Mark Carney: Some current issues in financial reform

Remarks by Mr Mark Carney, Governor of the Bank of Canada and Chairman of the Financial Stability Board, to the Canadian Club of Montréal, Montréal, Quebec, 8 November 2012.

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Introduction

I am pleased to be in Montréal today, having just returned from meetings of G-20 Finance Ministers and Central Bank Governors in Mexico City. While we covered many important topics, a substantial part of the agenda focused on assessing the progress of global financial sector reform.

This is my topic today – providing you with an update of what has been achieved, and what remains to be done.

The importance of these efforts should be obvious. Five years ago, the complete loss of confidence in private finance could only be arrested by comprehensive backstops from the world's richest economies. In the ensuing recession, the global economy lost more than $4 trillion in output and almost 28 million jobs.

Here in Canada, we learned that keeping our own house in order is not enough. Even with our strong and well-functioning financial system, the Canadian economy suffered a decline of almost $70 billion in GDP and lost more than 430,000 jobs. While we have more than recouped all those losses, our economy continues to be held back by the weak global recovery. That is why it is important for all Canadians that all countries follow through on these reforms.

To address the question of how G-20 countries are doing, I will concentrate on three issues:

- Are banks safer today?
- Have we ended the phenomenon of institutions that are "too big to fail"?
- Is shadow banking a force for good or ill?

Let me turn to the first.

Are banks safer?

Banking system frailties were cruelly exposed by the crisis. Many people remember the pivotal moment when Lehman Brothers collapsed, but that was only one example of a widespread failure of banking models across the advanced economies.

In 2008, major banks in the United States, the United Kingdom, Germany, France, Ireland, Switzerland, the Netherlands and Belgium either failed or were rescued by the state. Gallingly, on the eve of their collapse, every bank boasted of capital levels well in excess of the standards of the time.

How was this possible? In some cases, "off-balance-sheet" exposures proved to be very much the responsibility of the banks when push came to shove. In others, balance sheets were stuffed with supposedly risk-free structured products that turned out to be lethally toxic. In the end, the old risk-based capital standards were both too weak and too porous. This proved fatal when banks' loss absorbency was called upon.

Building capital

So it should be a surprise to no one that when building a more resilient system, the G-20 started with strengthening the bank capital regime. With the new Basel III rules, the quantity and quality of bank capital are being improved immensely:

- The minimum requirement for common equity will rise from 2 per cent to 4.5 per cent under Basel III, and to 7 per cent when the new capital conservation buffer is added. This more than triples the required amount of high-quality capital.
- A new countercyclical capital buffer will compel banks to further increase capital by up to 2.5 percentage points if threats of system-wide disruptions are rising.
- For those banks whose failure would pose a risk to the global financial system, even more capital will be required. By 2019, these institutions will face a capital surcharge that rises from 1 per cent to 2.5 per cent of risk-weighted assets.

In addition, the new rules will bring more exposures on balance sheets and require more capital against riskier activities (e.g., trading activities and securitisations). For example, capital required for the trading book will be tripled.

The effective increase in capital is even larger once the tougher definition of capital is factored in. In total, the largest banks will have to hold at least seven times as much capital as before the crisis.

While these measures are scheduled to be implemented over the next six years, banks are not waiting to rebuild confidence in their creditworthiness. Since the end of 2007, major banks in the United States and Europe have increased their common equity capital by $575 billion and their common equity capital ratios by 25 per cent. Based on the new rules, the average capital ratio of internationally active banks at the beginning of this year already stood at 7.7 per cent.[1]

In general, the industry can meet the new targets through earnings retention over the transition period. For example, for all large banks to reach the Basel III Tier 1 common equity target ratio by January 2019, they need to raise an amount about equal to their aggregate post-tax profits last year.

Canadian banks are setting the pace. Since the end of 2007, the major Canadian banks have increased their common equity capital by 70 per cent, or $67 billion. All major Canadian banks are expected to meet the stringent 2019 Basel III requirements by next January, as specified by the Office of the Superintendent of Financial Institutions (OSFI).

Reducing leverage

In an ideal world, regulators would accurately measure the riskiness of banks' assets when setting leverage. But who lives in a world where risks are known with certainty and can be measured with precision?

Therefore, as a backstop to the inherent imperfections of a risk-based capital framework, a simple, but effective, leverage ratio has been imported from Canada into the global standard. The leverage ratio sets a cap on how many assets a bank can hold for each dollar of equity. It protects the system from risks we might think are low but in fact are not.

In the run-up to the crisis, when concerns about risks were at their lowest (and risks themselves were, in fact, at their highest), Canadian banks were constrained by the leverage

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[1] Based on the Basel III definition. See Basel Committee on Banking Supervision, "Results of the Basel III Monitoring Exercise as of 31 December 2011," 20 September 2012, Table 2. The average capital ratio assumes full implementation of the new capital regulations, including all deductions.

ratio. Elsewhere, leverage soared, in some cases doubling or tripling, while risk-adjusted measures remained stable.

When the financial panic intensified, investors increasingly simplified their judgments about capital adequacy. In the end, only true loss-bearing capital and simple leverage tests mattered. In this light, many financial emperors around the world were seen to have no clothes. Canadian banks were comparatively draped in full winter regalia.

Belt and suspenders

The belt and suspenders approach of the capital and leverage ratios establishes two tests for the maximum amount of assets that financial institutions may hold relative to equity. An issue is which of these should bind first. If the leverage ratio does, banks will load up on riskier assets and push assets off their balance sheets in ways that satisfy accountants but not, ultimately, creditors. That is why a complex risk-weighted test is also necessary, and should be calibrated to bind before the leverage ratio in normal circumstances.

Banks are safer as a result of this combined approach. But much more is required. We need to ensure consistent implementation. That is why the Financial Stability Board (FSB) just released a review of implementation in major jurisdictions. This review identified some deficiencies that will need to be addressed. The FSB and the G-20 will continue to use such transparency and peer pressure to ensure a level playing field.

Of course, bank resilience is a function of much more than just capital. It also requires better risk management and improved governance. I will conclude later with some comments on how the totality of FSB reforms will encourage just that.

Have we ended too-big-to-fail?

The measures taken to date have lowered the probability of failure, but since failures will still happen, their impact must be reduced.

In particular, we must address, once and for all, the unfairness of a system that privatises gains and socialises losses. By restoring capitalism to the capitalists, discipline in the system will increase and, with time, systemic risks will be reduced. In addition, the knowledge that major firms in markets far away can fail, without meaningful consequences at home, will restore confidence in an open global system.

The cost of too-big-to-fail

In addition to the public cost of the bailouts, there is the less-transparent and ongoing implicit subsidy. Large banks enjoy lower borrowing costs owing to direct support and implicit government guarantees. This subsidy effectively saved the 20 largest global banks $70 billion per year prior to the crisis, equivalent to 20 per cent of their profits.[2]

Moreover, the moral hazard problems associated with implicit public support may amplify risk taking, reduce market discipline, create competitive distortions, and further increase the probability of distress.

What are we doing about it?

To eliminate those costs on taxpayers and to promote market discipline, G-20 countries are taking several steps.

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[2] A recent study by the International Monetary Fund finds that this implicit public guarantee effectively lowered the borrowing costs of banks in 14 advanced countries by approximately 60 basis points in 2007. The Bank of England estimates that, between 2002 and 2007, this was equivalent to about $70 billion per annum for the 20 largest global banks

First, the FSB has identified those banks that are systemically important at the global level, based on size, complexity and interconnectedness with other aspects of the financial system.[3] There are no Canadian banks on the current list.

Second, to address the systemic and moral hazard risks associated with these systemically important financial institutions (SIFIs), the FSB has developed a range of measures, known as the ***Key Attributes***.[4] When implemented, these will help to ensure that any financial institution can be resolved without severe disruption to the financial system and without exposing the taxpayer to the risk of loss. Under the ***Key Attributes***, bondholders, shareholders and management – rather than taxpayers – will have to bear the brunt of losses as a result of a new bail-in power in all G-20 member countries. Authorities will have the ability to convert some private debt to new equity in order to recapitalise, and share the losses of, a failing institution. The knowledge that this could happen should enhance market discipline of private creditors who previously enjoyed a free ride at the expense of taxpayers.

In addition, each global SIFI must have mandatory recovery and resolution plans and resolvability assessments, as well as a cross-border co-operation agreement between relevant authorities. Further, member countries will complete specific plans by mid-2013 to recover or, if necessary, resolve these global SIFIs. Finally, each SIFI should be subject to more intense and effective supervision.[5]

Other systemic financial firms

While these measures are being implemented, the FSB is working to extend this framework to other systemic financial firms, including domestic systemically important banks, global insurance companies, non-banks and core financial market infrastructure.

In particular, the FSB and the G-20 have agreed to a principles-based approach to regulating domestic systemically important banks (D-SIBs) that complements the framework for global systemically important banks (G-SIBs) and provides for national discretion in the way that systemic importance is assessed and policy tools are applied. In Canada, OSFI will make these determinations. As countries implement their D-SIB frameworks, the frameworks will be subject to peer review to preserve a level playing field and ensure compatibility with the G-SIB framework.

More progress required

While we have made solid progress, it is not clear yet that too-big-to-fail has been ended. For example, credit-rating agencies continue to boost their ratings of major banks by a factor that recognises implied government support. This boost has increased since the crisis, meaning that the implicit subsidy of taxpayers to large banks may have grown tenfold by some estimates.[6]

Despite the proclamations of G-20 leaders, investors seem to think governments will once again blink when faced with a failing large bank. In part, this reflects the need to legislate, not merely propose. But it may also underscore the need for further measures, and to articulate clearly plans to resolve each systemic institution. These may include improving the effectiveness of cross-border agreements for handling a failure, and in my view, clearly

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[3] The FSB has recently updated the list of global systemically important banks, reducing the number of such banks by one overall, from 29 to 28, as two banks have been added and three banks removed from the list.

[4] FSB, "Key Attributes of Effective Resolution Regimes for Financial Institutions," October, 2011.

[5] See "Increasing the Intensity and Effectiveness of SIFI Supervision," a progress report of the FSB to the G-20 Ministers and Governors, released on 1 November 2012.

[6] A. Haldane, "On Being the Right Size," a speech to the Institute of Economic Affairs' 22nd Annual Series, the 2012 Beesley Lectures at the Institute of Directors, 25 October 2012.

identifying bail-inable securities, requiring a minimum amount of them, and publishing a presumptive path for resolution.

This week, in Mexico City, we agreed to redouble our efforts on these fronts. The FSB will assess whether we have ended too-big-to-fail at the St. Petersburg Summit next September and I am confident the G-20 will agree on any further steps to do so if required. The G-20 is resolute in its intention to end too-big-to-fail.

Is shadow banking a force for good or ill?

There are valid concerns that as authorities take measures to make the traditional banking system safer, we will push risk into the shadow banking sector. That is one reason why the FSB has launched, and the G-20 endorsed, a comprehensive reform of the oversight and regulation of shadow banking.

Shadow banking is best described as credit intermediation involving entities and activities (fully or partially) outside the regular banking system. When this intermediation is conducted appropriately, it is a valuable alternative to bank funding that supports real economic activity. But experience from the crisis demonstrates that non-bank entities and transactions can operate on a large scale in ways that create bank-like risks to financial stability.

Like banks, the shadow banking system can be vulnerable to “runs,” thereby amplifying systemic risk. It can feed booms during surges in confidence and magnify busts when confidence evaporates.

For example, in a dynamic that fed the U.S. housing bubble, the value of structured investment vehicles (SIVs) tripled in the three years to 2007, and credit default swaps grew sixfold. Following the sudden reappraisal of the creditworthiness of these instruments, asset-backed commercial paper (ABCP) markets froze, SIVs failed, and money market funds experienced runs.

The feedback to the regulated sector was immediate and devastating. Money market mutual funds pulled short-term funding from the banking sector. Other core financial markets, such as repo and over-the-counter derivatives markets, seized up. Virtually all American investment banks and many commercial banks could not roll over their funding positions.

During this time, the Canadian non-bank ABCP sector – a classic shadow banking activity – also collapsed.[7] Only the Herculean efforts of the public and private sector through the Montréal Accord could resolve this debacle.

We should all hope that the lessons of these sorry episodes remain fresh in the minds of investors, banks and regulators for some time. However, experience suggests it would be foolish to rely on memory alone. That is why the FSB and G-20 are acting.

Our core objective is to address bank-like risks to financial stability that emerge outside the regular banking system. At the same time, we want to preserve sustainable non-bank financing models that do not pose such risks but provide needed competition to banks and credit to the real economy.

As a result, the FSB’s approach, outlined this week in Mexico, is proportionate to financial stability risks and starts with those activities that were sources of problems during the crisis. It also provides a process for monitoring the shadow banking system so that any rapidly growing new activities that pose bank-like risks can be identified early and, where needed, addressed.

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[7] These vehicles were part of a complex chain that transformed short-term investments in commercial paper into long-term loans. As confidence that this paper could be rolled over faltered, there was indiscriminate selling of structured assets.

There are five work streams to address vulnerabilities. They seek to:

- mitigate the spillovers between the regular and the shadow banking systems;
- reduce the susceptibility of money market funds to runs;
- mitigate systemic risks posed by other shadow banking entities;
- align the incentives in the securitisation process to prevent excessive leverage in the financial system; and
- dampen risks and procyclical incentives associated with secured financing contracts such as repos and securities lending.

Initial recommendations will be released shortly for public consultation. Detailed assessments of the impact of these measures on financial system resilience and economic growth will be conducted. Based on these findings, the FSB will deliver a final integrated set of recommendations for approval by the G-20 leaders at the St. Petersburg Summit.

The ultimate goal of these reforms is to turn risky shadow banking into resilient market-based financing. The latter is an essential and valuable part of the modern financial system.

Getting the market to work

I have spent some time today outlining an ambitious and necessary set of measures that will significantly improve the safety and the stability of the financial system. The unique nature of financial firms and the enormous costs of failure require regulation and supervision to supplement internal governance of banks and market discipline.[8] The new Basel capital and liquidity rules will encourage better risk management. New FSB compensation standards will better align incentives of bankers and shareholders with the needs of the broader economy.[9] More intensive and effective supervision will reinforce internal governance and risk management.[10]

But the point is not to pile up capital and other regulatory capital requirements so high that banks are never heard from again as either a source of risk or credit to the real economy. No supervisory system can catch everything.

The main responsibility for identifying and managing risk rests with each firm's management, whose risk managers, compliance staff and internal audit personnel will always greatly outnumber the resources available to supervisors. And since regulation alone cannot optimise risk and return, the FSB is taking steps to enhance the role of the market in achieving the right balance.

By ending too-big-to-fail and thereby subjecting firms to the ultimate sanction of the market, discipline in the system will increase.

In Mexico, the G-20 also endorsed the FSB's new road map to end the mechanistic reliance on credit ratings. Doing so will promote diverse private sector judgment, reducing cliff effects and building resilience.

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[8] For a more complete discussion, see W. Byres, Secretary General of the Basel Committee on Banking Supervision, "Regulatory Reforms – Incentives Matter (Can We Make Bankers More Like Pilots?)," a speech to the Bank of Portugal conference on Global Risk Management: Governance and Control, Lisbon, 24 October 2012.

[9] See Financial Stability Forum, "FSF Principles for Sound Compensation Practices," released on 2 April 2009, and FSB, "Principles for Sound Compensation Practices: Implementation Standards," released on 25 September 2009.

[10] See FSB progress report, "Increasing the Intensity and Effectiveness of SIFI Supervision," released on 1 November 2012.

Moreover, improving risk disclosure, risk governance and risk management will further build a more resilient financial system. That is why I welcome the recently published report of the Enhanced Disclosure Task Force. This private sector effort, encouraged by the FSB, offers recommendations to provide investors with better disclosure about bank business models, key risks and risk-measurement practices. This should contribute, over time, to improved market confidence in financial institutions and financial market functioning, complementing regulatory developments by the public sector. I strongly encourage banks to implement these recommendations.

As the Basel capital rules are implemented, as market infrastructure changes, and as banks – and, crucially, their investors – develop a better appreciation of their prospects for risk and return, banks are beginning to change their business models. Already, a couple of banks have fallen off the list of G-SIBs because they have simplified, downsized and de-risked their business models. Other institutions are de-emphasizing high-profile but risky capital markets businesses that benefited employees more than shareholders and society. As the reform process progresses, we can expect further adjustments that should ultimately lead to a more resilient, diversified sector with a more sustainable risk-return profile.

Conclusion

Last month in Tokyo, the International Monetary Fund rightly asked whether the financial system is safer today than on the eve of the crisis.[11] The answer is yes.

Despite the challenging economic environment, banks have substantially increased capital and liquidity. They are more actively managing risks. Countries are diligently implementing measures so that they can resolve failing institutions. The infrastructure of derivatives markets is being transformed to reduce systemic risks. The size of the shadow banking sector has fallen by 20 percentage points of GDP, back to levels last seen in 2004–05.

However, while progress has been made, the global financial system is still not as safe as it needs to be. While much has been accomplished, much more needs to be done.

The ambitious reform agenda I have described today will make a huge difference when fully implemented. All G-20 nations need to raise their game. That is why the FSB is increasingly focused on ***timely and consistent implementation*** of agreed reforms. We will identify those who drag their feet or bend the rules and hold them to account.

The case for reform remains as clear today as it did when the G-20 began the process in 2008. Measures to strengthen financial stability support economic growth and create jobs rather than hold them back, even in the short term. Credit growth has resumed in those countries where financial institutions have decisively strengthened their balance sheets, refocused their core business activities, and improved their funding sources – in other words, returned to a more sustainable business model.

As I have outlined today, more steps are required. But I can assure you, based on our recent conversations in Mexico, that the G-20 and the FSB remain resolute in their intention to create a more resilient, efficient global financial system.

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[11] International Monetary Fund, *Global Financial Stability Report: Restoring Confidence and Progressing on Reforms*, October 2012. See Chapter 3: "The Reform Agenda: An Interim Report on Progress Toward a Safer Financial System."