Lawrence Schembri: Building trust, not walls – the case for cross-border financial integration

Remarks by Mr Lawrence Schembri, Deputy Governor of the Bank of Canada, to the Windsor–Essex Regional Chamber of Commerce, Windsor, Ontario, 25 June 2015.

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Before I built a wall I'd ask to know
What I was walling in or walling out,
And to whom I was like to give offence."
—*Mending Wall by Robert Frost*

Introduction

Good afternoon. Thank you for the invitation to speak to you today. I am especially pleased to be in Windsor in 2015, which marks the 50th anniversary of the path-breaking Canada–U.S. Auto Pact.1[1] The benefits of the pact and subsequent Canada–U.S. trade agreements are plainly evident in the steady flow of commercial traffic here at Canada's busiest border crossing. Windsor residents understand better than most that Canada remains the largest trading partner of the United States. In 2014, trade between our countries amounted to more than $850 billion—40 per cent of Canada's entire GDP.

You also understand that this high level of trade is not just a feature of geography. It is the result of almost 200 years of good-neighbour collaboration, founded on trust, not walls. As a result of these co-operative efforts, we have achieved a high degree of cross-border access and economic integration that is the envy of the world. And most importantly, *both countries* have benefited.

Today, I want to talk to you about cross-border *financial* collaboration, another key aspect of our relationship with the United States, as well as with other countries.

We all know that a well-regulated and globally integrated financial system is essential for promoting trade and achieving sustainable economic and employment growth. However, the recent global financial crisis clearly demonstrated that while financial systems are indeed highly integrated across countries, many were inadequately regulated and supervised.

In Canada, our financial system was, and is, well regulated and supervised. No Canadian banks failed during the crisis.[2] The strength of our financial system helped us avoid the worst of the damage. Yet, we still lost 430,000 jobs and our exports plunged by more than 16 per cent.[3] That experience taught us a valuable lesson. In a trading economy like ours, keeping our own financial house in order is not sufficient to shelter us from global financial storms. We need financial stability not just *within* countries but *across* them.

The G-20 responded to the crisis with a comprehensive financial reform agenda, coordinated by the Financial Stability Board (FSB), to address the exposed weaknesses, to promote global financial stability, and to enhance financial and economic integration. Since then, FSB member countries have made unprecedented progress on these objectives.

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1 Canada and the United States have signed three major trade liberalization agreements over the past 50 years: the 1965 Auto Pact, the 1988 Canada–U.S. Free Trade Agreement and the 1994 North American Free Trade Agreement, which also included Mexico.

2 The banking system did, however, require significant liquidity support because of the severe disruption to global funding markets.

3 M. Carney, "Exporting in a Post-Crisis World" (speech to the Greater Kitchener-Waterloo Chamber of Commerce, Waterloo, Ontario, 2 April 2012).

I'll start with a brief overview of important reforms to the global banking system and to shadow banking—which refers to credit intermediation activities outside the traditional banking system—that have made the financial system as a whole safer.[4] Then, I'll zero in on two reform areas that need more work: global banks that are "too big to fail" and over-the-counter (OTC) derivatives markets. Finally, I'll say a few words about a third policy issue that is critical for supporting financial integration—cross-border payments.

Reforming the financial system

Led by the G-20, the FSB and the international standard-setters are developing and monitoring the implementation of the required regulatory standards.[5] Their successful reform efforts have helped rebuild trust in financial integration that was severely damaged by the crisis.

A significant accomplishment is the Basel III framework, which has made global banks much stronger and more resilient. The framework, which requires banks to hold more capital and liquidity and imposes a backstop leverage limit, has largely been finalized.[6] Although the deadline for full implementation is not until 2019, many jurisdictions, including Canada, are well ahead of schedule.[7]

As for shadow banking activities, they represented key sources of financial instability during the crisis through faulty subprime mortgage securitization and runs on money market funds and repo markets. The FSB is creating a comprehensive approach to monitor and assess these non-bank credit intermediation activities.

Regulatory standards have been developed for several of the activities. For example, standards exist for securitization, specifically risk retention and disclosure; money market funds, including liquidity and valuation; and repo and securities-lending transactions, chiefly minimum haircuts. Several other types of shadow banking entities, such as broker-dealers, investment funds and finance companies, have been categorized by their economic function within a principles-based regulatory framework. Policy tool kits have been developed for each.

Implementation of these standards is ongoing globally and in Canada and will be monitored and promoted by country and thematic peer reviews conducted in 2015.

The next priority is to make further headway on the two areas I mentioned earlier—ending the threat of banks considered too big to fail and improving the safety of OTC derivatives markets—that pose complex cross-border issues.

Ending Too big to fail

To address the problem of too big to fail, most clearly exemplified by the hugely disruptive failure of Lehman Brothers in September 2008, the FSB has taken three bold policy actions.

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4 The FSB reform objective for shadow banking is to transform it into resilient market-based finance.

5 The international financial standard-setters include the Basel Committee on Banking Supervision (BCBS), the International Organization of Securities Commissions (IOSCO), the Committee on Payments and Market Infrastructures (CPMI), and the International Association of Insurance Supervisors (IAIS).

6 Basel III "is a comprehensive set of reform measures, developed by the Basel Committee on Banking Supervision, to strengthen the regulation, supervision and risk management of banks." See www.bis.org/bcbs/basel3.htm.

7 The Office of the Superintendent of Financial Institutions (OSFI) has obliged Canadian banks to meet or exceed Basel III standards on an accelerated timetable. For example, since 2013, Canadian banks have been required to hold at least 7 per cent of Common Equity Tier 1 capital, compared with the Basel requirement to hold 4.5 per cent by 2015. OSFI has also required full implementation of the Liquidity Coverage Ratio (LCR) beginning in 2015, rather than the 2019 requirement under Basel III.

First, the effectiveness of the supervision of large internationally active banks has been increased.

Second, approximately 30 of the most systemically important global banks—those so large that their failure would have an impact on the entire financial *system*—have been identified and will have to hold more capital to make them safer and discourage them from becoming even more systemically important. At this point, there are no Canadian banks on this list.

In Canada, however, the Office of the Superintendent of Financial Institutions (OSFI) identified six of our banks as systemically important at the *domestic* level, mandated that they hold 1 per cent more capital and strengthened its oversight of them.

Third, and perhaps most significant, the FSB has developed a set of policy standards, known as the Key Attributes for Effective Resolution Regimes, to resolve these global banks when they become non-viable.[8] The objective of resolution is to maintain their critical functions, such as deposit taking, payments and lending, without disrupting the financial system and without taxpayers being the first line of defense.[9] The Key Attributes were a major breakthrough, and these standards are gradually being implemented.

However, because these global systemically important banks operate in many jurisdictions through subsidiaries and branches, we need to tackle a number of difficult cross-border home-host issues.

For example, whose rules will govern the resolution, those of the home jurisdiction of the parent bank or those of the host jurisdiction of the subsidiary or branch?

Where will the capital to absorb losses be held? In the parent bank? The subsidiary?

How do we ensure that cross-border financial contracts are maintained and not torn up in resolution?

The FSB is methodically addressing each of these questions and making solid progress.[10] In the meantime, there is a risk that some countries, understandably concerned about the safety of their own financial systems, may take measures that run counter to the spirit of the G-20 reforms to promote financial integration.

An example of this is the set of rules governing foreign bank operations in the Dodd-Frank Act of 2010, the most comprehensive reform of the financial system that the United States has undertaken since the Great Depression.[11] Under Dodd-Frank, subsidiaries and branches of international banks of a certain size will have to meet separate capital and liquidity requirements inside the United States.[12]

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[8] The Key Attributes are 12 essential features that the FSB considers necessary for the resolution regimes of all jurisdictions. See www.financialstabilityboard.org/2014/10/r_141015.

[9] In the 2015 federal budget, the government announced that it plans to adopt measures to ensure that "systemically important banks' shareholders and creditors are responsible for bearing losses, thereby giving them stronger incentives to monitor banks' risk-taking activities." One of the measures "would allow for the permanent conversion of eligible liabilities of a non-viable bank into common shares." See www.budget.gc.ca/2015/docs/plan/toc-tdm-eng.html. See also the Department of Finance's consultation paper on bank recapitalization, at www.fin.gc.ca/activty/consult/tpbrr-rpcrb-eng.asp.

[10] The FSB's progress report on resolution regimes is available at www.financialstabilityboard.org/2014/11/report-to-the-g20-on-progress-in-reform-of-resolution-regimes-and-resolution-planning-for-globally-systemically-important-financial-institutions-g-sifis.

[11] See sections 165 and 166 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, at www.sec.gov/about/laws/wallstreetreform-cpa.pdf.

[12] The Fed's final rule on strengthening the supervision and regulation of foreign banking organizations is available at www.federalreserve.gov/newsevents/press/bcreg/20140218a.htm.

What does this mean for Canadian banks? Our largest banks have sizable U.S. operations. Some will likely meet the size threshold and will be subject to these new requirements.

These national rules will not only impose new legal and administrative costs on Canadian banks, but might also constrain their ability to allocate capital and liquidity efficiently in the North American market.[13] And if a Canadian bank with U.S. subsidiaries were to fail, it bears asking whether the pre-emptive actions of U.S. authorities would create obstacles for the orderly resolution of the consolidated bank by Canadian authorities, led by the Canada Deposit Insurance Corporation.

This "one-size fits all" approach overlooks the existing degree of integration between our two economies, Canada's impressive record for financial stability and the fact that Canadian banks have long been active and well trusted in the United States.[14]

That, in brief, is where we stand at the moment on cross-border bank-resolution issues. And, as you will see in a minute, the cross-border issues related to OTC derivatives are equally complex.

Making Over-the-counter derivatives markets safer

OTC derivatives were largely unregulated before the crisis. For example, when Lehman Brothers failed, it had roughly one million outstanding derivatives contracts. No one outside the company knew the full extent of Lehman's exposures. Uncertainty rippled through the market, spreading fear about the solvency of other banks and impairing the functioning of markets. This experience highlighted the interconnectedness within markets and how the failure of one institution can pose a systemic risk that threatens the entire financial system.

Under the G-20 reforms aimed at reducing systemic risk, countries have agreed to report all transactions to trade repositories and to centrally clear all standardized contracts. Again, much progress has been made on improving the reporting and central clearing of transactions.[15] The challenge ahead is to ensure that the rules for on-the-ground implementation of some of these reforms are consistent across jurisdictions.

To understand how complicated this is, it is useful to compare the processes for the Basel III framework with that for OTC derivatives. Because the Basel Committee already had granular rules for bank regulation, a process was established to achieve a multilateral consensus on the next set of bank standards. For OTC derivatives, no such process existed because they had previously been largely unregulated.

The United States—the jurisdiction most affected by the crisis—was the first to respond, with the Dodd-Frank Act. Other countries were slower off the mark, and this has led to differences

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[13] For well over a century, major Canadian banks have safely raised funding and managed liquidity through branch operations in U.S. money markets. See, for example, C. A .E. Goodhart, *The New York Money Market and the Finance of Trade, 1900-1913* (Cambridge: Harvard University Press, 1969).

[14] In C. W. Calomiris and S. H. Haber, *Fragile by Design: The Political Origins of Banking Crises and Scarce Credit* (Princeton: Princeton University Press, 2014), the authors remark that "the extraordinary stability of the Canadian banking system has been one of its most visible and oft-noted characteristics for nearly two centuries."

[15] The third OTC derivatives reform priority, expanding the use of trading platforms, is being implemented more gradually.

in implementation, especially among major jurisdictions.[16] These differences are slowly being resolved.[17]

In the meantime, market participants are trying to cope with these regulatory inconsistencies. As a consequence, the costs of cross-border trade are rising and markets are starting to fragment. Canada and other jurisdictions are caught in the middle.

One of the ways countries are managing these inconsistencies is by recognizing each other's regulatory approaches when they achieve similar prudential outcomes.

In this regard, the U.S. Commodity Futures Trading Commission (CFTC), which took the lead in OTC derivatives rule-making in the United States, has recognized that OSFI's requirements are equivalent to the U.S. rules in a number of cases.[18]

However, the Commission still wants Canadian banks to submit to its oversight, which could include on-site visits. Canadian and U.S. authorities are working together to limit the additional burden this places on affected banks.

As noted, monitoring exposures in the derivatives market is important for helping to reduce systemic risk. To do so, authorities need access to transactions data held in trade repositories. However, a provision in Dodd-Frank that requires authorities using these data to sign an indemnity in the event of their misuse effectively precludes the Bank of Canada, OSFI and others (including the U.S. Federal Reserve) from obtaining this information.[19] Consequently, the data on OTC transactions performed by Canadian banks and reported by them to U.S. trade repositories are currently not being used to assess systemic risk in the OTC derivatives market.

To summarize, national authorities should strive to build trust and achieve more cross-border recognition of comparable regulatory requirements. Such an approach would reduce regulatory uncertainty and enhance the ability of market participants—ranging from global banks to small factory owners and farmers—to hedge risks and protect themselves from economic shocks.

Improving cross-border payments

Let me turn now to cross-border payments, an issue that all of you have likely had some experience with as consumers or in your businesses. As you know, sending funds to or receiving them from the United States or any other country is slow, inconvenient and costly.

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16 S. O'Malia, "No Answer Yet to Cross-Border Concerns," International Swaps and Derivatives Association, 11 May 2015. Available at http://isda.derivativiews.org/2015/05/11/no-answer-yet-to-cross-border-concerns.

17 The Financial Stability Board publishes an annual report on the implementation of reforms in the OTC derivatives market. The 2014 report is available at www.financialstabilityboard.org/2014/11/eighth-progress-report-on-implementation-of-otc-derivatives-market-reforms/.

18 The Dodd-Frank Act allows exemptions where there is comparable, comprehensive supervision and regulation in the home country. See Sections 725 and 733 of the Dodd-Frank Act.

19 Sections 728 and 763 of the Dodd-Frank Act require U.S.-based trade repositories to obtain a written indemnification agreement from the authorities confirming that they will indemnify the trade repository and the U.S. regulatory commissions for any expenses arising from litigation relating to the information. The CFTC has released an interpretative statement allowing some access to data reported under non-U.S. regulatory regimes but has applied this only to authorities that directly regulate the trade repository. In recent speeches, Federal Reserve Board governors Lael Brainard and Jerome Powell have called for increased data transparency regarding OTC derivatives. See L. Brainard, "The Federal Reserve's Financial Stability Agenda" (speech at the Hutchins Center on Fiscal and Monetary Policy, Washington, D.C., 3 December 2014); and J. Powell, "Financial Institutions, Financial Markets, and Financial Stability" (speech to Stern School of Business, New York, 18 February 2015).

You won't be surprised to hear that a recent report by the Federal Reserve described cross-border payments in much the same way.[20] And you'll be pleased to hear that the Fed and the Bank of Canada are working with the financial industry, including payments associations, to promote efforts within their respective jurisdictions to modernize cross-border payments.[21]

In its report, the Fed argued that the U.S. payments system is at a critical juncture because of three factors:

- technological advances in high-speed data networks;
- the related need to ensure the safety and security of payments; and
- user demands for faster, less costly domestic and cross-border payments, manifested by the growth of other means, such as PayPal.

To improve cross-border payments, a number of key barriers need to be addressed. They range from regulatory requirements for anti-money laundering rules to a lack of standardization of electronic formats. Standardizing formats would allow more business information to be transmitted with payments. These barriers are not easy to overcome. Resolving them, however, will significantly increase efficiency and greatly reduce the costs of cross-border payments.

Building trust to move forward

What can we do to overcome these challenges to cross-border integration?

The ideal, of course, would be a broad agreement among all G-20 members. But securing a multilateral compromise could take several years. Still, we shouldn't abandon this possibility. The FSB has helped build trust through its consensus-forming processes and should continue to press for the timely development and consistent implementation of global minimum standards.[22]

In this vein, and especially with regard to Canada, we should urge U.S. authorities to respect the G-20 leaders' agreement at the 2014 Brisbane Summit to defer to each other's regulatory requirements when they achieve a similar prudential outcome.[23] If this were to occur, Canada would clearly benefit, given its strong and crisis-tested regulatory and supervisory framework.

At the same time, it would be wise to consider alternative approaches.

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[20] See Payment System Improvement—Public Consultation Paper, The Federal Reserve Banks, 10 September 2013, https://fedpaymentsimprovement.org/wp-content/uploads/2013/09/Payment_System_Improvement-Public_Consultation_Paper.pdf.

[21] The Fed's strategies for improving the payment system can be found at: www.federalreserve.gov/newsevents/press/other/20150126a.htm. In Canada, the Canadian Payments Association is leading the work to modernize the payments system. For details on improvements to the payments system in Canada, see L. Embree and P. Miller, "Improving the Foundation of Canada's Payments System," Bank of Canada Review (Spring 2015: 26–34) and L. Schembri, "A Dual Vision for the Canadian Payments System (speech to the Canadian Payments Association, Charlottetown, Prince Edward Island, 27 June 2014).

[22] For FSB Chair Mark Carney's most recent report on too-big-to-fail initiatives and other issues, see www.financialstabilityboard.org/2015/04/fsb-chairs-letter-to-g20-on-financial-reforms-progress-on-the-work-plan-for-the-antalya-summit.

[23] The G-20 leaders agreed that "jurisdictions and regulators should be able to defer to each other when it is justified by the quality of their respective regulatory and enforcement regimes, based on similar outcomes, in a non-discriminatory way, paying due respect to home country regulation regimes." See "Jurisdictions' Ability to Defer to Each Other's OTC Derivatives Market Regulatory Regimes," FSB report to G20 Finance Ministers and Central Bank Governors, 18 September 2014, at www.financialstabilityboard.org/wp-content/uploads/r_140918.pdf.

For instance, Canada and the United States should consider the option of a bilateral agreement on the resolution of banks with cross-border operations in order to clarify responsibilities and enhance co-operation.[24] We have a long history of stable financial and economic integration, and U.S. financial institutions and legal frameworks are similar to ours. If any two jurisdictions could achieve such an agreement, it is Canada and the United States. We could set an example for other countries.

In this regard, the 1988 free trade agreement between Canada and the United States offers a useful precedent. It served as a template for other regional agreements at a time when multilateral trade negotiations were making little headway.

On cross-border payments, we should come to terms on more efficient arrangements, including harmonizing standards, reducing processing times and establishing direct links between our respective systems. We could, for instance, explore opportunities to enhance the existing FedGlobal program for cross-border payments, which is currently limited to northbound transactions.[25]

Conclusion

Let me conclude with a few words of wisdom from a great American poet. In his poem "Mending Wall," Robert Frost questions his neighbour's belief in the old adage that "good walls make good neighbors." Instead, Frost writes, before we build a wall we should first consider what we are "walling in or walling out." The message I take from his words is that good neighbours should work together to build trust, not walls.

Canada and the United States have long-established economic and financial ties built on trust that have served both countries well. Today, we have a unique opportunity to advance the global financial reform agenda in the critical, but thorny, areas of bank resolution, OTC derivatives and payments. We both have much to gain by strengthening financial integration between our countries. More efficient cross-border financial services will facilitate more trade. And more trade will contribute to stronger economic growth in both countries.

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24 The Canada Deposit Insurance Corporation and the Federal Deposit Insurance Corporation have a memorandum of understanding in place to consult, co-operate and share with each other information on the resolution of cross-border banks. Nonetheless, a more comprehensive bilateral resolution agreement—which builds on the FSB's ongoing work on cross-border resolution issues, including total loss absorbency and recognition of resolution actions—would reduce uncertainty, increase confidence in the resolution regime and help foster a more integrated banking sector.

25 FedGlobal ACH Payments, which is owned by the Federal Reserve Bank Services, sends cross-border ACH (automated clearing house) credit payments to more than 35 countries in addition to debit payments that are to Canada only.