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## Regulatory Reform in Response to the Global Financial Turmoil: Finding the Middle Road Between Over-reaction and Complacency

By A. Michael Andrews

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# Regulatory Reform in Response to the Global Financial Turmoil: Finding the Middle Road Between Over-reaction and Complacency

By A. Michael Andrews

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International Proposals for Financial Regulatory Reform .....	4
The Crisis of 2007 – Causes and Chronology .....	5
Lessons from the Crisis.....	10
Global Response .....	13
International Consensus and Divergence .....	18
Outlook .....	21

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# International Proposals for Financial Regulatory Reform

As the global financial turmoil enters its third year, consensus has emerged around specific shortcomings in the international architecture for financial sector oversight that contributed to or exacerbated the crisis. In response, reform proposals have been developed in international forums. Implementation of these reforms is dependent on national authorities implementing change within individual countries as well as through multi-lateral agreements and international institutions.

One of the risks for Canada is that the financial crisis may not provide the same sense of urgency for reform prevalent elsewhere. Canada has been internationally hailed as a success story for the resiliency of its banking system — one of the few developed countries that has not had to provide government capital or guarantees to support the banking system. The higher capital levels required for Canadian banks and more conservative approaches to innovative financial products are now cited as models for revised approaches to bank supervision.

The crisis highlighted some fundamental weaknesses in the Canadian approach, even if the pillars of the financial system have stood up well. Despite not having been severely impacted by some of the shortcomings international reforms are intended to address, there is an opportunity to learn from the experience and introduce pre-emptive reforms.

It is equally important to avoid ill-considered reforms in a rush to regulate away the causes of the last crisis. Prescriptive and intrusive requirements may fail to address the true problems. The Sarbanes-Oxley Act implemented following the Enron collapse illustrates the dangers of a reactionary response increasing the regulatory burden without corresponding fundamental improvements in the regime.

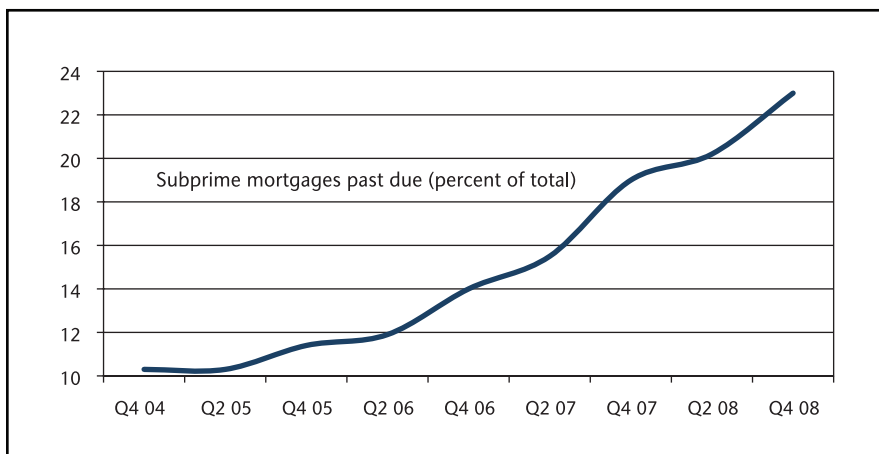
The next section of this paper outlines the causes and chronology of the current crisis, and is followed by a summary of the lessons derived to date about shortcomings in the national and international architecture for financial sector oversight. This is followed by a discussion of the global response and specific national proposals for reform and an assessment of areas of consensus and divergence. The paper concludes with a brief overview of likely future developments in financial regulatory reform.

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## The Crisis of 2007 — Causes and Chronology

The proximate cause of the global financial turmoil was the deterioration of the U.S. sub-prime mortgage market in 2007. Delinquencies had been increasing since 2005 with the rate of growth accelerating sharply in 2007, reaching 15 percent by mid-year (Figure 1). Unlike previous episodes of credit-quality problems such as the savings and loan crisis of the 1980s and early 1990s, much of the initial impact was felt by non-banks. The prevalence of the originate and distribute model<sup>1</sup> meant that most of the credit risk was borne by the non-bank purchasers of mortgage-backed securities or more exotic structured financial products derived from pools of underlying assets.

**Figure 1 – Rising U.S. Mortgage Delinquency**



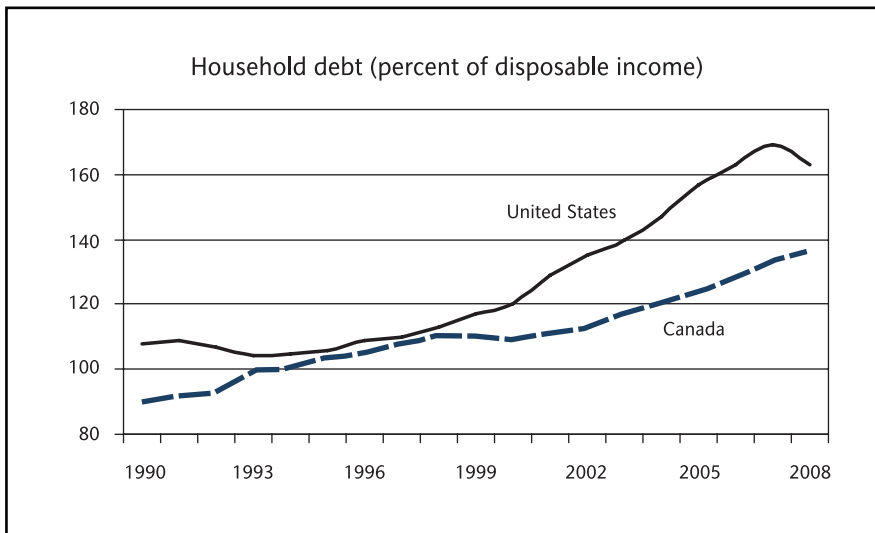
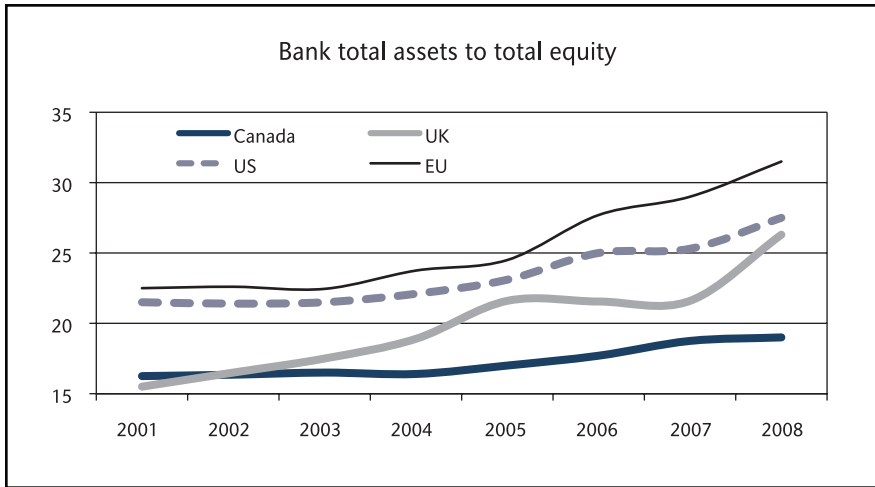
Source: Mortgage Bankers Association.

Contagion from collapse of the U.S. sub-prime market brought to light the fundamental causes of the crisis. Banks, other financial institutions and individual consumers had become highly levered over an unprecedented period of economic expansion (Figure 2), with rising asset prices hiding weak risk management. Banks and their supervisors had paid insufficient attention to liquidity risk when liquidity was plentiful, and were ill-prepared for a serious market disruption. The risk-mitigation effects of credit-default swaps were undermined by the concentration of risk in a handful of counterparties underwriting the swaps, most notably the American International Group (AIG).

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<sup>1</sup> In traditional intermediation, banks raise deposits to fund loans which are held by the bank until maturity. In the originate and distribute model, banks do not hold the loans to maturity, but sell them, typically through a special investment vehicle (SIV) or conduit, to investors who purchase securities derived from the underlying loan assets. The banks use the proceeds of the sale of the loans to fund more lending.

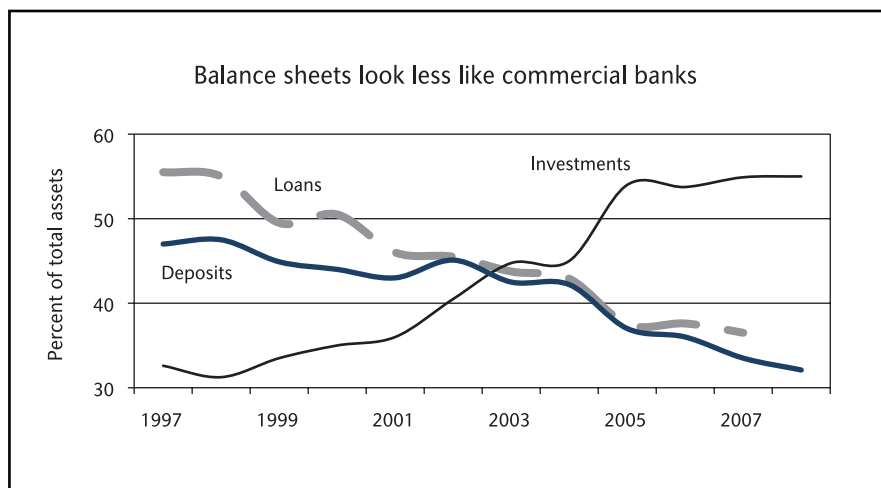
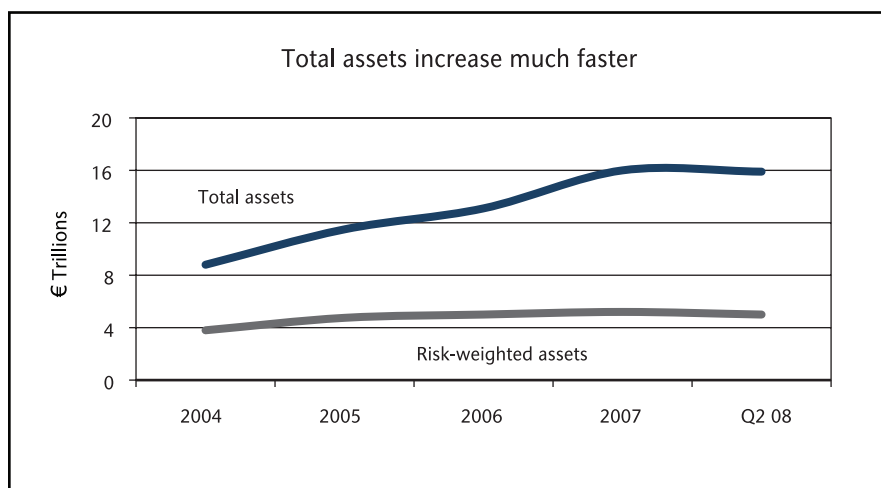
**Figure 2 – Increasing Leverage**



Note: Canada, six large banks; U.K., six large banks; EU, seven large banks; U.S., five large commercial banks.  
 Sources: Top panel, Export Development Corporation, Bloomberg, financial statements;  
 Bottom panel, Bank of Canada Financial System Review.

Capital requirements, especially for securitized assets, were too low. European banks in particular had taken advantage of lower capital requirements for “trading book” assets — securities purchased and available for resale, relative to “banking book” assets — loans and investments intended to be held to maturity. Because of the lower risk-weighting for trading book assets, the same capital base could support a larger bank as investments displaced traditional loans in bank portfolios (Figure 3, top panel). Many large commercial banks came to resemble merchant or investment banks, relying less on deposit-funding as they securitized more assets, with investments increasingly displacing loans on their balance sheets (Figure 3, bottom panel).

**Figure 3 – Transformation of Large Commercial Banks**



Bank of America, Citigroup, Hong Kong and Shanghai Banking Corporation, Societe Generale, BNP Paribas, Barclays, Credit Agricole, Royal Bank of Scotland, Union Bank of Switzerland, Deutsche Bank.  
Sources: Thomson Financial, International Monetary Fund.

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Canadian banks are constrained by a leverage ratio — assets can total no more than 20 times regulatory capital — in addition to the risk-weighted capital adequacy requirement applicable in Europe. Thus, one of the key incentives for the “originate and distribute” model of banking — the ability to increase leverage and thus the return on equity — had much less impact in Canada because of the leverage limit. Canadian banks retained a more traditional bank profile with lower leverage and a strong retail deposit base and continued to hold a majority of loans on their books.

While there was a tendency at the early stages of the unfolding crisis to view it as an American phenomenon, the scope of exposure started to become apparent in late June and early July 2007. Hedge funds, including some in Europe and Australia, announced losses and began to freeze redemptions. In mid-July there were ratings agency downgrades of some sub-prime mortgage backed securities and related collateralized debt obligations. In August BNP Paribas suspended withdrawals from funds that had invested in U.S. sub-prime related debt, and many large European banks revealed significant exposure to toxic U.S. assets.

Some investors, particularly highly leveraged hedge funds, had been using asset-backed securities as collateral for further borrowing. As the value of the securities fell, the hedge funds were required to provide additional collateral or repay the loans — a classic margin call. Seeing the risk of further losses as funds had to sell at fire-sale prices, investors ran for the exits, putting prices and liquidity into a downward spiral. Runs began on Northern Rock, the U.K. mortgage bank, and IndyMac, a large U.S. bank, was placed in receivership.

The contagion continued in August and September 2007, with investor concern spreading from mortgage-backed securities to asset-backed commercial paper (ABCP) more broadly. The conduits or special investment vehicles (SIVs) used to package the underlying assets and sell the commercial paper were unable to roll over their maturing securities. In order to redeem maturing securities, conduits began to draw on standby liquidity facilities provided by banks. Banks in Europe and the U.S. were suddenly themselves squeezed for liquidity when required to lend to the SIVs at the same time wholesale financial markets were drying up.

The situation in Canada was somewhat different as Canadian banks were not committed to fund the standby credit facilities of ABCP conduits in the event of severe market disruption. Even with this less committed form of standby liquidity Dominion Bond Rating Service rated many of the issues “A” or higher. In mid-August 2007 the issuing conduits were unable to roll-over their maturing securities, and were unable to tap bank credit to repay maturing issues. For reputational risk reasons, some Canadian banks took back on their own balance sheets securities issued by related SIVs, but about \$32 billion of non-bank ABCP remained frozen and subject to a lengthy work-out process.<sup>2</sup>

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<sup>2</sup> See John Chant, 2008, “The ABCP Crisis in Canada: The Implications for the Regulation of Financial Markets” available at <http://www.expertpanel.ca/eng/reports/research-studies/index.html>

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Losses in global markets accelerated through the fall of 2008 leading to government interventions to support major institutions. Key developments in September included:

- U.S. government takeover of Fannie Mae and Freddie Mac
- Merrill Lynch sold to Bank of America
- Bankruptcy of Lehman Brothers
- Credit downgrade of AIG triggering a U.S. government rescue
- Collapse of Washington Mutual — a large U.S. savings bank; Bradford & Bingley — a U.K. building society; and the Icelandic banking system
- Government intervention in Fortis, a major European bank-insurance conglomerate

As losses continued and liquidity disappeared in October, the U.S. government announced the Troubled Asset Relief Program (TARP). The U.K. provided government support for three of the largest banks — Royal Bank of Scotland, Halifax Bank of Scotland and Lloyds TSB, and the Netherlands supported the ING Group.

The Bank of Canada, in common with central banks around the world, took extraordinary measures to provide liquidity for Canadian institutions. The Bank of Canada routinely provides overnight credit to facilitate the smooth functioning of the clearing and settlement system, with borrowings by institutions secured by the highest quality collateral — government securities. As part of the crisis response, the Bank of Canada expanded the range of acceptable collateral to include other securities and banks' non-mortgage loan portfolios. Longer term liquidity was provided through term Purchase and Resale Agreements (PRAs), whereby the Bank purchased eligible assets from institutions, to be resold to the institution after 28 days rather than the usual overnight term. Additional liquidity was provided through the purchase by Canada Mortgage and Housing Corporation of pools of mortgage loans, and the federal government made available guaranteed borrowing facilities.

Through 2009 liquidity in Canadian and international markets has shown signs of returning to more normal conditions, with central banks contemplating the gradual withdrawal of the extraordinary credit facilities. Losses through the crisis have yet to be tallied, but the most recent estimates by the International Monetary Fund total US\$4 trillion, two-thirds of which will be absorbed by banks, and the balance by other financial institutions and investors.<sup>3</sup>

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<sup>3</sup> *Global Financial Stability Report*, April 2009 (Washington: International Monetary Fund).

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## Lessons from the Crisis

While it may be premature to draw firm conclusions with the crisis not yet over, a consensus has developed around key issues viewed as contributing to the crisis.

- Some important institutions or activities were unregulated or inappropriately regulated in a “shadow banking system.” Examples include hedge funds (unregulated), and the credit default swap business of insurer AIG (subject to insufficient oversight).
- Cross-border coordination has been found lacking, particularly with respect to the supervision and crisis-management response for banks such as Dexia and Fortis with significant operations in multiple European countries.
- Accounting standards, particularly fair value accounting, have been questioned. The process and governance of international standard setting bodies has been criticized as insufficiently responsive to regulatory authorities.
- Credit rating agencies’ approach to structured financial products did not sufficiently highlight the risks.
- Governance of institutions was flawed. Compensation schemes not linked to the overall long-term profitability of the firm have been especially criticized.
- Institutions’ risk management practices and the concomitant supervisory oversight were deficient. Liquidity management policies and practices, and statistical models for valuation and capital allocation based on years of relatively benign market conditions, significantly underestimated volatility and risk in a period of turmoil.
- Capital requirements for banks were too low, particularly for off-balance sheet vehicles and securitized assets.
- Basel II has been criticized as pro-cyclical, with requirements to raise new capital in deteriorating conditions compounding the credit crunch.

There is clear scope to address many of these international issues in the Canadian context. Most needed reforms require refinement or revision of current approaches, but others will require more fundamental change.

The core of a financial regulatory system is protecting consumers and the integrity and stability of financial markets. This basic premise is applied in many different ways around the world because national financial systems have evolved in many different directions. Effective regulatory structures include conduct of business rules to protect investors and promote efficient and transparent capital markets, prudential regulation to address the safety and soundness of institutions, and an overarching focus on financial stability or macro-prudential oversight.

In practice many structures can work provided there is coordination and communication among the regulatory authorities. Market conduct and prudential regulation can be combined in a single

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unified agency, as with the FSA in the United Kingdom, or conducted in separate agencies like the Australian Prudential Regulation Authority and Australian Securities and Investment Commission in the “twin peaks” model. Many countries including the United States retain a sectoral approach, with different regulators for securities firms, banks and insurance companies.

Central banks are usually charged with an overall focus on financial stability — this is the case with the Bank of Canada. The Office of the Superintendent of Financial Institutions (OSFI) is responsible for prudential oversight of deposit-taking institutions and insurance companies and contributing to financial stability through mandating solvency standards. Canada’s 13 securities regulators focus on a single sector in discharging their provincial and territorial mandates.

Regulatory structure alone cannot ensure adequate consumer protection, market integrity and financial stability. There needs to be a mechanism for coordination, information sharing and rapid response among all the financial sector regulators. However, the current fragmented structure for securities regulation in Canada inhibits the achievement of this basic precondition for effective regulation. Each of Canada’s securities regulators necessarily has a provincial or territorial mandate, none of the 13 can speak for Canada internationally, and the Canadian Securities Administrators group does not itself have supervisory authority.

An illustration of the shortcomings of the current structure was the lack of Canadian participation in the September 2008 decision by U.S. and U.K. authorities to suspend short-selling of financial stocks as part of efforts to restore market stability, and the period of one to five days required for the various provincial authorities to respond to this international initiative. A further issue is the lack of a securities counterpart to the federal authorities participating in the Financial Institutions Supervisory Committee (FISC) — chaired by the Superintendent of Financial Institutions, and including the Governor of the Bank of Canada, Deputy Minister of Finance, and heads of the Canada Deposit Insurance Corporation and Financial Consumer Agency of Canada.

The freezing of the ABCP market and difficulty in orchestrating a coordinated response highlights the need for an overarching approach to financial stability, even though Canadian banks are largely emerging from the crisis with their liquidity and capital intact.

The coordinating body for the federal agencies accountable for financial stability — FISC — is chaired by OSFI which is primarily responsible for prudential oversight of individual institutions. Even the committee’s name may have contributed to a focus on the soundness of institutions at the expense of the system overall. The need for a new approach to address systemic risk has been publicly discussed, with suggestions including a new coordination mechanism or changes to the federal mandates and structure for financial sector oversight.<sup>4</sup>

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4 See John Crow, June 2009, “A Bank for All Seasons: The Bank of Canada and the Regulatory Challenge: (CD Howe Institute: Toronto).

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## Canadian Securities Regulators React to International Action

### **September 18, 2008:**

The United States Securities and Exchange Commission (SEC), acting in concert with the U.K. Financial Services Authority (FSA), took temporary emergency action to protect the integrity of the securities market and strengthen investor confidence. The SEC issued an emergency order halting short-selling in financial stocks. (SEC Release No. 34-58592)

### **September 19, 2008:**

*Morning:* "The Commission notes the similar announcement by the U.K. FSA. The SEC and FSA are consulting on an ongoing basis with regard to short selling matters and will continue to cooperate in carrying out regulatory actions" (SEC press release)

*Late Afternoon:* "The Ontario Securities Commission (OSC) banned short selling of securities of certain financial sector issuers that are listed on the Toronto Stock Exchange (TSX) and are also interlisted in the United States" (OSC Press Release)

*Evening:* "The CSA is supportive of the action taken by the OSC today...jurisdictions in the CSA will be taking similar action today, or in the coming days." (Canadian Securities Administrators Press Release)

### **September 22, 2008:**

"A decision temporarily prohibiting the short-selling of securities of 13 financial-sector issuers was issued today by the New Brunswick Securities Commission (NBSC)." (NBSC Press Release)

### **September 23, 2008:**

"At the request of the Autorité des marchés financiers (AMF), the Bureau de décision et de révision en valeurs mobilières (BDRVM) today issued an amended temporary order prohibiting short selling of securities of certain financial sector issuers that are listed on the Toronto Stock Exchange (TSX) and are also interlisted in the United States" (AMF Press Release)

"On September 23, 2008 the Director of the Commission's Securities Division issued a temporary order under section 134 of The Securities Act, 1988 prohibiting the short selling of the securities of specified financial sector issuers." (Saskatchewan Financial Services Commission Notice)

### **September 24, 2008:**

"The Alberta Securities Commission (ASC) has issued an amended order under the Securities Act (Alberta) temporarily prohibiting short selling of securities of certain financial sector securities listed on the Toronto Stock Exchange" (ASC Press Release)

Major structural change to Canada's regulatory framework, with the exception of the inclusion of a national securities authority, is not required. With the addition of a national securities authority, FISC brings the right counterparts to the table. The Bank of Canada already has a mandate for financial stability, reflected in part in its publication since 2002 of a semi-annual *Financial System Review*. However, FSIC should be recast and renamed, with a mandate for overall financial stability and chaired by the Bank of Canada. The role of coordination would continue, but the leadership of the Bank of Canada would emphasize the importance of macro-prudential oversight.

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## Global Response

Policy-makers around the world have considered how approaches to financial sector oversight could be improved to address these identified weaknesses. Many of the initial reform proposals were developed in international forums. This reflects in part calls for increased international coordination, recognition that some key recommendations cannot be implemented by individual country authorities, and that some of the hardest hit countries necessarily had to dedicate most of their initial response to stabilization and crisis management. Ultimately, individual country responses will be a combination of measures to implement internationally agreed recommendations and efforts to address specific domestic concerns.

The international response to the global turmoil began in October 2007, when the G7 countries tasked the Financial Stability Forum (FSF)<sup>5</sup> with preparing recommendations for increasing the resilience of institutions and markets. The FSF responded with an initial report in April 2008, with updates and further recommendations provided in October 2008 and April 2009. The FSF recommendations focus on improvements to the existing international architecture, and do not address regulatory structure or expanding the scope of regulation.

The response to the financial crisis became entwined with previous discussions of the role of the non-G7 countries in the international financial architecture, particularly the governance of international financial institutions such as the International Monetary Fund (IMF). The G7 commissioned work by the FSF is now proceeding in parallel with a workplan directed by the G20 countries. While the FSF response has generally been less prescriptive than the proposals from the G20 and European Union (EU), some of the more recent FSF recommendations, for example on compensation schemes, have moved in more prescriptive directions.

The G20 Declaration of the Summit on Financial Markets and the World Economy, November 15, 2008, endorsed common principles for reform and adopted an action plan. Four working groups were established to further review and make recommendations on:

- enhancing sound regulation and strengthening transparency (co-chaired by Canada);
- reinforcing international cooperation and promoting integrity in financial markets;
- reforming the IMF; and,
- reviewing the role of the World Bank and other multilateral development banks.

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<sup>5</sup> The Financial Stability Forum brings together senior representatives of central banks, supervisory authorities and finance departments, international financial institutions, international regulatory and supervisory groupings, committees of central bank experts and the European Central Bank. It will be renamed the Financial Stability Board and have its membership expanded to include all G20 countries as part of the international response to the crisis.

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The working groups released their recommendations in advance of the April 2009 G20 meeting.<sup>6</sup> Many of the specific proposals such as expanding the scope of regulation, and oversight of credit rating agencies are generally consistent with the prescriptive EU recommendations.

The EU released in February 2009 the recommendations of a review committee for reform of financial sector supervision.<sup>7</sup> These include creation of a more centralized approach to systemic risk and financial supervision. National authorities would continue day-to-day supervision, but within a framework including pan-European supervisory authorities in place of the current coordinating committees for supervision of banks, securities firms, pensions and insurance companies.

Other recommendations of the EU committee include expanding the boundaries of regulation to include all systemically important institutions, more prescriptive risk-management rules, and an expanded role for the IMF. These proposals will be subject to extensive debate within the EU and may not be wholly endorsed by all member countries. However, the underlying philosophy of more intrusive regulation has been broadly reflected in the recommendations of the G20.

The Basel Committee on Banking Supervision (BCBS), the international standard-setter for oversight of banking systems, has made a number of specific responses to the G7 and G20 initiatives. These include the expansion of its membership,<sup>8</sup> enhanced guidance on management and supervisory oversight of liquidity risk, revisions to the Basel Capital Accord to require higher capital for securitized and other off-balance sheet assets, and initiation of a review of the Basel II capital adequacy framework with a view to further strengthening capital levels. All Basel standards have to be implemented by national authorities — the BCBS itself has no regulatory or supervisory role.

The IMF, also taking its cue from the G7 and G20, has recommended an expanded and more flexible perimeter for regulation, with sufficient disclosure to determine the systemic importance of institutions which would then lead to an appropriate degree of oversight. Approaches to regulation and compensation are advocated that would mitigate pro-cyclicality, promote robust accounting rules, and increase transparency about the nature and location of risk to foster market discipline.<sup>9</sup>

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6 G20 Working Group 1: Enhancing Sound Regulation and Strengthening Transparency, *Final Report*, March 25, 2009. G20 Working Group on Reinforcing International Cooperation and Promoting Integrity in Financial Markets, *Final Report*, March 27, 2009. G20 Working Group 3, Reform of the IMF, *Final Report*, March 3, 2009. G20 Working Group 4: The World Bank and Other Multilateral Development Banks, *Final Report*, March 2009.

7 Report of *The High-Level Group on Financial Supervision in the EU*, February 25, 2009.

8 Current Basel Committee members are Belgium, Canada, France, Germany, Italy, Japan, Luxembourg, the Netherlands, Spain, Sweden, Switzerland, the United Kingdom and the United States. In March 2009 invitations to join were extended to Australia, Brazil, China, India, Korea, Mexico and Russia.

9 *Initial Lesson of the Crisis*, February 6, 2009 (Washington: International Monetary Fund).

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Numerous specific recommendations for regulatory reform in the United Kingdom were proposed in the March 2009 report of Lord Turner, chair of the FSA. These include a reconsideration of the FSA's "light" regulatory touch in favour of a more intrusive approach as well as a call for expanded powers by the FSA to oversee the non-U.K. operations of institutions with a substantial presence in the U.K. Enhanced FSA oversight of non-U.K. operations may conflict with EU proposals for a European authority, and may also be challenging to integrate into the "colleges of supervisors" being established for all internationally active institutions. Many of the U.K. proposals are similar to current international and European proposals:

- Adoption of a macro-prudential approach, focusing on systemic stability as well as individual institutions
- Strengthened capital adequacy requirements, building counter-cyclical capital buffers and use of a leverage ratio in addition to risk-weighted capital adequacy requirements
- Enhanced risk management standards
- Registration and supervision of credit ratings agencies

Other proposals address specific U.K. concerns, such as reform of deposit insurance in light of the experience with Northern Rock.

Most other European countries are likely to defer any substantive proposals until greater clarity and consensus develops around the EU proposals, although Ireland has announced that changes to its regulatory structure are forthcoming to create a new central banking commission to combine responsibility for prudential oversight and financial stability.

Following earlier U.S. proposals that did not gain traction,<sup>10</sup> the Obama administration released on March 26, 2009, a framework for regulatory reform which was followed in June by more detailed proposals. While many of the recommendations deal with issues of structure and policy unique to the United States, many others reflect the emerging international consensus around key elements of regulatory reform. These include:

- Adoption of a macro-prudential mandate for the Federal Reserve
- Expanding the regulatory perimeter to include all systemically important institutions, including registration of hedge fund advisors with the SEC
- Strengthened capital adequacy requirements
- Regulation of credit rating agencies
- Comprehensive regulation of over-the-counter (OTC) derivatives

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<sup>10</sup> The U.S. Treasury *Blueprint for A Modernized Financial Regulatory Structure* released in March 2008 focused on rationalizing and addressing the gaps in the complex U.S. domestic regulatory structure, but no progress was made in the final months of the Bush administration. A January 2009 report by the U.S. Government Accountability Office *A Framework for Crafting and Assessing Proposals to Modernize the Outdated U.S. Financial Regulatory System* focused on broad principles, but provides few specific recommendations.

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## U.S. Proposals for Financial Regulatory Reform

Proposals for reform of the U.S. regulatory system were released by the Obama administration in June 2009.

The recommendations are intended to meet five objectives:

- 1) Promote robust supervision of regulation of financial firms
  - Create a new Financial Services Oversight Council of regulators to identify emerging systemic risks and improve interagency cooperation
  - Authority for the Federal Reserve to supervise all systemically important institutions
  - Strengthened capital and other prudential standards, especially for large institutions
  - A new National Bank Supervisor for all federally chartered banks
  - Elimination of the federal thrift charter and other provisions which allowed some bank holding companies to avoid oversight by the Federal Reserve
  - Registration with the Securities and Exchange Commission of advisers of hedge funds and other private pools of capital
- 2) Establish comprehensive supervision of financial markets
  - Enhanced regulation of securitizations, including improved market transparency, regulation of credit rating agencies and a requirement for originators to retain a significant financial interest in securitized assets
  - Comprehensive regulation of over-the-counter derivatives
  - New authority for oversight by the Federal Reserve of clearing, payment and settlement systems
- 3) Protect consumers and investors from financial abuse
  - New Consumer Financial Protection Agency
  - Stronger regulations on transparency, fairness and appropriateness, applied in a uniform manner to bank and non-bank products and services
- 4) Provide government with the tools to manage financial crises
  - New regime for resolution of systemically important non-bank financial institutions
  - Improved accountability for the Federal Reserve's emergency lending authority
- 5) Raise international standards and improve international cooperation
  - Strengthening capital standards
  - Improving oversight of global markets
  - Coordinating supervision of international firms
  - Enhancing international crisis management

Source: Department of the Treasury, June 2009, *Financial Regulatory Reform: A New Foundation* (Washington).

Some of the U.S. recommendations have specific relevance for Canada. The proposal to create an Office of National Insurance is an attempt to deal with weaknesses in U.S. insurance oversight that has strong parallels with securities regulation in Canada. As with Canadian securities regulation, there is currently no single U.S. authority with responsibility for national insurance markets. This means there is no U.S. federal head of insurance oversight to identify and supervise systemically important insurance companies and coordinate with other federal agencies and international counterparts in routine supervision and crisis management. Recent events have highlighted the shortcomings of state supervision of national and increasingly international insurance markets.

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The crisis highlighted similar shortcomings in Canadian securities regulation. Canada's unique status as the only Financial Stability Forum member country without a national securities regulator will come under increasing international scrutiny as jurisdictions around the world implement the recommendations to establish more robust and cross-cutting arrangements for dealing with stress in financial markets.

U.S. proposals include the establishment of a new coordinating council of regulatory authorities and to give the Federal Reserve a mandate for macro-prudential oversight. The needed reforms are not so far reaching in Canada, however, there is a clear need to include the head of the proposed new federal securities regulator in FISC. Also, recasting FISC with a new name and clear mandate for macro-prudential oversight under the chairmanship of the Bank of Canada would parallel the proposed explicit financial stability mandate for the Federal Reserve.

The U.S. and other international recommendations for regulation of OTC derivatives highlight the divergent approaches in Canada. Alberta and British Columbia regulate derivatives directly through securities legislation. In Ontario and Manitoba exchange-traded derivatives are governed by separate commodity futures legislation, with some uncertainty about the application of securities legislation to OTC derivatives. The recently passed Quebec Derivatives Act regulates exchange-traded and OTC derivatives, but the legislation is not yet in force and the rules which will determine the specific application have not yet been published. Clearly, introducing a single consistent approach to OTC derivatives in line with the proposals being adopted in the U.S. and around the world in response to the crisis, should be an early priority of the new federal securities regulator.

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## International Consensus And Divergence

Recommendations for reform of financial sector regulation can conceptually be placed on a continuum from tweaking or enhancing the existing structure on the one hand, to major revisions to the international architecture and national approaches to regulation and supervision on the other. The recommendations of the EU high level committee are the furthest to date towards major revisions, although all proposals contain at least some elements of significant change in regulatory structure and approach. Discussion and debate over the coming months will be crucial in reaching consensus in a number of controversial areas.

### **Regulatory Structure**

There is broad agreement on the need for regulatory structures without gaps or overlaps, avoidance of regulatory arbitrage, and improved coordination among the domestic authorities with responsibilities for different sectors or functions, and internationally. No regulatory structure is perfect, whether an FSA-style unified regulator, the “twin peaks” of prudential and market conduct regulation found in Australia, or the sectoral approach of the United States. The most far-reaching proposals to date are to establish pan-European authorities in a new more centralized approach to macro-prudential oversight and systemic risk. The EU proposals also include an enhanced role for the IMF in developing a financial stability early warning system, and taking action to police implementation of international standards. This is likely to be strongly opposed by the U.S., and may not be fully supported by all EU members, but an enhanced role for the IMF has been endorsed by the G20.

One of the lessons from the global financial turmoil is the need to focus on the soundness and stability of the overall financial sector. Supervisory authorities’ traditional focus on individual institutions may not identify the build-up of aggregate risks. Functional oversight, for instance of the banking sector, will not capture the risks outside the banking sector. The crisis has made it clear that Canada requires one major structural change — establishment of a national securities regulator — and some revision to the existing mechanisms for coordination to ensure an adequate focus on macro-prudential oversight and systemic risk.

### **Boundaries of Regulation**

There is broad consensus around the need to ensure all systemically important institutions are subject to appropriate oversight. It is less clear how systemic importance will be determined, and what constitutes appropriate oversight in specific circumstances. When specific national proposals are developed they are likely to err on the side of over-inclusion and over-regulation given the fallout attributed in the current crisis to the role of hedge funds and over-the-counter derivatives.

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There has been little direct fall-out in Canada attributed to unregulated entities. Nevertheless, FISC, when reconstituted with a macro-prudential mandate, should focus on ensuring that all significant risks and vulnerabilities are identified and monitored on an ongoing basis. Pursuant to its financial stability mandate, the Bank of Canada would take a lead role in this analysis, particularly when risks lie outside of the responsibilities of the functional authorities — OSFI and the new federal securities regulator.

### **Accounting Standards**

Most proposals address the process of standard-setting as well as calling for a review of specific standards. Both the G20 and EU have called for enhanced accountability of the IASB through a board more independent of the accounting profession and greater involvement by regulators and the private sector in the standard-setting process. These proposals support the view that Canada requires a streamlined and accountable structure for standard-setting and oversight.

The EU proposals for a wider review of mark-to-market accounting are the most far-reaching to date. Other proposals have focused on specific accounting standards issues such as the need for enhanced guidance on valuation and disclosure, and accounting for off-balance sheet vehicles and complex products. There is consensus on the need for international convergence of accounting standards, although it is unclear how this might be achieved.

### **Credit Rating Agencies**

There is consensus that ratings agencies should clearly differentiate ratings of structured products from their ratings of more straightforward debt. There is also wide-spread concern about the bias of a business model wherein the issuer pays for the rating. While earlier G20 and FSF proposals left open the possibility of voluntary compliance by ratings agencies with the International Organization of Securities Commissions (IOSCO) standards, there now appears to be an emerging consensus in the G20 that credit ratings agencies should be subject to formal regulatory oversight, although the details of an appropriate regime are yet to be agreed upon. Canadian proposals have yet to be developed, but given the international consensus, appear inevitable.

### **Compensation**

Financial institutions' compensation schemes have been singled out among other concerns about governance. This is at least partly attributable to public outcry over the large bonuses paid to executives of failing institutions. There is consensus on the need to ensure that compensation schemes do not reward excessive short-term returns or risk-taking at the expense of the longer-term soundness of the institution. The EU proposals include supervisory oversight of the suitability of compensation schemes. Earlier proposals focused more on voluntary efforts by financial institutions, but the FSF and G20 now recommend supervisory assessment of compensation

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schemes as part of the overall risk-assessment of institutions. Compensation is likely to be addressed by OSFI as part of its broader assessment of risk and risk management in supervised institutions.

### **Prudential Standards**

There is broad consensus on the need for improved risk-management by institutions and oversight by supervisors. Reflecting the proximate causes of the ongoing turmoil, there are specific recommendations for over-the-counter-derivatives, credit default swaps, strengthening internal models, stress testing, liquidity management and supervisory review. Many of these recommendations will be implemented by national authorities responding to already completed and ongoing development of new guidance by the BCBS. The principal differences among jurisdictions relate to the amount and detail of regulatory prescription. The EU proposals are most prescriptive, however, the recent FSF and G20 recommendations have moved in the direction of more detailed requirements.

The BCBS has already introduced strengthened capital requirements for structured products and securitization, and is in the process of considering increasing the capital requirements of Basel II. Harmonization of capital definitions is being pursued, with a view to encouraging higher levels of high-quality capital — common equity and retained earnings. OSFI is likely to amend its capital guidelines to reflect new international capital standards, although OSFI's prior use of supervisory discretion to require institutions to hold higher than the minimum capital has been widely hailed as contributing to the soundness of Canadian banks through the crisis.

There is widespread support for a counter-cyclical capital regime. This could include requirements for higher capital levels in normal times, which could be eroded without impairing solvency to absorb losses in a downturn. An alternative or complimentary approach is counter-cyclical or through-the-cycle provisioning, which would require banks to build general provisions during good times. Accounting standards-setters have previously opposed establishing provisions in the absence of evidence of impairment, however there is now considerable support among policy-makers for the view that in case of conflict, prudential soundness considerations should take precedence over accounting principles.

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## Outlook

At a high level there is broad international agreement on the appropriate reforms to financial regulation in light of the ongoing turmoil. The disagreements over the specific measures arise from fundamentally different philosophies. Many EU and other G20 members believe that an era of deregulation and innovation has conspicuously revealed the need for an expanded scope of more prescriptive regulation. Other countries are likely to advocate a more cautious approach, attempting to limit expansion of the regulatory perimeter to clearly systemically important institutions, with a greater tendency to rely on industry compliance with supervisory guidance rather than prescriptive rules and direct supervisory interventions to ensure financial stability.

Even the most well-founded recommendations will be extremely challenging to implement. The desirability of a counter-cyclical regime — one that requires financial institutions to build buffers of excess capital or loan-loss provisions during good times — is universally accepted. However, it will take a remarkably prescient supervisory authority to determine the minimums required for “through-the-cycle” stability and to identify the trends, peaks and troughs in the cycle. Similarly, while the desirability of compensation schemes providing incentives that align with the long-term profitability of a financial institution is universally acknowledged, decades of compensation research attest to the difficulties of design.

In Canada, the risk is that as the immediacy of the crisis fades, the motivation for needed reforms, particularly establishing a national securities regulator, will also fade. It is important not to lose the opportunity to strengthen the regulatory regime, even while drawing comfort from a system that proved more robust than most through the last crisis.