Carolyn Wilkins: Panel remarks for round table discussion at the 21st Conference of Montréal

Panel remarks by Ms Carolyn Wilkins, Senior Deputy Governor of the Bank of Canada, for round table discussion at the 21st Conference of Montréal: International Economic Forum of the Americas, Montréal, Quebec, 8 June 2015.

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Introduction

Thank you for the invitation to be here today. I'm honoured to be part of this panel.

It's been more than seven years since the global financial crisis began, and we're still coping with its aftermath. One of the consequences of the crisis has been a disruption of financial globalization. Global capital flows – to give just one measure – have fallen by more than half from their pre-crisis peak of over US$8 trillion.[1]

I'll spend a few minutes on why we're seeing this fragmentation. I'll then offer my views on what we should do to realize the full benefits of financial globalization and manage the risks associated with it.

Causes of fragmentation

The retreat from financial globalization that we've seen reflects cyclical economic forces, such as the slowdown of global trade and investment. It also reflects structural adjustments, including the deleveraging undertaken by banks to repair their balance sheets and respond to regulatory changes. None of this should come as a surprise, given what we've been through.

On the cyclical side, the crisis has cost the world economy as much as US$10 trillion in lost output, or almost 15 per cent of production. Global trade slowed, as did the demand for the international financial services that support it. The share of trade in GDP fell after the crisis, reversing some of the 20-percentage-point increase over the two decades that preceded it.[2]

On the structural side, financial institutions that experienced losses during the crisis had to repair their balance sheets by scaling back their lending – not only at home but especially internationally. Trade, commodities and infrastructure financing were particularly hard hit.

Since the crisis, banks have more than doubled the amount of common equity capital they hold. While doing this, banks have tended to focus on their home market and the best ways to allocate capital in the new environment. Rules such as anti-money laundering and counter terrorism financing laws may also be altering the terrain.

Financial institutions have also had to respond to regulatory changes. For example, derivatives dealers appear to be doing more business with domestic counterparties in part because of more stringent, and sometimes inconsistent, rules.[3] While the level of cross-

[1] The Institute of International Finance, "Financial Globalization: Maximizing Benefits, Containing Risks" December 2014.

[2] M. Francis and L. Morel, "The Slowdown in Global Trade", Bank of Canada Review (Spring 2015): 13–25.

[3] S. O'Malia, "No Answer Yet to Cross-Border Concerns", International Swaps and Derivatives Association, 11 May 2015.

border activity in this area is still robust, one study finds that regulatory changes can explain roughly half of the drop in cross-border claims since before the crisis.[4]

To put things in perspective, total foreign banking claims measured as a share of global GDP have fallen by one-third since 2008, to 39 per cent at the end of 2014.[5]

This fragmentation is of concern to people like me, who believe that open global financial markets are generally a good thing for economies because they facilitate the most efficient allocation of capital and boost growth.

At the same time, the crisis taught us that integrated markets also entail risks that need to be properly managed. We know that, unchecked, financial globalization could increase pro-cyclicality and make financial cycles larger.[6] In other words, booms and busts could become more frequent and more destabilizing. And it's possible that international financial flows were inflated by excessive growth in finance relative to global GDP.[7]

So authorities have to find the right balance between encouraging globalization and guarding against its risks.

Getting the right balance

Progress is being made globally. We have put in place a framework to better manage the risks that come with financial globalization through reforms agreed to by G-20 leaders. The Basel Committee on Banking Supervision has established new rules for banks, and the Financial Stability Board (FSB) published its Key Attributes of Effective Resolution Regimes for Financial Institutions. These are big steps in the right direction.

Some of these reforms have been substantially implemented. I'm talking about the Basel III rules, which impose more stringent standards on capital and liquidity and a surcharge for systemically important banks, and the Principles for Financial Market Infrastructures, which establish higher standards for central counterparties and other systemically important infrastructures. A level playing field on this is supported by peer reviews conducted by the FSB to ensure consistent implementation in different countries.

At the national level, recovery and resolution regimes are being introduced to further protect taxpayers and minimize systemic disruption in the event that a domestic systemically important bank (D-SIB) fails.

Canada has made good progress in putting in place the G-20 reforms in the spirit in which they were intended. We've implemented Basel III ahead of schedule and started work on recovery and resolution plans for D-SIBs.

Some jurisdictions have also made rules that deliberately separate different parts of their financial systems. For example, some have enacted changes to ring-fence retail banking activities within banking groups to limit the funding of investment banking activities with deposits backed by government safety nets – Vickers in the United Kingdom and Volcker in the United States.

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4 International Monetary Fund, *Navigating Monetary Policy Challenges and Managing Risks*, Global Financial Stability Report, April 2015.

5 Based on calculations using data from the Bank for International Settlements (BIS) (Consolidated Banking Statistics) and the International Monetary Fund (World GDP, from the World Economic Outlook (WEO) database).

6 C. Borio, "The International Monetary and Financial System: Its Achilles Heel and What to Do about It", BIS Working Paper No. 456, September 2014.

7 In the decade leading up to financial crisis, global banks' cross-border claims as a share of world GDP increased tenfold, from 6 per cent in 1995 to 60 per cent in 2007.

Every jurisdiction has different requirements, and our view is that we must ensure that jurisdictions don't go too far down the road toward more domestically oriented financial system reforms. In an interconnected world, the actions of one country affect others. If all jurisdictions act in their own national interest, narrowly defined, everyone could be left worse off. Co-operative outcomes are superior.

Mutual recognition

This points to the need for coordination among regulators. The G-20 reforms can make the world safer for international capital flows only as long as there is consistent implementation of international standards and mutual recognition among authorities. If we fail to achieve this, we could end up with inconsistent and incomplete regulations that impede desirable flows and create scope for circumvention.

Canada has stayed away from imposing structural reforms that would create a separation between commercial and investment banking activities, focusing instead on a principles-based approach. Historically, Canadian banks have benefited from diversification in their business lines, and the consolidated supervision of the banking group by the Office of the Superintendent of Financial Institutions has been effective.[8]

A lot of work remains at the international level. It hasn't been easy to agree on plans to coordinate cross-border recovery and resolution for global systemically important banks (G-SIBs), and not for a lack of effort and goodwill on the part of the home and host authorities. One major step was taken in October, when 18 G-SIBs agreed to a protocol established by the International Swaps and Derivatives Association that will give authorities more time to organize an orderly resolution of a troubled bank. The success of this mechanism depends on its broad adoption by market participants, so industry also has a responsibility here.

If multilateral agreements prove intractable, bilateral agreements could be another way to reach the same goal, in light of the trend toward regional banking. In time, successful bilateral agreements could even serve as models for more ambitious multilateral agreements.

Conclusion

Let me wrap up. The global financial system is important to Canada. We're a small, open economy, highly dependent on global trade. That means we rely on cross-border financial flows to fund exports and investment. And Canadian banks have continued to increase their foreign presence in the post-crisis period. In the past five years, their foreign claims have risen by 70 per cent.

This is why Canada is pushing for consistent implementation of global rules. With more homogeneous financial regulation and good co-operation on supervision, we will achieve solid prudential outcomes, build trust and reduce the tension that contributes to ring-fencing and fragmentation. While there are still some challenges at the international level, notably around the resolution of international banks, we continue to make progress.

As the reform agenda is implemented, we'll see an improvement in global financial flows. We probably won't get back to the pre-crisis pace of globalization. This pace was probably unsustainable anyway. We should nonetheless achieve close to the right balance between sustainable growth and financial stability.

I'd like to thank Paul Chilcott and Alexandra Lai for their help in preparing these remarks.

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8 M. Zelmer, "Promoting a Safe and Sound Financial System: Lessons from the Goose That Laid the Golden Egg" (remarks to the 2012 Canadian Financial Services Insolvency Protection Forum, Toronto, 21 November 2012).