Lawrence Schembri: Born of necessity and built to succeed – why Canada and the world need the Financial Stability Board

Remarks by Mr Lawrence Schembri, Deputy Governor of the Bank of Canada, to the CFA Society (Ottawa), Ottawa, Ontario, 24 September 2013.

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Introduction

It has been just over five years since the worst days of the global financial crisis, which began with the dramatic collapse of Lehman Brothers in September 2008. While the subsequent Great Recession officially ended in June 2009, it hardly seems over, given the slow-motion recovery of the global economy. This is especially the case in Europe and the United States, where employment has not yet returned to pre-crisis levels.

Looking back at Canada's experience of the past five years, a key lesson from the crisis is that keeping our own house in order is not enough to shelter us from global financial storms. Yes, Canada's recovery has been stronger than virtually all other advanced economies, thanks in part to our resilient financial system. Our sound monetary, fiscal and financial sector policies protected us from the worst of the financial crisis and recession. But make no mistake: Canada was still hit hard. Output fell by 3.5 per cent. And from October 2008 to October 2009, the unemployment rate rose from 6.1 per cent to 8.3 per cent.

Harder lessons were learned at the international level. The breadth and depth of the crisis, and the speed with which it travelled around the globe, made world leaders sit up and take notice. In 2009, the G-20 identified the important task of reducing the likelihood of future financial crises and limiting their spillovers across borders. The Financial Stability Board (FSB) was set up to coordinate this work.[1]

Today, I am going to talk about the FSB, especially its coordinating role for Canada and the global economy. I will focus on:

- why the FSB is needed,
- how it works, and
- its accomplishments to date and plans for the future.

I will also discuss implications of the FSB's financial reform agenda for Canada.

Why we need the FSB

From my perspective, the FSB is a unique international organization that has certain qualities that many associate with Canadians, qualities I believe will help ensure its success in making the global financial system more resilient. A resilient global financial system is not an end in itself, but a necessary foundation for strong, sustainable and balanced global economic growth, leading to higher employment and improved living standards.

The FSB was born of necessity in the aftermath of the financial crisis. Its raison d'être stems from one overarching fact: the global financial system is highly integrated.[2] Financial institutions and markets are interconnected and interdependent within and across various

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[1] The FSB grew out of the Financial Stability Forum (FSF), founded in 1999 by the G-7 in the wake of the financial crises in Asia, Latin America and Russia.

[2] Bank of Canada Deputy Governor Timothy Lane, in his 2013 speech, "Financial Stability in One Country?" argues that because of global financial integration, it is impossible to achieve financial stability in one jurisdiction by focusing exclusively on domestic considerations.

sectors, including banking, insurance, and pension and investment funds, and, increasingly, across national jurisdictions.

Thus, to achieve a comprehensive and coherent approach to the financial regulation and oversight necessary to attain the global public good of financial stability, coordination is essential across countries, across all of the elements of the reforms, and across many different regulators and supervisors. Failure to coordinate would lead to the fragmentation of the financial system, which would impede the global recovery. This need for effective coordination is why the G-20 established the FSB in 2009.[3]

What is the FSB?

The FSB is not only the newest, it is by far the smallest – with only about 25 full-time staff – and probably the least well known of the major international organizations.[4] These include such postwar heavyweights as the International Monetary Fund (IMF), the World Bank and the Organisation for Economic Co-operation and Development (OECD).

It is an international organization like no other:

- Its membership is composed of national financial authorities from 24 countries, including G-20 members and other significant financial jurisdictions such as Switzerland and Singapore.[5] An important innovation is that it also includes international financial institutions such as the IMF, the World Bank and the Bank for International Settlements, as well as international bodies that set standards for banking, insurance, securities and accounting.[6]
- The FSB punches well above its weight by levering the knowledge of its 70 member agencies, which are home to several thousand financial sector experts. It is these experts who do most of the heavy lifting, sitting on committees and working groups to develop policy and conduct peer reviews of implementation, supported by the small FSB Secretariat.
- At the FSB, decision making is based on consensus. The process of policy development allows members to input their views at each stage, thereby ensuring collective ownership of the policy decisions. The FSB relies on moral suasion, or what political scientists like to call "soft power."

  As such, the FSB wields no legal sanctions but encourages countries to adhere to global standards and promotes a "race to the top" through disclosure and peer pressure. The FSB or its member standard-setting bodies regularly produce peer-led, country-by-country assessments of compliance with global standards.

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[3] The FSB charter affirms "the FSB's role in coordinating at the international level the work of national financial authorities and international standard setting bodies in developing and promoting the implementation of effective regulatory, supervisory and other financial sector policies in the interest of global financial stability". See: http://www.financialstabilityboard.org/publications/r_120809.pdf.

[4] The majority of FSB staff members are on temporary secondments from member institutions.

[5] In addition to the 70 member agencies from 24 member countries, the FSB has six regional consultative groups to disseminate information and collect feedback from an additional 70 non-member countries. Broader implementation of global financial standards is important for supporting the ongoing process of global financial and economic integration.

[6] These standard-setting bodies include the Basel Committee on Banking Supervision (BCBS), the International Association of Insurance Supervisors (IAIS), the International Organization of Securities Commissions (IOSCO), the Committee on Payment and Settlement Systems (CPSS), and the International Accounting Standards Board (IASB).

- Because the FSB is a creation of the G-20 Leaders, it has the weight of the G-20 behind it. The G-20 provides direction and receives regular progress updates from the FSB on the financial reform agenda. This close working relationship gives the FSB the political leverage it needs to be effective.

In short, the FSB was designed to succeed in its coordinating role. It is an efficient and inclusive international organization that can act nimbly to coordinate the efforts needed to address serious financial vulnerabilities.[7]

The FSB may be small, but it is powerful, undertaking work of great significance to create a resilient, competitive and integrated global financial system, which is necessary to support a rapidly evolving global economy. Countries such as Canada, with open global financial markets and internationally active financial institutions, especially benefit from the work of the FSB.

As I mentioned earlier, the FSB also embodies characteristics that are important to Canadians. It is consultative, guided by common sense and consensus; co-operative; and respectful of process. This perhaps should not be surprising, given that senior officials from the Bank of Canada and the Office of the Superintendent of Financial Institutions (OSFI) have played prominent leadership roles at the FSB.[8]

How does the FSB work?

The FSB works to achieve its goal of global financial stability through four main functions, or steps, which I call the financial policy cycle:

i. Identify and assess financial vulnerabilities. The recent financial crisis pinpointed several, and I will discuss those in a moment.

ii. Develop the necessary policies or global standards to address these vulnerabilities.

iii. Monitor the implementation of these standards by national jurisdictions to ensure consistency; and

iv. Assess the effectiveness of the regulation, including any unintended adverse consequences on financial market outcomes.

The FSB is organized around these four functions, with standing committees of FSB members who carry out the necessary work.[9]

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7 Working with the BCBS, the FSB was able to use its soft-power approach, including its political leverage with the G-20, to get the new Basel III capital framework developed and largely put in place in five years. In contrast, it took almost twice as long to reach the same stage with the earlier capital framework.

8 Former Bank of Canada Governor and current Bank of England Governor Mark Carney has served as the FSB Chair since November 2011; Senior Deputy Governor Tiff Macklem was Chair of the FSB's Standing Committee on Standards Implementation from June 2009 to April 2013; and Julie Dickson, Superintendent of OSFI, has chaired the FSB's Committee on Supervisory Intensity and Effectiveness since its creation in 2010. See M. Carney, "Rebuilding Trust in Global Banking" (speech to the 7th Annual Thomas d'Aquino Lecture on Leadership, London, Ontario, 25 February 2013); J. Dickson, Remarks to the Institute of Internal Auditors, Toronto, 31 May 2013, and Remarks to the International Institute of Finance, Madrid, 21 May 2012; and T. Macklem, "Raising the House of Reform" (speech to the Rotman Institute for International Business, Toronto, 7 February 2012).

9 The Standing Committee on Assessment of Vulnerabilities (SCAV) conducts regular monitoring exercises to identify and assess vulnerabilities; the Standing Committee on Supervisory and Regulatory Cooperation (SRC) decides how best to address these vulnerabilities through policy development; and the Standing Committee on Standards Implementation (SCSI) monitors implementation and assesses effectiveness. The work of these committees is directed and overseen by the Steering Committee and the Plenary, the FSB's decision-making body.

Let me illustrate the execution of the first two steps in this policy cycle by outlining four principal weaknesses in the global financial system exposed by the financial crisis and how the FSB responded.

(i) Inadequately capitalized banks

In 2008, major banks in the United States, the United Kingdom and continental Europe either failed or were publicly rescued, in large part because they had insufficient levels of good-quality capital to absorb the losses incurred from taking on too much credit risk.

Building more resilient banks

To address this weakness and build more resilient banks, the Basel Committee on Banking Supervision, an FSB member, developed the Basel III rules to strengthen the quantity and quality of bank capital. These rules call for more than tripling the required amount of capital.[10]

This updated Basel framework will be further buttressed by enhanced liquidity rules, a backstop leverage ratio similar to one that has been used in Canada, a countercyclical capital buffer and stronger supervision to enforce adoption by banks.

(ii) Financial institutions that were considered "too big to fail"

Large financial institutions, like Lehman Brothers and AIG, were able to take on excessive risk because they were seen as being "too big to fail." Consequently, when risks were realized, the actual or looming failure of these institutions weakened investor confidence, spread uncertainty and severely disrupted the global financial system. To stem the massive contagion, many of these institutions had to be bailed out at taxpayers' expense, which was patently unfair. Losses should not be socialized; they should be borne by those who profited from taking the risk.

Ending "too big to fail"

To end "too big to fail," the FSB has adopted a three-pronged approach, known as the Systemically Important Financial Institution (SIFI) framework. The three key elements in development are:

- higher capital requirements for financial institutions that are deemed to be systemically important;[11]
- standards for the effective resolution of such institutions that eliminate the need for taxpayer bailouts and minimize the disruption to the financial system; and[12]
- more intense and more effective supervisory oversight.

(iii) Shadow banking

Credit intermediation activities outside the perimeter of traditional regulation are often referred to as "shadow banking." I prefer to call them "market-based finance" because they include securitization, repurchase agreements (repos) and money market funds, which are

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[10] The minimum requirement for common equity has increased from 2 per cent to 4.5 per cent, and will rise to 7 per cent when the new capital conservation buffer is added.

[11] In 2011, the FSB identified an initial group of global systemically important financial institutions (G-SIFIs). The current group of 28 global systemically important banks (G-SIBs) will be updated in November 2013. The FSB and other standard-setting bodies are extending the SIFI framework to domestic systemically important banks (D-SIBs). National authorities should begin to apply phase-in arrangements for the requirements for D-SIBs as of January 2016. See: http://www.financialstabilityboard.org/publications/r_121031ac.pdf. An initial list of global systemically important insurers was published in July 2013.

[12] In 2011, the FSB published the "Key Attributes of Effective Resolution Regimes for Financial Institutions", which set out how authorities could resolve financial institutions in an orderly manner.

important and useful forms of credit intermediation. If they are not properly regulated, however, these activities are subject to the same sort of systemic risks as banks, including contagious runs. The worst example from the crisis was the faulty securitization of U.S. subprime mortgages.

Transforming shadow banking into more resilient market-based finance

As measures are put in place to make banks more resilient, there are legitimate concerns that greater scrutiny and regulation of the traditional banking sector could result in more risky activities migrating beyond the regulatory perimeter to the shadow banking sector.

First, as part of its ongoing work on vulnerabilities assessment, the FSB has established a framework for monitoring shadow banking to identify and evaluate emerging risks.

Second, as part of its efforts to ensure that shadow banking is transformed into more resilient market-based finance, the FSB, at the G-20 meetings in St. Petersburg earlier this month, presented a set of recommendations for the regulation of shadow banking. These recommendations are aimed at increasing transparency, reducing moral hazard and limiting maturity and liquidity transformation, with the overall goal of striking a balance between the efficiency and competition these activities offer and the bank-like risks they pose.

(iv) Critical financial markets seizing up

An important example of a financial market seizing up was the US$600 trillion over-the-counter (OTC) derivatives market, which is a critical source of funding and risk management, especially for major financial institutions.

While the OTC derivatives market was not an underlying cause of the financial crisis, its complexity, opacity and interconnectedness made the crisis worse.

Creating more robust and continuous OTC derivatives markets

To increase the transparency and reduce the systemic risk in these markets, the FSB has coordinated the development of policies to ensure that transactions are reported to trade repositories and that standardized OTC derivatives are cleared through central counterparties, or CCPs. A central counterparty acts as a buyer to every seller and a seller to every buyer for the financial transactions that it clears. This increases transparency and reduces counterparty credit risk.[13]

Next step: implementation

The third step in the FSB's policy cycle is the implementation of these global policies or standards at the national level.

This is the most difficult and time-consuming step because it means taking global minimum standards or principles for financial sector regulation and adapting them for local implementation. This is where the rubber hits the road.

The stated goal of the FSB is for "full, timely and consistent" implementation of global standards at the national level. Each of these adjectives is essential: they underscore the importance of a coherent and comprehensive approach to regulation to create a level regulatory playing field across jurisdictions. The FSB and its member agencies are developing a multi-year framework to monitor the implementation of these reforms.

Implementation at the national level typically requires several steps, including revising existing laws or passing new legislation, and developing rules or guidelines for market

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[13] Central counterparties concentrate and mutualize risk but don't eliminate it. Thus, they need stringent standards for risk management and oversight.

participants. Consistency is difficult to achieve because jurisdictions have different legal and institutional frameworks that must be modified to meet new global standards.

Where is Canada in the implementation process?

Because Canada's regulatory and supervisory frameworks were relatively well developed going into the crisis, the extent of the reforms needed here is less profound, but still important.

Nonetheless, Canada is leading by example. It was one of the first jurisdictions to implement the Basel III capital framework.[14] At the beginning of this year, all major Canadian banks were expected to meet the stringent Basel III requirements as specified by OSFI – six years ahead of the agreed deadline of 1 January 2019.[15]

Canada has also made progress in addressing the problem of too big to fail. OSFI recently designated Canada's six largest banks as domestic systemically important banks and required that they hold 1 per cent more capital and be more closely supervised.[16]

Market-based finance is generally viewed as less vulnerable in Canada than in other jurisdictions, and the Bank of Canada and our partner agencies want to keep it that way. To that end, we have participated fully in the FSB's shadow banking monitoring exercise and will work together to consider how best to implement recent FSB recommendations.[17,18]

Finally, we have moved forward in the implementation of the G-20 commitments for OTC derivatives. In fact, the Bank of Canada has joined a multilateral arrangement for the co-operative oversight of LCH.Clearnet's SwapClear, a global central counterparty based in London, England, and the dominant counterparty for clearing Canadian interest rate swaps.[19]

As I noted, the Bank is working closely with other agencies at the federal and provincial levels to implement the new global standards within a framework that is best suited for Canada.

[14] Since the end of 2007, the major Canadian banks have increased their common equity capital by 70 per cent, or $67 billion.

[15] The capital levels of Canada's major banks are now at roughly 9 per cent or higher. Canadian banks are also moving ahead to implement the recommendations of the FSB-sponsored, private-sector-led Enhanced Disclosure Task Force. This task force is providing principles and recommendations for improved bank risk disclosures so that investors and others will have timely and useful information about the risk undertaken by banks. This report is available at: http://www.financialstabilityboard.org/press/pr_121029.pdf.

[16] The recent federal budget proposed that these banks would be subject to a system of bail-in debt that could be used to recapitalize them should their capital levels fall below the level of non-viability. This proposal represents an important step in implementing the FSB's "Key Attributes of Effective Resolution Regimes for Financial Institutions".

[17] T. Gravelle, T. Grieder and S. Lavoie, "Monitoring and Assessing Risks in Canada's Shadow Banking Sector", Bank of Canada Financial System Review (June 2013): 55?63.

[18] Canada has gone beyond these shadow banking recommendations by establishing and promoting the use of a central counterparty for repurchase agreements to reduce counterparty and overall systemic risk and to use collateral efficiently by netting exposures.

[19] As of 2 April 2013, the Bank of Canada acted under the Payment Clearing and Settlement Act to designate SwapClear as systemically important. Designation brings the system under the formal oversight of the Bank of Canada. It also provides the system's clearing and settlement rules with legal protections under Canadian law, including those pertaining to netting, finality of payment and finality of settlement. See http://www.bankofcanada.ca/2013/03/publications/press-releases/bank-canada-designates-swapclear-payment-clearing/.

Closing remarks – maintaining momentum

As the dark days of the global financial crisis slowly fade in our collective memory, the real challenge is to maintain the momentum of reform, and, in particular, to confront difficult cross-border issues, especially with respect to resolving international financial institutions and regulating global financial markets. The groundwork is there. The FSB has fostered the necessary co-operation and has made solid progress in coordinating the development of appropriate global policies to address the main weaknesses exposed by the crisis. It is also pushing forward in other directions, including reforming financial benchmarks, like LIBOR, improving data collection and information exchange, and achieving a common global set of high-quality accounting standards. The G-20 Leaders have recognized the importance of the FSB's work and last year, at the Los Cabos Summit, took steps to further strengthen the FSB's role in coordinating the development and implementation of financial reforms.[20]

At the recent G-20 Summit, Leaders once again affirmed the FSB-led financial reform agenda. Nonetheless, some have argued that, given the weak recovery, now is not the time for the broad financial sector reform being promoted by the FSB. That argument is wrong-headed for several reasons.

First, financial stability is an important precondition for economic growth. In particular, the countries with the strongest financial systems were the first to recover. Indeed, the experience of the United States is an important example. U.S. officials took bold measures to stress test and recapitalize their banking system. Now, they are reaping the benefits as the recovery in the United States gathers momentum.

Second, the overall coherence of the reforms, their proportionality relative to the risks and their macroeconomic effects are considered before the reforms are finalized and implemented.[21]

Third, concerns about possible adverse effects of these reforms on the financial system and, in particular, on market functioning, are being addressed by the fourth step in the FSB policy cycle. The FSB regularly and closely monitors the effectiveness of new regulations, keeping an eye out for any material unintended consequences.

As we know only too well, the global economy and, in particular, the global financial system, are highly integrated. Canada learned that lesson during the recent financial crisis, when adverse shocks spread rapidly through financial channels. We also know that the pace of global financial and economic integration will continue unabated. Thus, to ensure the resilience of the global financial system and, ultimately, of the global economy, we need a global organization that can coordinate the necessary efforts, especially across borders, to tackle emerging gaps and weaknesses in financial regulation and supervision and thereby help to prevent future crises like the one we just experienced.

For this we have the FSB – a post-financial-crisis institution for a post-financial-crisis world.

Thank you very much.

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[20] The G-20 Leaders agreed that the FSB's mandate should be strengthened; that it be given permanent legal standing; and that its capacity and resources be increased.

[21] 21. See "Assessing the Macroeconomic Impact of the Transition to Stronger Capital and Liquidity Requirements", Bank for International Settlements, December 2010; "Assessment of the Macroeconomic Impact of Higher Loss Absorbency for Global Systemically Important Banks", Bank for International Settlements, October 2011, and "Macroeconomic Impact Assessment of OTC Derivatives Regulatory Reforms", Bank for International Settlements, August 2013.