Office of the Superintendent of Financial Institutions Canada
Bureau du surintendant des institutions financières Canada

Remarks by Superintendent Julie Dickson
Office of the Superintendent of Financial Institutions Canada (OSFI)
to the
C.D. Howe Institute Policy Roundtable Luncheon

Toronto, Ontario
Wednesday, October 28, 2009

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Considerations along the Path to Financial Regulatory Reform

Introduction

Thank you for the invitation to come and speak with you today.

With the tumultuous events of the past two years still fresh in our minds, many ideas have been put on the table as proposed solutions to minimize the chance of a repeat of the global financial crisis. Many of these ideas require considerable analysis, and honest discussion with a touch of humility with respect to our true capabilities.

In this regard, at the International Monetary Fund (IMF) annual meetings in Istanbul earlier this month, I was asked to answer three questions:

- What areas for regulatory reform should be given the highest priority, and why?
- How realistic is macro-prudential regulation at the national and international levels?
- How should systemically important institutions be defined and identified?

Today I will repeat the answers I provided at the IMF meetings, and I would be happy to have your input on the answers I gave. Before going further however, it may be useful to provide a framework.

Canada, like most of its international peers, has a constrained market economy. We do not want an unfettered market economy, because we would not want to risk the outcomes that unconstrained private decision-making can lead to. Nor do we want a centrally planned economy, because we do value the discipline that the market can impose on participants.

Furthermore, we have decided that the banking sector will not be treated like a public utility company, but will have to succeed, or fail, on its own merits in a competitive market (albeit with various constraints).

So with this in mind, in Canada, we do try to use inherent market discipline to do as much of our work as we feel it can reasonably accomplish. At the same time, where the market does move away from socially desirable outcomes, we will intervene with constraints (e.g. Basel rules).

Before I get into the answers I provided to the IMF about regulatory reform, I think it is important to remember that any rules or regulations we put in place can create incentives to do one action, and not another. Therefore we must be vigilant to push for incentives that lead to the outcomes we want, and not incentives that lead to unintended consequences – consequences which we will all subsequently have to deal with, and which could have an unforeseen, yet dramatic, impact.

Highest Priority Areas for Regulatory Reform

With this framework in mind, let's deal with the first question: <u>what areas for regulatory reform should be given the highest priority, and why?</u>

The highest priority should be given to policies aimed at re-asserting market discipline in the financial services sector. By market discipline I mean that we have to end the continuation of deeply embedded expectations of implicit or explicit support of financial institutions by governments. Markets need to understand there are consequences for poor decisions, and conduct themselves accordingly.

Without market discipline, financial institutions will have incentives to take more risk than optimal. Without market discipline, too much of the oversight role will be shifted to regulators, and regulators cannot completely replace the markets – regulatory agencies are small relative to the entities they regulate.

Unsecured bondholders of systemically important banks (with certain rare exceptions, such as the debtors of Lehman Brothers) suffered the least amount of consequences, especially considering the amounts of capital and funding they provided to the banks. As was the case in many countries, most unsecured bondholders had downside protection provided by the taxpayer.

Rating agencies have already begun cementing the presumption of government support into the ratings of big banks. While rating agencies had been on this course prior to the turmoil, they have moved further down the path and have for the first time extended the concept to the US, which prior to the crisis had been widely considered as a jurisdiction where market discipline would prevail.

Developing policies to deal with the market discipline problem is challenging. Some ideas are more advanced than others. Policies that would fall under the banner of re-asserting market discipline include:

Penalties for Failure

- Provide more certainty about what will happen if there is a failure at a financial institution, particularly with respect to penalties. While a financial institution can fail while still being left open (such as in a bridge bank), penalties must be doled out (management must be replaced, etc.).
- Explore the use of contingent capital. This refers to sizeable levels of lower quality capital that could convert into high quality capital at pre-specified points, and clearly before an institution could receive government support. Such conversions could make use of triggers in the terms of a bank's lower quality capital, *while the bank remains a going-concern*. This would add market discipline for even the largest banks during good times (as common shareholders could be significantly diluted in an adverse scenario), while stabilizing the situation by recapitalizing such banks if they fall on hard times. Boards and management of these recapitalized banks could be replaced. Issues to be studied to make such a proposal operational include grandfathering of existing lower quality securities, and/or transitioning towards new features in lower quality securities, considering capital markets implications of changing the terms of lower quality capital and the selection of triggers, and determining the amounts and market for such instruments.

Making Failure a Viable Option

- Risk proof the system via the establishment of central counterparties for various derivatives, and increase the monitoring of bespoke transactions so they can be moved onto such exchanges at the appropriate time. Central counterparties help to make failure a viable option by ensuring systems can settle even with the failure of large participants.
- More control of counterparty risk via capital rules and limits, so that imposing losses on major institutions who are debt holders in a failed financial institution does not prove fatal.
- A focus on wind-down arrangements to ensure we have information on problems posed by complex structures in advance, so that problems can be rectified or understood early.

Re-asserting market discipline is an important step towards having a global financial system that takes acceptable risks.

Realistic Macroprudential Regulation

Now, to the second question: <u>How realistic is macro-prudential regulation at the national and international levels</u>?

Some aspects of macro-prudential regulation are very realistic: loan-to-value ratios, pillar 2 and through-the-cycle estimates, and an expected-loss approach to loan-loss provisions, are prime examples. More challenging, and possibly less realistic at this point based on the work which has been done, is the notion of moving capital targets up and down based on macro indicators, so as to "lean against the wind".

The FSB agreed that, "capital requirements will operate countercyclically, so that financial institutions will be required to build capital buffers above the minimum requirements during good times that can be drawn down during more difficult periods." OSFI agrees with this, and of course, this was also supported by the G-20. Capital cushions have to be available for unexpected losses in difficult periods, and the capital cushion should be robust going into a downturn.

At OSFI, our first concern is that institutions have appropriate levels of capital to meet solvency requirements. An appropriate level means a level that, in the ordinary course of business cycles (which can include deep or shallow recessions), would allow a bank to meet unexpected losses, without necessarily raising further capital.

In contrast, in a tail event, an appropriate capital level is robust enough that it would allow the bank to maintain the confidence of the market so it can raise more capital.

Above that appropriate level one could try to experiment and adjust capital requirements up or down based on macro indicators. But, the challenge will be how to make a regime which ties macro indicators to capital effective. Indeed, in upturns in the domestic market where capital targets are increased due to macro factors, companies would have the option to obtain loans from banks in countries with less robust economic conditions, as banks in that country will have lower requirements. Thus, an increase in capital in the domestic market might not have the desired impact of slowing things down.

Alternatively, because many countries have well developed financial sectors, borrowers can go beyond the regulated financial sector to find money, as regulated financial institutions are not the only game in town.

Another complicating factor is that history has shown that when risk aversion goes up, the market demands more capital. If regulators reduce capital requirements in periods of stress, the outcome may not be that bank lending will go up – the outcome may be that markets will still demand more capital. Thus, countercyclical capital that is driven by macro indicators may be extremely difficult to operationalize given expected market behaviours. However, we will continue to work hard on this.

Declaring some Institutions as Systemic

The third question: How should systemically important institutions be defined and identified?

Yes, regulators should try to assess systemic risk. But no, we should not try to define systemically important financial institutions.

Identifying financial institutions as systemic would increase moral hazard. The only place where identifying something as systemic makes sense is with clearing and settlement systems, or central counterparties. This is something we do in Canada; with government consent, the central bank has the authority to designate a system as systemic, at which point numerous internationally-agreed upon requirements come into effect. The system is designed to handle the failure of massive institutions, and still ensure that counterparties will be paid. As the Bank for International Settlements (BIS) has noted, a well designed central counterparty with appropriate risk management arrangements reduces risks to all financial institutions who participate, and contributes to the goal of financial stability.

Designating some banks as systemic does not reduce risk – it increases it. Banks designated as systemically important would receive higher ratings from ratings agencies, have a lower cost of funds, and might suffer a lack of market discipline – despite our best efforts to re-assert that market discipline. Overall, financial institutions designated as systemically important would essentially be granted the ability to take on more risks.

Such a policy might also defeat other important goals, such as having competition in the market (as business would likely flow to the systemic institution), and efficiency (as there would be fewer competitors).

Aside from the perils of labeling institutions as systemic, it is difficult to even reach a determination as to who is systemic and who is not. Bear Sterns, Lehman, AIG and LTCM were recognized as threats to the system at a point in time when it was already too late to increase capital or to regulate them more closely. The IMF work on identifying systemic institutions rightly points out that what is systemic in one situation may not be in another, and that there is considerable judgement involved.

Proponents of the notion of designating some institutions as systemic suggest that after designation, the next step would be to establish higher capital requirements and implement better regulation and supervision on such banks, to make it highly unlikely that any such institution would fail.

In terms of higher capital requirements, the Financial Stability Board (FSB) report sent to the G-20 indicates that regulators will assess whether a capital surcharge on systemic banks is needed. We will need to answer questions such as: how much more capital? Who exactly would it apply to? What incentives does it create? And that is in addition to all the other issues associated with designating certain institutions as systemic.

In terms of better regulation, it is hard to disagree that better regulation is a good idea, but coupling it with a systemically important designation is a problem. Regulators would shoulder inordinate responsibility in such cases, because the implicit message might be that failure of a systemically important institution should never happen, even if an effective and efficient means of closing such an institution existed. The incentive might be for regulators to either become extremely conservative, or, the opposite, to avoid the "will to act" and not intervene when required. The risk of having a supervisor that is in charge of systemically important financial institutions, but that also behaves in ways that are unhelpful, cannot be dismissed.

Different sizes, different risks, different expectations

While identifying institutions as systemic is problematic, the fact is that supervisory expectations for large complex financial institutions are different than they are for small to medium-sized institutions. At the same time, we have to keep in mind that risk can manifest itself in both small and large financial institutions.

For example, when a small institution becomes a medium-sized institution, its management team has to understand that what worked for a small bank might not work for a medium-sized bank. You need more automated processes, and less reliance on manual spreadsheets, the bigger the organization becomes. You need documented policies and procedures. OSFI would be looking for this.

For large complex institutions the bar goes way up, but it is still a question of judgement. We would expect more sophisticated controls, but at the same time, controls that are adequate at one big bank may not be adequate at another. It will depend on the risks, the various businesses in which they are engaging, and other variables.

OSFI uses cross system reviews and other experience to continually inform us about the range of control practices being used. Having informed ourselves about good-better-best practices, we then recommend improvements to institutions where we feel improvements may be necessary. Again, considerable judgement is required. A bank with adequate controls in every business might be far safer than a bank with strong controls everywhere, except in Internal Audit.

We need to be continually vigilant and look for areas where we might want to encourage more robust controls. Examples of where robust controls are required in a more complex business would include capital, where for large banks one would expect advanced IRB-approaches to capital, and the expenditures that adopting such systems would entail.

Stress testing is moving in the same direction. While we expect all institutions to have rigorous stress testing, the more complex a business is, the more advanced their stress testing should be.

The Senior Supervisors Group (SSG) zeroed in on other areas where the bar should be raised, including better systems to obtain timely and accurate data on a variety of variables, including counterparty exposures and liquidity. The more complex an organization, the more of a challenge it can be to understand the data being collected, and ensuring the data is meaningful.

Understanding the drivers behind the creation of large complex institutions and raising the bar on corporate governance are areas where large institutions need to focus, as well as regulators. As noted by the Walker Committee in the UK, "Boards of large and complex groups should thus keep under review whether the interests of their shareholders would be better served by a less complex product array, a more dependably manageable business model and more limited geographic reach."

Conclusion

Hopefully my comments today have given you a sense of some of the difficult issues we are dealing with – market discipline, contra-cyclical capital buffers, and whether institutions should be designated as systemically important. And there are many more issues beyond these.

Given the nature of this crisis, speed is of the essence and thus regulators have been moving quickly. Perhaps a pause to fully consider all of the potential consequences should not be interpreted as a loss of momentum, but rather a needed part of the process to avoid planting the seeds of the next crisis.

While we need to ensure that capital rules produce adequate buffers for unexpected losses, we have to keep in mind that providers of capital do have choices – they can provide capital to the non-financial sector instead of the banking sector and they will be looking at the returns and earnings capacity of banks in making their investment decisions. Sustainable profits are an important component, as important as capital and good risk management, to a safe and sound financial sector.

Thank you.