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CHECK AGAINST DELIVERY

Some Current Issues in Financial Reform

Thank you for the invitation to speak today. In the hope of addressing some of your concerns, I waded through the more than 1,000 pages of reports and notes that the Institute of International Finance (IIF) has produced over the past year. Your messages have been consistent, if not always concise, so I would like to focus on three particular concerns about the financial reform agenda you have recently expressed:

1. the consistency in implementation across jurisdictions;
2. the possibility of substantial regulatory arbitrage in the shadow banking system; and
3. the macroeconomic impact of the reforms.

Before I do, allow me a general observation.

The G-20 is undertaking a radical and comprehensive program to strengthen the regulation, supervision and infrastructure of the global financial system. Its ambition can hardly be a surprise. Four years ago, manifest deficiencies in capital adequacy, liquidity buffers and risk management led to the collapse of some of the most storied names in finance and triggered the worst financial crisis since the Great Depression. The complete loss of confidence in private finance—your membership—could only be arrested by the provision of comprehensive backstops by the richest economies in the world. With about $4 trillion in output and almost 28 million jobs lost in the ensuing recession, the case for reform was clear then and remains so today.

Let me now turn to your issues.

Consistency in Implementation

Authorities are increasingly hearing concerns about the pitch of the playing field for Basel III implementation. Everyone is claiming to be a boy scout while accusing others of juvenile delinquency. However, neither merit badges nor detentions will be self-selected but, rather, determined by impartial peer review and mutual oversight.

It is important to remember that the Basel rules have always been, and continue to be, international minimums, rather than a "one-size-fits-all" approach. There are legitimate reasons why implementation may differ across countries.

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Some countries will implement Basel III **faster** than others. The current transition period to 2019 for Basel III has been variously described as enlightened, leisurely and generous. It reflects a lowest-common-denominator compromise that gives the time needed to rebuild capital buffers in those crisis economies that are furthest from compliance. Some countries may decide it is not in their best interests to take full advantage of this flexibility.

Indeed, how quickly the new rules are adopted is bound to be a function of both the current health of the financial system and the macrofinancial environment in each jurisdiction. In Canada, we expect banks to be fully compliant with Basel III (2019 definitions) by early in the transition period, which starts in January 2013. This reflects the strong starting positions of Canadian banks and the benefits of building capital in the face of currently buoyant credit expansion.

Some will adopt **tougher** rules. Countries such as Sweden, Switzerland and the United Kingdom, with very large banking sectors relative to their domestic economies, have signalled their preference for higher loss-absorbency capacity. In these jurisdictions, since the failure of a major bank would have disproportionately large consequences, additional prudence is desirable.

Finally, there will always be countries that opt for a tighter interpretation of the rules, even as they adhere to the international minimum standards. For example, national supervisors may take a more conservative approach to approving bank internal risk measurement systems under the advanced measurement approach of Basel II.

I would stress that in order to foster a race to the top, Basel III permits **better** rules, but it is a minimum standard. As the IIF has emphasised, it is vital that we prevent regulatory fragmentation. In this regard, there are several new measures that will help to contain unwarranted differences in implementation across countries. For example, the new leverage ratio acts as a backstop that effectively limits differences in risk weights. Speaking from experience, we in Canada know that the leverage ratio protects banks from risks that people think are low but are, in fact, high.

In addition, policy-makers are significantly enhancing the mutual-surveillance processes that each jurisdiction accepts as part of its membership on the Basel Committee on Banking Supervision (BCBS). In particular, the Financial Stability Board (FSB) and the standard-setting bodies, including the Basel Committee, are jointly developing an implementation-monitoring framework that will coordinate activities and include annual progress reports on a country-by-country basis to the FSB and G-20, as well as less frequent, but more in-depth, peer reviews.

Ad hoc reviews of new legislation and regulations could also be conducted. In this regard, a review by the BCBS of new European and American rules would be welcome to build confidence today in the consistency of application in major jurisdictions.

Coordinated FSB/BCBS monitoring mechanisms will be in addition to the International Monetary Fund's (IMF) annual Article IV surveillance and the IMF

and World Bank's periodic independent assessments across countries of compliance with international standards.[1]

All in all, while there will be legitimate reasons for some countries to adopt standards more quickly or to go beyond international minimums, there will be much less scope in the future for countries to give their banks a competitive advantage by not fully implementing the agreed global rules.

If some jurisdictions do not comply, I am certain that you will let us know. The IIF's commitment to fair application and peer review would complement official initiatives, and I urge you to develop a more formal approach.

In the end, it is in your interests to comply. While there will be periods of exuberance during which aggressive banks and jurisdictions can sail close to the wind, financial history suggests that well-capitalised institutions and transparent systems will ultimately have premium ratings, valuations and outcomes.

Regulatory Arbitrage

Let me turn to your second issue: regulatory arbitrage.

There are valid concerns that the recent measures will push risk into shadow banking. Even as reforms make the core of the financial system more resilient, they increase incentives to move classic banking activities, such as maturity transformation and credit intermediation, to the unregulated periphery.

This tendency is of particular concern, given the role the shadow banking sector played in the run-up to the crisis. In the final years of the boom, when complacency about liquidity reached its zenith, the scale of shadow banking activity exploded. The value of structured investment vehicles, for example, tripled in the three years to 2007, and credit default swaps grew sixfold.

The feedback to the regulated sector was pernicious. Financial institutions, including many banks, had come to rely on high levels of market and funding liquidity. For instance, short-term money markets, particularly repo markets, were the predominant source of financing for the one-third increase in the gross leverage of American investment banks, as well as British and European banks. The system's exposure to market confidence was enormous.

The crisis exposed how boom-bust liquidity cycles cascade through the shadow banking sector and reverberate on the regulated core. Market forces proved inadequate to manage these swings between confidence and despair.

Today, despite the fact that shadow banking, or as we prefer to call it, market-based financing (MBF), is at least as large as the regulated sector in most jurisdictions, it is often unregulated and/or overseen by authorities without a systemic focus. This should change.

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[1] The IMF and the World Bank jointly conduct both the Financial Sector Assessment Program (FSAP) and Reports of the Observance of Standards and Codes (ROSCs).

As it does, regulation and supervision must strike a balance between mitigating systemic risks and realizing the benefits from financial deepening. Properly structured, shadow banking can increase efficiency, provide diversification, and spur competition and innovation. It has the potential to make the system more robust, provided it does not rely on the regulated sector for liquidity or pretend to provide it with liquidity in times of stress. However, experience also teaches that shadow banking activities mutate, usually through complex and highly leveraged instruments, into regulatory gaps created by the response to the last crisis.

With all of this in mind, there are four broad categories of regulatory initiatives under consideration. The first, and most important, is **indirect** regulation through limits on the size and nature of banks' exposure to shadow banking entities. Examples include tighter consolidation rules for bank-sponsored conduits and higher risk-based capital requirements for liquidity lines. These measures will help to reduce opportunities for regulatory arbitrage, in which banks seek to reduce capital or liquidity requirements by organising transactions wholly or in part through shadow banking entities while retaining much of the underlying tail risk.

The second approach would try to address systemic risks in shadow banking **directly**. For example, macroprudential measures are being considered to address procyclical haircut and collateral rules for securities lending and repo transactions. These measures could do much to dampen liquidity cycles.

Contagion could be further constrained by strengthening financial market infrastructure. In Canada, in the coming months, a central counterparty (CCP) for repo transactions will be launched. This repo CCP will strengthen counterparty credit risk management, reduce collateral and balance sheet requirements via netting, and reduce the impact if there were a failure of one of its participants. By helping to ensure that core funding markets are continuously open, the heart of the financial system will be more resilient to shocks.

The third approach is to **regulate shadow banking activities themselves**, such as money markets and exchange-traded funds (ETFs), through disclosure obligations or restrictions on certain financial transactions and instruments. This will require dynamic monitoring of the financial system and coordination across authorities.

Finally, the FSB is examining the possible **regulation of shadow banking entities**, such as hedge funds, that may pose systemic risks by limiting their maturity transformation and leverage. This last option should take into account the relative size of these institutions and the cumulative impact of other measures.

Whatever decisions are taken in the coming months, no one should be tempted to declare "mission accomplished." In order to maintain systemic resilience, the

monitoring, supervision and regulation of shadow banking will need to be dynamic.[2]

The recent loss incurred by UBS on its Delta One trading desk demonstrates the need for vigilant risk management of complex new products. Fortunately for the system, the loss was manageable, given the increased capital buffer at the bank, and a broader liquidity squeeze was avoided. The FSB has been prescient in highlighting the risks associated with synthetic ETFs.[3] Synthetic ETFs are sometimes being used to fund illiquid collateral which, if financed on a bank's balance sheet, would carry a higher risk weight. The potential for a procyclical liquidity cycle needs to be monitored carefully.

Reform of the shadow banking sector offers an opportunity to ensure the consistency of the overall financial reform package. For example, capital rules will have to balance risks to institutions with the benefits of incentivizing direct and indirect settlement of standardized derivatives through CCPs. Liquidity standards and market infrastructure should reinforce the continuous availability of core funding markets. In this manner, both systemic resiliency *and* efficiency can increase.

As authorities examine measures on a comprehensive, system-wide basis, adjustments may need to be made. Liquidity standards are one example. The Basel Committee and the Committee on the Global Financial System (CGFS) are currently using the observation period to review contentious design issues concerning the Liquidity Coverage Ratio (LCR), such as uncertainty regarding how the liquid assets can be used in times of stress, and how the liquidity rules are supposed to operate in tandem with the new leverage ratio requirement. They are also examining potential unintended consequences on the commercial paper market and market-making for equities. The FSB's work on shadow banking will shed more light on the intersection among these standards, key markets and economic performance.

These issues need to be addressed before the new rules are fully implemented.[4] There would appear to be little value in delaying decisions on potential amendments to the LCR beyond early in the new year. Work on the Net Stable Funding Ratio (NFSR) will take longer.

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[2] The FSB has developed a two-step approach to monitoring. The first step calls for a broad scanning of the shadow banking sector to understand the key developments and trends. The second involves detailed assessments of the activities and entities of the sector to identify systemic risks, paying particular attention to regulatory arbitrage, excessive maturity and liquidity transformation, imperfect credit risk transfer and undue leverage. Although the goal is to implement this approach by the end of 2012, obtaining sufficiently granular data will be a challenge.

[3] "Potential Financial Stability Issues Arising from Recent Trends in Exchange-Traded Funds (ETFs)," Financial Stability Board, 12 April 2011.

[4] As part of this work on liquidity rules, banks have been asked to supply data every six months and to complete a detailed survey on their liquidity-management practices to help gather information about the impact of their practices on the financial system.

Macroeconomic Implications of Financial Reform

Let me now turn to your third, most fundamental, concern. Based on the current challenging economic outlook, some argue that we should revisit the pace and breadth of financial reforms. This position is based on two questionable propositions.

The first is that the prospect of financial reforms is contributing to current economic weakness. A corollary is that delayed implementation of the Basel III capital rules, for example, will somehow strengthen the recovery.

Really?

Weak credit growth in the crisis economies is often cited as supporting evidence. However, the fact that household credit is flat to falling in the United States and the United Kingdom can hardly be a surprise. American and British households are overleveraged. With personal net worth substantially lower following the crisis, the need to rebuild balance sheets in an environment of economic uncertainty is quite naturally weighing on credit demand. In the vast array of countries that did not experience a home-grown financial crisis, the issue has been that household borrowing has been too robust, despite adherence to a common timetable for implementing Basel III. The issue in the crisis economies is primarily one of demand, not supply.

More broadly, the G-20's comprehensive reform program seeks to boost confidence in global financial institutions and markets by providing a path to a more resilient system and an end to government support. It is hard to see how backsliding would help. Indeed, at a time when the conviction of policymakers across a range of issues is being called into question, there appears to be little value in feeding this concern.

Moreover, recall that the implementation timetable for Basel III begins in two years and ends in 2019. It is difficult to believe that prolonging this implementation phase even further would have a material impact on real economic outcomes. If some institutions feel pressure today, it is because they have done too little for too long, rather than because they are being asked to do too much, too soon.

The second proposition is that, once implemented, the reforms will substantially reduce global growth. A recently released IIF report estimates output losses during the transition phase that are more than an order of magnitude greater than those produced by the Bank for International Settlements, the Bank of Canada, the IMF and other public institutions and academic bodies.

Allow me to raise a few of the many problems with the IIF's analysis. The IIF study assumes banks pay out most of their earnings and therefore must rely heavily on external sources to raise capital. Debt-fuelled consumption is a central driver of output growth in its econometric model, despite the obvious bias to reduce debt in most major economies. Monetary policy is assumed to be in suspended animation until 2020. While I would welcome the time off, this presumption is inconsistent both with the range of unconventional tools that

central banks have and the medium-term prospects for the global economy. The estimated impact of the reforms on the cost of bank debt exceeds the increase experienced during the crisis! It is hard to see how more capital, better liquidity and stronger infrastructure would lead to such a result. Put differently, the IIF is suggesting that the current public subsidy of the financial sector is massive.

Finally, the analysis assumes that all of these reform efforts are for naught as it includes none of the benefits. Given the recent experience, no one would argue that financial crises are without costs, and only the most jaded would argue that their probability and severity cannot be reduced.

Countries like Canada and Australia, with well-capitalized and well-managed banks, did not experience any failures or bailouts. Partly as a consequence, their economies have substantially outperformed those of their advanced-economy peers. Our estimates indicate that even if Basel III were to reduce slightly the probability of such crises in the future, the potential gains would far exceed the cost of marginally slower growth. The Bank of Canada estimates a net present value of Basel III for G-20 economies is 30 per cent of GDP in present-value terms, or about $US13 trillion.[5]

In short, while the worsening global economic outlook has implications for bank performance, it does not provide a rationale for delaying the implementation of Basel III.

Conclusion

To conclude, critics of reform generally succumb to three world-weary arguments:

- any rule will be arbitraged;
- any insurance will promote greater risk taking; and
- there will always be financial crises.

Such fatalism should be rejected. In no other aspect of human endeavour do men and women not strive to learn and to improve. The sad experience of the past few years shows that there is ample scope to improve the efficiency and resilience of the global financial system. By clarity of purpose and resolute implementation, we can do so. The current reform initiatives mark real progress.

The fundamental objective of the G-20 measures is a resilient, global financial system that efficiently supports global growth. Our destination should be one where financial institutions and markets play critical—and complementary—roles to support long-term economic prosperity.

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[5] Assuming a 2-percentage-point increase in capital (plus liquidity changes). For Canada, estimates are approximately 13 per cent of GDP in present-value terms, which is equal to about Can$200 billion. See Bank of Canada, “Strengthening International Capital and Liquidity Standards: A Macroeconomic Impact Assessment for Canada,” August 2010, and M. Carney, “Bundesbank Lecture 2010: The Economic Consequences of the Reforms,” speech to Deutsche Bundesbank, Berlin, 14 September 2010.

This requires institutions that are adequately capitalized, with sufficient liquidity buffers to manage shocks. It also requires that market forces be allowed to determine the relative sizes and boundaries of the banking and shadow banking sectors; and that the market decides which firms prosper and which firms fail.

The FSB has a clear role to oversee and coordinate the development of the G-20 reforms. It should provide a system-wide perspective and assess the total impact of reforms. It must strive to resolve any conflicts that may arise between regulations that are locally optimal but systemically inconsistent. It must balance the need to guard against regulatory arbitrage with the value of preserving diverse risk-taking strategies and productive innovation. Finally, it must ensure consistent implementation across jurisdictions to build an open and competitive system.

It is also important not to lose sight of the limitations of regulation. New and better rules are necessary, but not sufficient. People will always try to find ways around them. Some may succeed, for a while. That is why good supervision is paramount. Rules are only as good as the supervisors who enforce them, and good supervisors look beyond the letter of the rules to their spirit.

Of course, belief by the industry in the appropriateness of the measures will also aid their application. As you are well aware, you have the ultimate duty to ensure your institutions bear responsibly the risks you are taking. We have all learned from the events of the past few years, and so I look forward to a continued constructive dialogue with the IIF as we develop and implement this vital agenda.