

Tiff Macklem: Raising the house of reform

Remarks by Mr Tiff Macklem, Senior Deputy Governor of the Bank of Canada, presented to the Rotman Institute for International Business, Toronto, Ontario, 7 February 2012.

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Introduction

It is a pleasure to be here this morning. I want to thank the Rotman Institute for International Business, and particularly its co-directors, Wendy Dobson and Ig Horstmann, for inviting me. Like many of us, I have benefited tremendously from Wendy's insight, her ruthless truth telling and her sage advice on international issues. Ig Horstmann was one of my professors in graduate school. And I owe him a debt of gratitude for turning an enthusiastic student of macroeconomics on to the importance and utility of microeconomics – training that has proven invaluable in grappling with issues of financial regulation. My remarks today combine both these elements – international economics and financial regulation.

I want to talk to you about the imperative of completing the reform of the global financial system.

Some are calling for a slowdown of the reform process, arguing that a weak global recovery and elevated uncertainty are good reasons to ease up on implementation.

The global economy is certainly underperforming. The euro area appears to have fallen back into recession, with a sovereign debt crisis that poses clear and present downside risks. In the United States, housing and labour markets have proven stubbornly slow to recover, and there is a large fiscal adjustment still to come.

But the current challenges are not an excuse for delay. Quite the opposite – they underscore the urgent need to make the financial system more resilient. In a risky world, the need to make the financial system safer and restore confidence is vital. If there is a reproach to be made, it is that progress has not been faster.

The G-20 Leaders' 2009 plan of action to strengthen the financial system was appropriately sweeping. It included:

- enhanced transparency and disclosure so markets work better;
- larger capital and liquidity buffers to make banks safer;
- broadening the span of regulation and oversight so that all systemically important financial institutions, markets and products are included;
- stronger infrastructure so that core financial markets continue to function in periods of stress; and
- credible and effective resolution regimes for all financial institutions so that no institution is too big to fail.

With the architecture for their house of reform sketched out, the Leaders assigned responsibility for the detailed design and construction to the Financial Stability Board (FSB). Now, almost three years later, construction is well underway.

But it's a big house with several wings. The foundation has been laid and the framing has been completed. Some wings are even ready for occupancy, while in others the walls are still going up.

In my remarks today, I will focus on the key prerequisites for completing construction and the challenges of moving in. I will organize my remarks around the three Cs essential to get to completion: the need to be comprehensive, coordinated and consistent.

Reform must be comprehensive, spanning institutions, markets and products, from inception to resolution.

Reform must be coordinated across its many elements, across jurisdictions and with stakeholders.

And reform must be implemented in a consistent manner around the globe.

Comprehensive

To ensure the reforms are comprehensive, work began at the core of the financial system and is now moving outward to the periphery. Three wings that will house the reforms to the core are now ready to move into.

First, the new Basel III capital rules have been finalized and are now being implemented over a suitably gradual transition period. The new standard substantially increases the loss-bearing capital that financial institutions must hold and establishes a new limit on leverage. This is a significant strengthening of the global rules, effectively raising the minimum global capital requirement sevenfold.

Second, a methodology to assess systemic importance has been developed, and 29 banks have been identified as globally systemic. These banks are required to have additional loss-absorption capacity tailored to their systemic importance, ranging from 1 per cent to 2.5 per cent of risk-weighted assets, to be held in common equity. They will also be subject to closer scrutiny by bank supervisors.

Third, to be able to resolve firms – no matter how large – without disruption to the economy or cost to taxpayers, the FSB has developed a new international resolution standard. Work is now turning to the implementation of the Key Attributes for Effective Resolution.

By the end of this year, global systemically important financial institutions (SIFIs) will have completed:

- resolvability assessments;
- recovery and resolution plans; and
- institution-specific, cross-border co-operation agreements so that home and host authorities are better equipped to deal with crises.

The sooner we move in, the sooner we roll back too big to fail.

Other wings of the house are at various stages of construction. Permit me a few words about each.

Liquidity standards

The construction of new minimum standards to enhance banks' liquidity buffers is well advanced, but needs some remodelling before completion. The current definition of high-quality liquid assets is too narrow, focusing only on sovereign debt and cash. This may have the unintended consequence of increasing segmentation and reducing liquidity in some financial markets. Consideration should be given to broadening the definition to allow for a continuum of asset types, with suitable haircuts and limits.

Systemically important financial institutions

With additional protections for global SIFIs agreed, work is now under way to extend extra resiliency requirements to banks that are not globally systemic but are systemic at the national or domestic level. This includes developing an appropriate methodology for identifying domestic SIFIs, and outlining prudential measures to mitigate the risks they pose.

Given the significant differences across countries in the structure of national banking systems, this framework should adopt a principles-based approach so that regulators have the flexibility to focus on the additional requirements that will be most effective within their domestic context.

The systemic risks posed by other types of financial institutions and financial infrastructures are also being reviewed. The International Association of Insurance Supervisors (IAIS) is developing a methodology to identify activities of insurance companies that are systemically important on a global scale, including both traditional insurance and ancillary activities. Once the nature of their systemic activities has been identified, consideration will need to be given to any additional buffers that may be required – a task made more difficult by the lack of an international prudential accord for insurance companies.

The Committee on Payment and Settlement Systems (CPSS) and the International Organization of Securities Commissions (IOSCO) are currently developing safety and soundness principles for financial market infrastructures, such as central counterparties (CCPs). Work is also under way to examine the systemic activities of other types of non-bank financial firms or so-called shadow banks.

Shadow banking

Drawing the systemic elements of shadow banking into the regulatory net was a central element of the G-20 Leaders' reform vision. They agreed that regulation and oversight should depend on the nature of the activity – not legal structure – and that like activities should receive like treatment.

In many countries, including Canada, market-based financing or shadow banking is at least as large as the traditional banking sector. Shadow banking spans a range of activities, including repurchase agreements, mortgage-backed securities, other types of securitization, short-term debt instruments and money market mutual funds. The sector provides competition to traditional banking and is an important source of diversification and innovation. But it also entails many of the same risks that are inherent in traditional banking.

Like the credit intermediation of banks, shadow banking involves liquidity and maturity transformation, often with some degree of leverage. Moreover, as the financial crisis made painfully clear, the systemic risks of shadow-banking activities can be magnified by the interconnectedness of the financial system – stresses within shadow banks can be transmitted to the core of the financial system in unforeseen ways.

Foundational elements to achieve more comparable treatment are now in place, including enhanced disclosure requirements, the new consolidation accounting standard and minimum risk-retention rules. But much work is needed on the full range of policy options to control systemic risks in the shadow-banking sector. These include: direct regulation of the activities of shadow banks; indirect regulation via links to the traditional banking sector; targeting specific products; and various macroprudential measures.

By the end of 2012, the FSB, with the relevant standard-setting bodies, will develop policy recommendations on shadow banking in five priority areas:

- the interactions of regulated banks with shadow banking entities and activities;
- money market mutual funds;
- other shadow-banking entities;
- securitization; and
- securities lending and repos.

Policy reforms in all of these areas should be guided by four considerations.

First, with the capital and liquidity standards applied to banks set to increase, we can expect to see new incentives for activities to migrate to the shadow-banking sector, increasing the need for timely reform.

Second, the reforms must strike an effective balance between the benefits of shadow banking, in terms of competition, diversification and innovation, and the risks related to regulatory arbitrage and systemic vulnerabilities.

Third, given the important differences in the structure of shadow-banking activities across countries, the best means of mitigating systemic risks is likely to differ across jurisdictions. But given that shadow-banking activity crosses national borders, there is a need for a coherent global approach to these issues.

Fourth, the reforms and the approach to monitoring the sector must be flexible and adaptable, since changes in regulation and innovation can lead to rapid expansion and mutation of shadow-banking activities.

Central counterparties for OTC derivatives

The final element of the comprehensive reform plan is mitigating contagion between sectors and institutions in the financial system. The house needs firewalls.

Recognizing this imperative, the G-20 Leaders mandated that all standardized OTC derivatives contracts should be traded on exchanges or electronic trading platforms, where appropriate, and cleared through CCPs. In addition, all OTC derivatives trades should be reported to trade repositories.

The architecture for trade repositories is converging on a global platform, although important issues of data access are still to be worked out.

For CCPs, the basic architecture has yet to be resolved. There are two competing designs – global and local – and each has its costs and benefits.

The global design has the greatest potential to reduce fixed costs, maximize netting benefits and economize on collateral. At the same time, these very benefits would concentrate clearing risk in a small number of very large global CCPs. They could also create a competitive advantage for the largest global banks, serving to reinforce their systemic importance.

The alternative is a more distributed model in which local CCPs are established to clear OTC derivatives transactions outside the United States and the European Union. While this design would reduce concentration and provide for greater competition, it could result in an overly fragmented architecture, with local CCPs that are not sufficiently efficient and robust.

To inform decisions on architectural design, the FSB, working with the standard setters, is coordinating efforts to develop adequate safeguards for a global architecture, especially with regard to access, cross-border emergency liquidity arrangements, co-operative oversight and resolution.

The goal is to complete the work on these safeguards by June so that each jurisdiction can make an informed choice about its preferred clearing architecture this year.

Coordinated

Let me now turn to the second C – coordinated. Reform elements must be balanced, coherent, mutually reinforcing and well integrated. The FSB's overarching role is to ensure global coordination across all the elements of reform and across countries.

Coordination across the elements means we must consider the combined effect of the totality of the reforms, including both their cumulative impact and their interaction. We should avoid

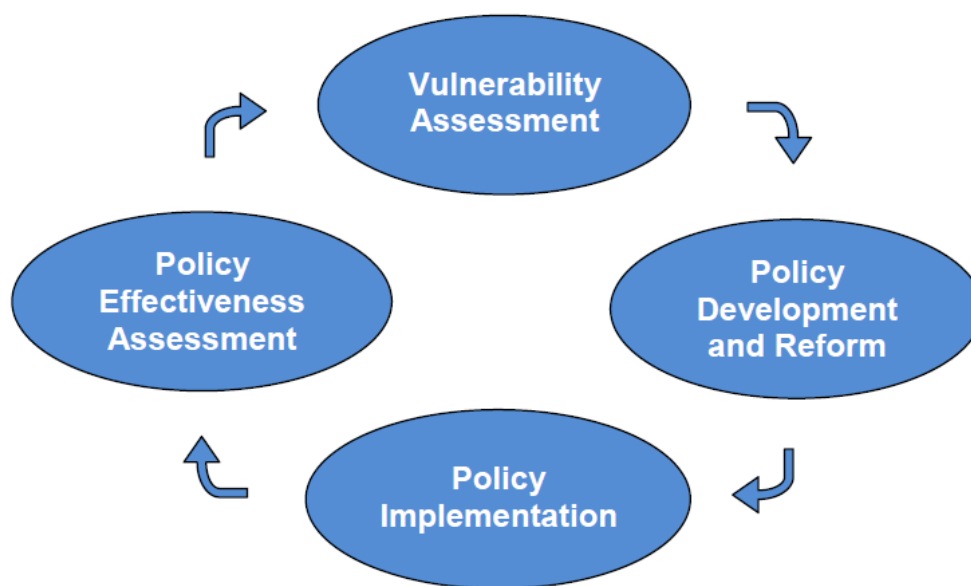
overreliance on one instrument, and strive for balance. For example, as the experience of some firms in the financial crisis highlighted, even strong capital levels, by themselves, do not provide adequate protection. While important, capital buffers need to be buttressed with sound risk management, a leverage cap, liquidity requirements and measures to limit contagion.

Coordination across countries requires a coordinating process. Historically, responsibility for financial sector policy has been spread across national agencies as well as international standard-setting bodies. The crisis underscored the importance of the FSB's key coordinating role.

Now chaired by Bank of Canada Governor Mark Carney, the FSB is acting on a clear remit from the G-20. As the general contractor in the reform process, the FSB coordinates all aspects of construction. Over the past four years, the FSB has undertaken much of the policy work itself through its standing committees, while other aspects of construction have been subcontracted to international standard-setting bodies, including the Basel Committee, CPSS and IOSCO.

The FSB's responsibilities loop from conception to feedback. The FSB takes the lead in identifying critical financial vulnerabilities, developing new policies and then assessing their implementation and effectiveness (Figure 1).

Figure 1: FSB coordination of the financial-reform policy cycle



These efforts are being undertaken in coordination with the private sector. Broad consultation is essential to effective design. To steal a line from the late Michael Mussa on the perils of seeking input from just one kind of specialist, if you only consult plumbers, every room is going to have a toilet. Reform proposals are being developed in consultation with the financial community and released for public commentary and input from industry round tables.

Consistent

That brings me to the third C – consistent implementation.

If the new global standards are to promote international financial stability, they must be consistently implemented across the major financial jurisdictions. Consistent does not mean

one size fits all. Most standards, such as the Basel capital rules, are international minimums. Countries can adopt stronger rules or, as Canada is doing with Basel III, implement more quickly than the generous maximum phase-in period.

The monitoring of implementation is coordinated by the FSB's Standing Committee on Standards Implementation, which I chair. Assessment has proceeded along two complementary tracks: country reviews that examine the implementation of standards in a single FSB member country, and thematic reviews that focus on one element and assess implementation across the 24 FSB member countries. Six country peer reviews have now been completed, most recently for Canada and Switzerland. And five thematic peer reviews have examined implementation across the full FSB membership on topics ranging from compensation practices at banks, to mortgage underwriting standards and deposit insurance systems. So the FSB peer review system is up and running.

But already it is time for expansion.

To assess consistency in the implementation of major reforms, we are significantly enhancing the resources devoted to monitoring, and coordinating implementation-monitoring activities across the standard-setting bodies and the FSB. This will include annual progress reports to the G-20 on a country-by-country basis, as well as less-frequent but more in-depth peer reviews in priority areas.

Some commentators are concerned that the FSB lacks the authority to enforce the rules, and have argued that it must evolve to a treaty-based organization with the power to sanction its members. While this may ultimately prove to be the case, so far, this has not been demonstrated. The FSB is making good progress on the basis of consensus and co-operation. Peer reviews have reported that implementation is moving ahead, have identified remaining gaps and have increased the focus on impediments to implementation. Countries that are not complying have been called out.

But tougher tests lie ahead, and it is essential that the spirit of internationalism and co-operation is sustained. Implementing Basel III is the biggest and most immediate test.

The Basel Committee is taking primary responsibility for monitoring and reporting on national implementation of Basel III. The committee will first look at whether each member's financial system legislation is consistent with the Basel III requirements, and then at whether the risk-weighting rules are applied similarly across countries. It will conduct and publish country-by-country reviews and provide the FSB with an assessment of progress and gaps. If there are material deviations from Basel III, they will need to be fixed. Full and consistent implementation is imperative.

Conclusion

Allow me to conclude. The global financial system must be flexible enough to respond to the dynamics of the global economy. But it must also be able to retain its structural integrity in the face of powerful cross-currents generated by multi-polar economic development, rapid technological innovation and increasing financial globalization. The reforms we are constructing to house the financial system will allow us to track and identify emerging vulnerabilities and promote its stability. The goal is a dynamic and resilient financial system that serves the needs of households and businesses in good times and in bad.

The FSB is building the reforms on a foundation of consensus among G-20 members. Despite its small size, the FSB has accomplished a great deal in just two and half years. Now it needs to reach out and network to foster closer relationships with international financial institutions, standard-setting bodies and non-member countries.

The FSB also needs to be placed on a more secure footing if it is to be an enduring pillar of the international financial architecture. To that end, the G-20 Leaders agreed at the Cannes Summit last November that the FSB should expand its resources, and gain legal personality

and greater financial autonomy. This will extend the FSB's capacity to coordinate, monitor and assess financial reform.

But, ultimately, it is up to the FSB's member countries to ensure that the house of reform becomes the home to the financial system. Full implementation is the responsibility of every member. We should expect no less.

Thank you.