Monday, March 22nd, 2010

INTERNAL MEMORANDUM TO THE ASSISTANT DEPUTY MINISTER OF FINANCIAL SECTOR POLICY BRANCH

MACRO PRUDENTIAL REGULATIONS — CANADIAN POLICY OPTIONS AND POSITION - EXTERNAL ECONOMIC PRESSURES: A PUSH TOWARDS GLOBAL ECONOMIC REFORM

ISSUES AT STAKE

Domestic: Domestic policy options for Canada regarding formulation and management of macro-prudential regulations

International: Canada's potential leadership role in the global financial reform as it pertains to macro-prudential regulations that deal with long term structural economic problems

BRIEF BACKGROUND AND SIGNIFICANCE OF THE ISSUE

British Prime Minister, Mr. Gordon Brown has called for "a new financial architecture for the global age" and has displayed his discontent with the current global financial system in operation after its formation after the Second World War (Bretton Woods). Many experts agree with Mr. Brown when he stated that the current system needs an overhaul and is out of touch with the modern world order and realities. It is widely stated that the financial crisis should be viewed as an opportunity for global institutional reform. The reforms championed by Number 10 and, to a lesser extent the European Union, look at creating a stable global governance order that will supervise global financial institutions. This order will be maintained by imposing universal macro standards for accounting and regulations and addressing occasional build-up of systematic financial imbalances in the form of unsustainable credit and asset price booms. These potential threats to financial and macroeconomic stability inevitably occur in low and stable inflation economies like Canada. Financial crises have always acted as a catalyst for important changes in global financial governance and we are currently living through such a crisis, arguably worst since the Great Depression[1]. Canada's financial system has been comparatively less affected by the global financial crisis than those of other OECD countries, putting Canada in a unique place to influence regulations despite the smaller size of the Canadian economy[2].

The current global financial crisis has caused many institutes, ranging from global forums to sector specific associations, to demand change in the global financial system. Many principles, memoranda of understanding and statements have been made regarding the systematic and coordinated global effort required to better manage the crisis through use of increased regulations. The trust in market systems has eroded and the call for increased and stronger regulation leads to the question of how, what and who governs financial reform. One key area of reform where Canada is able to significantly influence and chart out the agenda is the setting up of early warning systems for future crisis. The debate in this realm has been between micro-prudential regulations and macro-prudential regulations. "Macro prudential regulations focus on the financial system as a whole, seeking to diminish system-wide distress in order to avoid reductions in aggregate output (GDP). Macro-prudential regulations include loan provisioning rules, capital standards, loan-to-value ratios, measures to address currency mismatches and a general increase in the supervisory review process[3]. This is unlike micro prudential regulation which seeks to minimize distress in individual institutions in order to protect depositors". Put another way, "Macro prudential regulation

[1] Eric Helleiner. Crisis and the Future of Global Financial Governance. Global Governance. volume 15 (2009), p.1–28
[2] Canadian International Council. Policy Issues in Global Financial Reform. June 10. 2009.
[3] Bank for International Settlements. BIS Working Papers No. 242. What can (macro-)prudential policy do to support monetary policy?. Monetary and Economic Department. Copyright 2007. http://www.bis.org/publ/work242.pdf

focuses on common exposures across financial systems and institutions rather than the entity-specific focus of micro prudential regulation"[4].

Macro-prudential regulation reform is only one area of global financial system, among many policy options available to address issues arising from the current crisis. The significance of this issue, Canada's relative stability throughout the crisis and our stable pre-crisis regulations and conservative policies have paved the way for us to lead this niche area of global financial reform in the upcoming world summits, G8 and G20 meetings.

CURRENT INTERNATIONAL AND DOMESTIC REALITIES

Timing, International Lack of Leadership and Fragmentation:

In response to the crisis, there have been three key patterns of international regulatory change witnessed. They can be summed up in three broad categories "(i) an expansion of the perimeter of international regulation (micro prudential and macro prudential regulation), (ii) efforts to strengthen the global institutional architecture, and (iii) a departure from the trend over the past decade of delegating regulatory and supervisory responsibilities to private market actors"[5]. Despite the push for regulatory change however, there has yet to be any substantial progress towards reforming the international financial system. A fragmented effort has been made by various governments to get their own house in order and there is a lack of leadership in the macro prudential regulation arena. France and Britain's head of governments have taken leadership roles and have made a considerable push towards global standardization in accounting regulations and the issues of executive compensation and elimination of offshore tax havens. Canadian experts have been recognized and called on to provide feedback and recommendations for a global

[4] Anita Anand. Canada should heed the call for macroprudential rules. Why macro is prudent. Financial Post - National Post, Canada. Copyright 2009. Posted: September 24th 2009

[5] Global Finance in Crisis: The politics of International Regulatory Change. Warwick studies in globalization. Copyright 2009. P2.

solution due to the resilience of the Canadian financial system to structural problems that plagued all OECD countries. This unique situation creates an opportunity for Canada to be a global leader in macro prudential regulations. "An exceptional opportunity for Canada to advance its values and interests on the world stage"[6] exists due to Canada's role as the host of the upcoming G8 meeting in Huntsville, Ontario. In addition to the G8 meeting, Canada will also host and co-chair the G20 meeting in Toronto later this year in June to "bring stability to financial markets and to promote economic cooperation"[7]. Consequently, the timing and opportunity available to Canada at this juncture is worth exploiting to the fullest.

Canadian Domestic Realities: A Complex Cobweb

In Canada, a multi-layered and fragmented approach is taken to regulating the financial industry with responsibilities scattered across many departments and bodies. The Office of the Superintendent of Financial Institutions (OSFI) is the independent agency setup to "contribute to public confidence in the Canadian financial system". "OSFI's proposed legislations give due regard to the need to allow institutions to compete effectively and take reasonable risks"[8], something the Office has managed to do very successfully in recent times. As securities regulation within each province was deemed a matter falling under Provincial jurisdiction, the OSFI, in consult with the Provincial securities regulators, Department of Finance and Bank of Canada tries to manage the Canadian financial system. This system is therefore a complex web of interconnections that further includes significant actors like the Canada Deposit Insurance Corporation, Canada Development Investment Corporation, Canada Pension Plan Investment Board, Canadian International Trade Tribunal and the Financial Consumer Agency of Canada. The largest of these organizations is the

[6] Office of the Prime Minister. Prime Minister announces Canada to host 2010 G8 Summit in Huntsville. Copyright 2009. Date published: 19th June 2009. Available online at: http://www.pm.gc.ca/eng/media.asp?id=2155
[7] Government of Canada. About the G20. Copyright 2010. Date published: 18th March 2010. Available online at: http://g20.gc.ca/
[8] Office of the Superintendent of Financial Institutions. Our Mandate. Copyright 2010. Available online at: http://www.osfi-bsif.gc.ca/

Bank of Canada, which is responsible for and is mandated "to ensure low and stable inflation, a safe and secure currency, financial stability, and the efficient management of government funds and public debt"[9]. Increasingly, there is a push for a Federal committee to be formed which brings together the aforementioned actors and experts to address the highly technical issue of regulations pertaining to the management of financial markets. It should be noted that "given their individual responsibilities over separate aspects of the financial system, none of these bodies can individually be mandated with monitoring the entire system"[10]. To understand the inherent complexities of the Canadian system, one does not need to look further than the example stated above. OSFI's current mandate doesn't extend to securities markets, which in turn is regulated by each Province's individual securities regulator. The picture is increasingly complicated when issues of foreign direct investment, free trade agreements and federal trade and commerce laws are included in the analysis. In short, any Canadian body's ability to engage in macro prudential oversight is limited due to multiple reporting structures and varying mandates and jurisdictions. This is one of the reasons, "why the blame for the subprime crisis easily shifted from regulator to regulator and from policymaker to policymaker"[11]. The various regulators separately focus on regulating each financial arena and collectively ignore the systemic importance of such factors as size of individual institutions, degree of leverage, and interconnectedness with the rest of the system.[12] The system briefly described above leads to a climate of excellent micro-prudential regulations, whilst leaving a gap in the Canadian regulatory framework for macro-prudential regulations. To complement the micro-prudential regulations, macro-prudential regulations must now be developed domestically incongruence with

[9] Bank of Canada. Mission Statement. Copyright 2010. Available online at: http://www.bankofcanada.ca
[10] Anita Anand. Canada should heed the call for macro prudential rules. Why macro is prudent. Financial Post - National Post, Canada. Copyright 2009. Posted: September 24th 2009.
[11] Eric Helleiner. Crisis and the Future of Global Financial Governance. Global Governance. volume 15 (2009), p.1–28
[12] Canadian International Council. Policy Issues in Global Financial Reform. June 10. 2009.

international standards to streamline global financial markets. According to the former Bank of Canada Governor, the role of the prudential supervisors is to chart out rules that provide reasonable assurances to customers that institutions are solvent and adequately liquid. "The objective of macro-prudential regulations is to then serve as a countervailing force to the natural decline in measured risks in a boom and the subsequent rise in measured risks in a collapse"[13].

To some extent Canada has macro prudential regulation in place already. The Bank of Canada Act has the authority vested within it to act as a liquidity provider of last resort in our financial system and has responsibility for the oversight of clearing and settlement systems for the purpose of controlling systemic risk[14]. In addition to systematic risk, many micro prudential regulators were not mandated to oversee rules of prudential risk management. The regulators did not cover investment banks, credit rating agencies, bond insurers, hedge funds and other institutions in Canada that were involved in the securities and assets markets.

POLICY OPTIONS

With the above realities of the Canadian financial system in mind, this section lists three different policy options that incorporate elements of domestic and international micro prudential regulation reform.

Policy Option A: *Do nothing/Status quo approach. (Reactionary)*.

> Analysis of the banking sector conducted so far in Canada is sufficient. If the previous crisis has proved anything is that Canadian institutions are well

[13] Charles Wyplosz. Bailing out the banks: Reconciling stability and competition. The ICMB-CEPR Geneva Report: "The Future of Financial Regulation". Date published: 27 January 2009. Copyright 2010.
[14] Anita Anand. Canada should heed the call for macroprudential rules. Why macro is prudent. Financial Post - National Post, Canada. Copyright 2009. Posted: September 24th 2009.

managed, regulated and firmly grounded. There is no need for stricter regulation on the already conservative macro-prudential regulations developed over the past two decades. This option will maintain Canada's role as one of the key economies in the international arena and let US and the EU economies take a leadership role in all talks regarding macro prudential regulations.

Policy Option B: *Review and strengthen the current macro-prudential regulations domestically by creating new regulatory bodies that incorporate previously unregulated entities to ensure endogenous risk is addressed. Participate actively in international negotiations but do not take a leading role in global policy formulation*. *(Constructive)*.

Conducting an analysis of the macro-prudential regulations in Canada to identify gaps and strengthening existing stabilizers to comply with international regulations that are yet to be developed by a host of international actors. By creating new regulatory bodies to supervise all financial instruments that were previously unregulated, the long-term viability and integrity of the Canadian economy can be ensured. Taking on an international leadership role is not critical for Canada due to its relatively small economy. Special attention should instead be paid only to our largest trade partners to harmonize regulations and trade, not the international financial system.

Policy Option C: *Review and Increase market regulation by strengthening the macro-prudential regulations domestically by bringing together all regulatory agencies under OSFI. Using Canada's relative financial institutional stability through the crisis as a launching point, take a leadership role in setting the agenda for global uniform macro-prudential regulations. (Proactive).*

Conduct an in-depth analysis of all macro-prudential regulations in Canada, including: 1) formation of a national securities regulator, 2) a regulator to standardize credit rating agencies, and 3) generally intensify the supervisory review process. In addition to domestic reorganization, Canada will work towards taking a leadership role in addressing macroeconomic structural issues through the G8, G20 and United Nations by translating and leveraging Canadian successes to date.

POLICY ANALYSIS, COMPARISIONS AND COMPLICATIONS

"From the standpoint of economic policymakers, the crisis has highlighted the need to bring private financial markets and institutions under tighter regulation"[15]. There has been a trend towards increasing government oversight by removing private business oversight and self regulation from the financial sector. Government oversight in the realm of macro prudential regulations requires significant organizational changes to the existing network of agencies and bodies. Explained broadly, the work of Canadian financial stability can be broken down into regulating and supervision. With proper policies, the macro structural failures that lead to the current crisis can be addressed by expanding the regulatory and supervisory frameworks. As the major office dealing with these functions, the Office of Superintendent of Financial Institutions (OSFI) is best equipped to bring together all domestic financial supervisors and banks. Despite the expansive applicability of OSFI, macro prudential policies still end up involving markets and institutions that exist outside of its purview. Significant reorientation in mandates and organizational direction is required to bring together regulatory agencies under OSFI's mandate. This is one of the main administrative obstacles concerning policy option C, which seeks to do just that. It can be argued that there is great potential for conflicting interests between the various regulatory and supervisory bodies

[15] Eric Helleiner. Crisis and the Future of Global Financial Governance. Global Governance. volume 15 (2009), p.1–28

that are proposed to oversee the macro prudential regulations under OSFI. As macro prudential regulations are fundamentally numerous and widespread, it leaves room for tradeoffs and compromises between financial supervisors that may ultimately weaken the integrity of the very system we are trying to manage with these regulations.

By far, the largest and most debated issue in regulation of the financial sector in Canada has been that of a national securities commission. Unlike most states, Canada's securities regulation is fragmented and falls under Provincial and Territorial jurisdictions. The issue of streamlining securities regulators is at the very heart of Canadian financial reform and no macro prudential regulatory framework can ignore the current fragmented administration of securities. There are many constitutional and political hurdles ahead due to Quèbec's refusal to partake in any initiative that looks at bringing all Canadian securities regulator under one umbrella. Ontario is the only province that has supported the attempts of the Federal government to bring all regulators under one roof due to the province's size and significance to the Canadian financial markets. The issue of a national securities regulator is further complicated when the currently unregulated credit rating agencies are added to the equation. There is a dire need for an overarching body that regulates and standardizes all credit rating agencies in Canada. This is essential to eliminate subjectivity, errors and consumer confusion that leads to a loss of confidence in the long term values of securities and assets and consequently causes a net increase in macroeconomic volatility. The bringing together of an informal securities commission or a national regulator that regulates securities as well as rating agencies will be a strong step in this direction. Regardless of who takes responsibility for credit rating agencies, it is highly improbable that any progress can be made towards sound macro prudential regulations without oversight and standardization of the credit rating agencies.

In direct contrast to the constructive and proactive approaches of policy options B and C, it has been argued that the Canadian financial system has exhibited resilience throughout the credit crisis and that Canadian banks are therefore risk averse. By extension, it can be further argued that the case for any strong macro prudential regulation in Canada is not sound. Despite being in the middle of an economic meltdown in the fall of 2008, the Canadian banking sector was ranked by the World Economic Forum as the soundest in the world, ahead of Sweden, Switzerland and Luxembourg, the traditional leaders in the Banking sector[16]. Canadian banks are therefore known to be stable, profitable, well-capitalized, and well-positioned to withstand macro economic shocks. Historically, the regulatory framework for Canada's financial sector has been more responsive and more prudent, with the excessive regulations being blamed for making Canadian banks uncompetitive in the global market. Advocates of free markets, over the years have been forced to recognize that tighter regulations are indeed required as a safety net when markets do occasionally fail. Moreover, on the more technocratic side, there is no guarantee that standardizing existing regulation and spreading them without gaps across institutions and jurisdictions will help reduce the propensity of future crisis to occur. Everyone selling and buying assets at the same time, i.e. homogenous behaviour is the reason for systematic weakness in the market. Encouraging standardization of existing rules across provinces (domestic), continents and international markets (international) will make the financial system more prone to failures. The cyclical nature of economic cycles and the

[16] Reuters - US. Canada rated world's soundest bank system: survey. World Economic Forum Global Competitiveness Report 2008-2009.

propensity for economies to move in sync during periods of slow and negative growth will contribute and expose the domestic financial system to external stimuli due to highly standardized global systems. It is well documented that invariably, market participants start off being heterogeneous but varying factors in the long run drive them to homogeneity"[17]. It is with this sentiment that the World Bank Group in consult with the International Finance Corporation denounced increased regulation as the answer. The report instead states that "the solution to the crisis is not more regulation; instead, it is better regulation—in particular, regulation with a greater macro prudential orientation". Although policy option A is feasible to execute, politically it is impossible for any government (minority or majority) to appear to be taking the macroeconomic condition and swings of the nation lightly. Unemployment and government bail outs effectively ensure that "taxpayers simply would not accept the allocation of such large sums of public money without guarantees that financial institutions will be regulated more tightly"[18]. The political unfeasibility of this option despite its legislative feasibility makes it very unattractive and highly controversial to execute.

As Canada has been repeatedly acknowledged as having one of the best banking systems in the world, the Canadian Office of the Superintendent of Financial Institutions (OSFI) is further recognized as an international model for prudential regulators and receives many requests to address conferences and events"[19]. In response, the superintendent and other senior OSFI officials deliver presentations to industry and regulatory forums across Canada and the world[20]. Canada has to have its banking and financial sector fully organized before

[17] Global Finance in Crisis: The politics of International Regulatory Change. Warwick studies in globalization. Copyright 2009..
[18] Eric Helleiner. Crisis and the Future of Global Financial Governance. Global Governance. volume 15 (2009), p.1–28
[19] Office of the Superintendent of Financial Institutions. Copyright 2010.
[20] Office of the Superintendent of Financial Institutions. Copyright 2010.

it can be a global leader in influencing international regulations. Due to the relatively smaller Canadian economy, Canada has a very limited number of policy areas it is able to influence globally. Using macro prudential regulations as a platform for global economic leadership will ensure Canada gets a stronger voice in future economic policy formulations that suit its best interests. Furthermore, due to active involvement in the regulation formulation process and having already done most of the housekeeping work in the domestic sphere, the compliance and adjustment costs to realign Canadian standards with international standards will be significantly lower than for other OECD states. This benefits domestic trade and increases the resilience of the Canadian economy. The success of options B and C depends on the time variable, as the ability to actively participate globally is hindered by the speed with which Canada is able to organize its regulatory and supervisory bodies. Creation of new bodies that address accounting standards, compensations and credit rating agencies and financial instruments like hedge funds within Canada is critical for success on the international front. Canada has been actively participating in G8 and G20 meetings and can continue to do so without much leadership if it so chooses to. With 90%+ of Canadian exports ending up in the United States and Japan, it makes sense for Canada to focus on only these economies to ensure flow of capital and international compliance. Leadership in the international arena can take up significant resources and targeted allocation of these resources maybe a better strategy. This is especially true in the short run. Conversely, taking a leadership role internationally in the regulation of global financial markets can create a tertiary market of Canadian experts that can work towards increased compliance with Made-in-Canada macro prudential rules, further reasserting Canadian dominance in this financial niche.

The brief policy analysis presented here is by no means exhaustive and the list of potential approaches to macro prudential regulations is literally endless. What is of critical importance is the need to define and hammer out a strategy and administrative approach that will structurally outline the Canadian position domestically and internationally to maximize efficiency and the potential benefits of an active involvement. After all, it was this active involvement that led Canada to have a stable and structured banking and financial sector to wither the recent surge of economic collapses seen globally.

RECOMMENDED POLICY OPTION

Regardless of policy measures, the fact that our global economy is in need for tweaking goes without saying. The question regarding what aspects of the system require work has become a subject of enormous controversy[21]. Despite the disagreements, one policy area in which there is broad consensus is the area of increased macro-prudential regulations. With the above broad analysis in mind, it is hereby recommended that Canada should pursue policy option C that sees Canada increase, tighten and develop better domestic macro-prudential regulations to address systematic long term structural problems by bringing the major stakeholders together under the authority of the Office of the Superintendent of Financial Services. Under this option, Canada will be able to build and improve on the existing stable financial and banking infrastructure by incorporating other actors that were traditionally unregulated and unaccounted for in the macro prudential framework (hedge funds, credit ratings agencies, etc). On the international front, the Department of Finance should mobilize staff and translate past performance, sound current economic policies and relative success throughout the crisis into a global voice of authority. Taking a leadership

[21] United Nations. Report of the Commission of Experts of the President of the United Nations General Assembly on Reforms of the International Monetary and Financial System. Copyright 2009. New York. page 8.

role will allow Canada to leverage its economy, give it stronger voice in future economic policy formulations and strengthen diplomatic and economic ties with key industrialized states. Option C marries the public and private desire for immediate action to protect the global financial system vis-à-vis macro-level regulations and the sector specific need for development and compliance with international financial regulations. This strategy reduces overall compliance costs and gives Canada a much needed edge in the global financial markets.

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Attachment/Enclosure: G-20 Commitments on Regulatory Reform

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Attachment/Enclosure: G-20 Commitments on Regulatory Reform

Box 1 G-20 commitments on regulatory reform

Gathered in London in April 2009, G-20 leaders committed to the following main regulatory measures in their Declaration on Strengthening the Financial System.

Financial Stability Board

- Establish, as a successor to the Financial Stability Forum (FSF), a new Financial Stability Board with greater capacity, expanded participation, and a stronger mandate for promoting financial stability

International cooperation

- Complete the creation of supervisory colleges for significant cross-border firms in 2009
- Implement the FSF principles for cross-border crisis management
- Support efforts to develop an international framework for cross-border bank resolution

Prudential regulation

- Maintain current international standards for minimum capital levels until recovery is assured, but then strengthen them
- Once recovery is assured, increase buffers above regulatory minimums, enhance the quality of capital, and develop guidelines for the harmonization of the definition of capital and for minimum capital levels internationally
- Implement recommendations to mitigate procyclicality, including anticyclical buffers
- Supplement risk-based capital requirements with an appropriate leverage ratio
- Improve incentives for risk management of securitization
- Progressively adopt the Basel II capital framework in all G-20 countries
- Develop a global framework for promoting stronger liquidity buffers at financial institutions

Scope of regulation

- Amend regulatory systems for macro-prudential risks and develop suitable tools for controlling such risks
- Ensure that national regulators are able to gather relevant information on all material financial institutions, markets, and instruments to assess systemic risk
- Produce guidelines for assessing whether a financial institution, market, or instrument is systemically important
- Require that hedge funds be registered and subject to oversight, including through disclosure to supervisors
- Require that institutions with hedge funds as counterparties have effective risk management
- Establish central clearing counterparties for credit derivatives that are subject to regulation
- Regularly review boundaries of the regulatory framework and promote good international practices

Compensation

- Endorse and ensure significant progress in implementing the FSF principles on pay and compensation in significant financial institutions by the 2009 remuneration round
- Require supervisors to monitor firms' compensation policies and intervene where necessary

Tax havens and noncooperative jurisdictions

- Encourage all jurisdictions to adhere to international standards on combating tax evasion, money laundering, and terrorist financing
- Develop a toolbox of effective countermeasures for noncooperative jurisdictions

Accounting standards

- Reduce the complexity of standards for financial instruments and improve standards for provisioning, off-balance-sheet exposures, and valuation uncertainty
- Strengthen accounting recognition of loan loss provisions by including more credit information
- Achieve clarity and consistency in the application of valuation standards internationally
- Make progress toward a single set of global accounting standards
- Improve the involvement of stakeholders in the process of setting accounting standards

Credit rating agencies

- Subject all credit rating agencies whose ratings are used for regulatory purposes to oversight that includes registration and is consistent with the International Organization of Securities Commissions (IOSCO) Code of Conduct Fundamentals
- Ensure that national authorities enforce compliance by credit rating agencies and require changes to their practices when needed
- Require that credit rating agencies differentiate ratings for structured products and provide full disclosure of their ratings track record and the information and assumptions underpinning the rating process
- Review the role of external ratings in prudential regulation and address any adverse incentives

Source: The World Bank Group. Crisis Response: Public Policy for the Private Sector. The Reform Agenda - Charting the future of financial regulation. Note 2. Published June 2009.