is the case. On the other hand, liquidity is a social good, as it facilitates exchange between institutions. While individual institutions are responsible for managing their own liquidity to buffer idiosyncratic shocks, and liquidity should be endogenously created by private agents in most states of the world, the ultimate provider of liquidity to the financial system is the lender of last resort – the central bank.

But the crisis has revealed that liquidity is not just a central bank's responsibility. It is now clear that a robust financial system requires the co-operation of all financial regulatory bodies, since illiquidity can be triggered by the insolvency of a single institution, shoddy infrastructure, or poor transparency. The more successful policymakers are in ensuring that liquidity generation is robust, the more efficient we can be with respect to the amount of capital required to protect against that risk.

Against this backdrop, the G-20's priorities should become clearer. In particular, the G-20 is pursuing three main strategies to reduce systemic risk:

- improving the resiliency of financial institutions;
- enhancing the robustness of financial markets; and,
- reducing the interconnectedness between institutions and between institutions and markets.

All are necessary, as the measures are mutually reinforcing.

Allow me to expand.

Improving the resiliency of financial institutions

Creating more resilient institutions requires more and better capital, improved balance sheet liquidity, and enhanced risk management. The crisis clearly underscored the need to better

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[2] For example, in mark-to-market accounting, illiquidity discounts can be quickly translated into accounting losses that can impair the reported capital position of a financial institution.

[3] J. Selody, "The Nature of Systemic Risk," forthcoming, in Managing Risk in the Financial System, edited by J. R. LaBrosse, R, Olivares-Caminal and D. Singh. (Cheltenham: Edward Elgar, 2011).

capture counterparty exposures, market risk, and a host of contingent claims. The so-called Basel III proposals address many of these issues.[4]

The most important elements are to:

- Create global standards for liquidity of sufficient rigour to allow our financial firms to withstand future volatility in the global financial system.
- Raise substantially the quantity, quality, consistency, and transparency of the Tier 1 capital base. It is essential that this is true loss-bearing capital, which means that it must be predominantly tangible common equity.
- Introduce a leverage ratio as a complement to the Basel II risk-based framework. The leverage ratio should be simple to calculate and non-binding in normal states. In effect, it is a safety harness that is designed to protect against risks that regulators think are low but which, in fact, are not.
- Introduce a capital buffer above the minimum capital requirement in order to ensure that banks and supervisors take prompt corrective action before bank capital levels fall below the minimum. It would appear reasonable that this buffer should be large enough to absorb the losses of the last crisis. It could also vary over time so that it is at its maximum in periods when credit is growing rapidly and system-wide risks are rising, and reduced in times of stress to ensure that the flow of credit is not undermined by regulatory constraints.[5]

While there will be some important innovations, in general, the final Basel III capital proposals will make the global system look more like Canada's. The rigour of Canadian capital regulation was an important – although far from exclusive – reason why the Canadian system fared so well during the crisis.

For the world as a whole, however, the changes will be substantial. Consequently, some are concerned that the implementation of these reforms could be damaging to the economic recovery. This apprehension is misplaced for several reasons.

First, business models and behaviour will adjust to the new rules. For example, measures to increase the capital held against trading books will encourage redeployment of capital from trading towards conventional lending.

Second, the transition timetable and grandfathering can be expected to be enlightened. The expressed intent of G-20 policy-makers is to get the measures right and then to phase them in as financial conditions improve and economic recovery is assured, with the aim of implementation by end-2012. We should not sacrifice our ambition for these measures to speed of implementation, nor the economic recovery to an arbitrary timeline.

Third, policy-makers are pursuing a number of ways to enhance the efficiency of the system by limiting the required increase in capital. These include contingent capital, countercyclical capital buffers to ensure that higher capital is only carried when necessary, building resilient financial markets, and enhancing the effectiveness of resolution mechanisms.

Policy-makers understand the desirability of providing as much certainty as possible as soon as possible. At present, the definition of capital, the deductions from it, the definitions of risk-weighted assets, and the calibration of both the minimum requirement and the buffer all

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[4] http://www.bis.org/press/p091217.htm.

[5] Banks should carry enough capital to absorb credit losses and declines in trading book asset values associated with changes in economic fundamentals. On the other hand, it is a waste of society's resources to expect them to also carry capital to cover unrealized losses that arise simply because market prices have become unhinged from economic fundamentals due to transitory factors, such as a breakdown in market liquidity.

remain to be finalised. Armed with the recent impact assessments, governors and supervisors will work quickly to make progress, consistent with the direction given by G-20 leaders to be finished by the November Summit in Seoul. If we can move faster, we will.

Reducing the interconnectedness between institutions and markets

In effect, the measures I just described reduce the probability of failure of a given financial institution. The second G-20 imperative is to reduce the impact of any failure that might occur.

A more resilient financial system must be able to withstand the failure of any single financial institution. From Bear Stearns to Hypo Real Estate to Lehman Brothers, markets failed that test.

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.

Measures to expose fully firms to the ultimate sanction of the market will also reduce the interconnectedness between institutions. Priorities include:

- All regulators should institute staged intervention regimes to catch problems early (as is the case in Canada).
- Banks themselves should develop "living wills," or plans to unwind themselves in an orderly fashion if they were to fail. At a minimum, the exercise will underscore the shared responsibility for financial stability and improve regulators' understanding of firms' business models.
- 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, it is likely the efficiency of the global system will decline, perhaps significantly.

In the Bank's view, less promising is a series of creative proposals to address the negative externalities created by systemically important financial institutions. Many of these require authorities to pass judgment on which institutions should be considered systemically important. However, it is hard to measure systemic importance, and making such identifications may give rise to moral hazard. Once made, would it be possible to remove such a designation? We need to reduce moral hazard in the financial system, not add to it.

As Minister Flaherty has written to his G-20 colleagues, Canada's view is that it is essential that any option respect the following principles for a robust resolution regime:

- Proper allocation of losses to reduce moral hazard and protect taxpayers;
- Certainty and uninterrupted service of critical functions and for insured depositors;
- Preservation of franchise value of the firm;
- Credibility of regime among financial institution counterparties, ex ante; and,
- Effective coordination and cooperation among jurisdictions in the event of a cross-border failure of an institution.

One promising avenue is to embed contingent capital features into debt and preferred shares issued by financial institutions. Contingent capital is a security that converts to capital when a financial institution is in serious trouble, thereby replenishing the capital of the institution

without the use of taxpayer funds. Contingent conversions could be embedded in all future new issues of senior unsecured debt and subordinated securities to create a broader bail-in approach. Its presence would also serve as a useful disciplinary device on management since common shareholders would be incented to act prudently and avoid having their stake in the institution diluted away by the prospect of conversion.

Building resilient markets

The third strategy to mitigate systemic risk is to enhance the resiliency of financial markets through initiatives to improve infrastructure and enhance transparency.

Continuously open financial markets are essential to a system that is robust to failure. Keeping markets continuously open requires policies and infrastructure that reinforce the private generation of liquidity in normal times and allow for central bank support in times of crisis. The cornerstone is clearing and settlement processes with risk-reducing elements, particularly central clearing counterparties or "CCPs."

Properly risk-proofed CCPs act as firewalls against the propagation of default shocks across major market participants. Moreover, in the case of a single-participant default, a CCP's standardized procedures can contribute to an orderly close out of that participant's positions, eliminating the chance of a "fire sale" and reducing spillovers to other markets.

For these reasons, the Bank of Canada has supported the development of a domestic CCP for Canadian-dollar repos, which should be launched later this year. The Bank is working with its domestic partners to develop similar infrastructure for over-the-counter (OTC) derivatives markets. Current G-20 efforts to transfer trading of standardized OTC derivatives to clearing houses have similar benefits.

Securities regulators and central banks have a shared interest in ensuring that the new infrastructure is properly risk-proofed. IOSCO recently provided helpful guidance for risk-management practices of central counterparties that clear OTC derivatives products.[6] Central banks look forward to the results of your consultations on this issue, which should serve to set robust standards to ensure that CCPs for OTC derivatives meet the highest risk-control standards.

Systemic risk can also be mitigated through better and more-readily available information. This reduces information asymmetry, facilitates the valuation process and, hence, supports market efficiency and stability. It also enhances investor protection by supporting informed investment decisions and a more level playing field for investors. This, in turn, reduces uncertainty regarding asset values, which translates into greater market confidence; a lower probability of unwarranted price volatility; and a lower risk of contagion, liquidity spirals, and market freezes.

Trade repositories are central to G-20 commitments to enhance the transparency of OTC derivatives markets. Trade repositories would reduce systemic risk and support market integrity and investor protection by reporting such data as aggregated live positions, transaction activity, aggregate settlement data, and transaction-level pricing. Greater use of electronic trading platforms could also improve price transparency, thereby supporting market liquidity and efficiency, as well as levelling the playing field for market participants.

The need for improved transparency extends to other systemically important markets, such as securitization. The nature of securitized products argues for different (and likely greater) disclosure than traditional corporate securities. IOSCO has rightly recognized this in its recently published disclosure principles for public offerings and listings of asset-backed

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[6] Guidance on the application of the 2004 CPSS-IOSCO Recommendations for Central Counterparties (RCCP) to OTC derivatives CCPs.

securities.[7] How securities regulators apply these principles in their respective jurisdictions could have important implications for the level of systemic risk in securitization markets.

Collaboration among prudential regulators, securities regulators, and central banks is critical. To achieve the full benefits of the new infrastructure, we need to work together to establish global central counterparties and trade repositories, with appropriate oversight and legal arrangements. These may need to be complemented by national arrangements in cases where local access is inadequate.

It is all related

Just as systemic risk is the product of interrelationships within the financial system, the G-20 reforms are mutually reinforcing.

In particular, capital requirements should buttress incentives to process standardised products centrally. That is, trading in standardised 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.

Liquidity can be enhanced by a number of strategies. More effective resolution processes will help ensure that markets are robust to the failure of participants, thereby promoting liquidity in more states of the world. Measures to develop continuously open funding markets, such as CCPs, should expand liquidity options, as will more effective securitization. Central bank liquidity facilities should reinforce continuously open markets and, potentially, securitization reforms. Securitization will also enhance liquidity options.

Most fundamentally, the more successful the market infrastructure and resolution agendas are, the lower the overall capital requirements for banks, and the more efficient the overall system.

Conclusion

G-20 leaders have mandated a series of reforms to put the global financial system on a more solid footing. These changes are radical, not incremental.

A focus on efficiently reducing systemic risk is essential. This means ensuring that individual financial institutions are both stronger and less systemically important, more options for liquidity are available in all states of the world, and the sum of the reforms is self-reinforcing and market-driven to reduce systemic risk. These solutions are being developed through closer collaboration between regulators and central banks.

IOSCO's efforts are central to this effort. I thank you for your focus on this critical agenda and for your attention today.

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[7] http://www.iosco.org/library/pubdocs/pdf/IOSCOPD318.pdf.