BANK OF CANADA
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Risk Management and Financial Reform

Introduction

Good morning and thank you for the invitation. It is a pleasure to be here in Montréal, where I was born and raised.

Sound risk management in Canada by both the private and the public sectors played a definitive role in steering us through the financial crisis. As you well know, none of our banks failed and none had to be rescued.

And importantly, our financial system continued to function. So when the Bank of Canada injected exceptional liquidity and monetary stimulus, and the federal and provincial governments undertook extraordinary fiscal stimulus, credit flowed to households and businesses and they responded. As a result, we had the shortest recession and the fastest recovery in the G-7.

But I am not here to boast. Lest we forget, we had our own risk-management failures here in Canada. I am sure I don't need to remind you that our non-bank asset-backed commercial paper market froze in the summer of 2007, at the onset of the crisis.

And the crisis reminded us that keeping our own house in order is not enough. Even if our financial system proved resilient, our exports plummeted 21 per cent in the wake of the global recession. And still today, our exports remain below their pre-recession level. The global financial crisis continues to cast a long shadow.

This underscores the importance of completing the global financial reforms that were launched exactly five years ago this week at the first G-20 Leaders Summit. Convened by President George W. Bush following the Lehman failure, it was held in Washington on the 14th and 15th of November in 2008.

At the Summit, the Leaders agreed on a set of common principles for the reform of the global financial system. And five months later, at the London Summit in April 2009, the Leaders elaborated on those principles by committing to a sweeping and comprehensive reform agenda. Their fundamental objective was to build a resilient global financial system that would serve households and

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businesses in good times and in bad. To do this, the Leaders created the Financial Stability Board (FSB), and gave it four core tasks:

- make banks safer;
- end “too big to fail”;
- mitigate bank-like risks in the shadow banking sector; and
- ensure continuously functioning core financial markets.

Since the London Summit, a great deal has been accomplished. And the financial system is much safer as a result.

But there are still some important elements that remain to be completed, and we need to get these across the finish line.

Today, I want to quickly review the highlights of what has been achieved and then turn to four areas that need further work: leverage limits; bail-inable securities; core funding markets; and finally, risk disclosure, governance and culture.

In a nutshell, my message is that while the roots of this crisis were in complex instruments and interactions, the foundational elements for a more resilient financial system are *not* complex: bigger capital and liquidity buffers combined with a leverage backstop, rigorous and proactive supervision, and robust financial system plumbing.

But risk *is* complex. Completing the reforms and then ensuring ongoing healthy vigilance requires investments in risk management by both the private sector and the public sector. Risk management is hard work. It can't be replaced by simplistic rules. There are no shortcuts. And risk does not take holidays—it only hides.

The completion of the ambitious reforms laid out five years ago is within reach. This is essential to a return to sustainable, natural growth in the global economy. Let's get it done.

What’s Been Achieved

To make banks safer, reform started by strengthening the bank capital regime. Under the new Basel III rules, the minimum capital requirement is being raised, the capital requirements for riskier activities are being increased and the definition of capital is being strengthened. All in, the largest banks will have to hold at least seven times as much high-quality capital as they did before the crisis.

While Basel III calls for these changes to be implemented over the next six years, banks are not waiting to rebuild confidence in their creditworthiness. Since the end of 2007, major banks in the United States and Europe have increased their common equity capital by $615 billion and their common equity capital ratios by almost 30 per cent.

National legislation has now been adopted to implement the Basel III capital framework in virtually all G-20 jurisdictions. Canada was one of the first jurisdictions to implement it. By the beginning of this year, all major Canadian banks had met the stringent Basel III requirements—six years ahead of the generous deadline of January 1st, 2019.

To end the problem of “too big to fail,” a three-pronged approach has been agreed upon.

First, banks whose failure would pose a risk to the global financial system will face a capital surcharge. This framework has also been extended to domestic banks. Here in Canada, our six largest banks have been designated as domestic systemically important banks by the Office of the Superintendent of Financial Institutions. And in Quebec, the Autorité des marchés financiers has designated Desjardins as a domestic systemically important financial institution. All seven are required to hold 1 per cent more capital.

Second, standards, known as the “Key Attributes,” have been established for the effective resolution of financial institutions. Under the Key Attributes, bondholders, shareholders and management—rather than taxpayers—will have to bear the brunt of losses.

Third, systemically important institutions are facing more intense and more effective supervisory oversight. This includes recovery and resolution plans, a cross-border co-operation agreement between relevant authorities, and a resolvability assessment.

Work is also well advanced to extend this framework to other systemic financial firms, including global insurance companies, non-banks and core financial market infrastructure.

On shadow banking, the goal is to transform it from a source of vulnerability to a source of market-based finance that adds competition, diversity and resilience to the financial system. Here, too, we have made good progress.

At the most recent G-20 Summit in St. Petersburg this past September, the Leaders endorsed a set of recommendations to increase transparency, reduce moral hazard, and limit maturity and liquidity transformation.

Finally, on strengthening the resilience of core financial markets, more than half of the FSB’s member jurisdictions now have legislative frameworks in place to ensure that derivatives transactions are reported to trade repositories; that standardized over-the-counter (OTC) derivatives are cleared through central counterparties; and that non-centrally-cleared derivatives have higher capital and margin requirements.

There is more, but I want to turn to the four issues that deserve particular attention.

Leverage Limits

In an ideal world, regulators would accurately measure the riskiness of bank assets when setting capital requirements. But risks, of course, are not known with certainty nor can they be measured with precision.

As a complement to the risk-based capital framework, a simple, but effective, leverage ratio was therefore imported from Canada into the global standard. This leverage ratio sets a cap on the value of the assets a bank can hold for each dollar of equity. It protects the system from risks that we might think are low but in fact are not.

We are big fans of a leverage limit here in Canada. We had one going into the crisis, and it served us well. But as the leverage ratio is finalized by the Basel Committee on Banking Supervision over the course of next year, it will be important to get its calibration right.

The belt and suspenders approach of the new capital standards and leverage ratios establishes two tests for the maximum amount of assets that financial institutions may hold relative to equity. At issue is which of these should typically bind first.

The leverage ratio was initially conceived as a backstop. Risk-weighted assets would normally be the binding constraint. The role of the leverage ratio is a simple, fail-safe second line of defence.

Some, however, are arguing that the Basel III capital framework is too complex and are reluctant to put their faith in risk-weighted assets. They point to recent studies by the Basel Committee that show significant variations in risk weights applied by banks across jurisdictions for similar portfolios of assets. They argue that the simpler leverage ratio should be calibrated as the binding constraint.

While this appeal to simplicity may be ostensibly attractive, it is likely to have a perverse effect.

If the leverage ratio normally binds, the incentives for banks to manage their risks will diminish. Banks will load up on riskier assets and push other assets off their balance sheets. The result will be more risk, not less.

We need to embrace risk management, not avoid it. In practice, this means three things.

First, the industry has to invest in risk assessment and analysis, including robust financial modelling.

Second, supervisors need to invest in strong oversight of all elements of good risk management, including the risk culture and risk-governance framework.

Third, there is work to be done at the Basel Committee and on the ground to improve the consistency of risk-weighted assets across jurisdictions. With a determined investment in risk management, this is achievable.

Bail-inable Securities

The higher capital standards in Basel III, combined with a well-designed leverage ratio and appropriate liquidity requirements, will substantially reduce the probability of failure, but since failures will still happen, we must also reduce their impact.

Bail-inable securities are part of the solution.

A bail-in regime can help authorities maintain critical banking operations by returning to viability institutions that are perceived as being too big to fail. Bail-in debt will give the authorities the power to recapitalize a failed bank by rapidly converting certain bank liabilities into regulatory capital. This reduces the risk that the burden will fall on taxpayers, and helps to eliminate any unfair advantage that institutions might enjoy from the markets' belief that they are too big to fail.

The FSB is currently developing an international approach on the adequacy of loss-absorption capacity in bank resolution. In the March 2013 budget, the Canadian government announced its intention to institute a bail-in regime for systemically important banks. Canadian authorities are considering the appropriate amount and nature of loss absorbency required for Canadian institutions. Public consultations will take place on how best to implement the regime, and implementation timelines will allow for a smooth transition for affected institutions, investors, and other market participants.

We will need the help of the private sector to design marketable financial contracts that can be bailed-in to resolve a major bank.

Continuously Functioning Core Funding Markets

Let me now turn to financial market infrastructure.

For the financial system, ensuring that core funding markets are continuously open in times of stress is essential to managing liquidity risk.

In Canada, a central counterparty (CCP) service to centrally clear repo transactions was launched last year by the Canadian Derivatives Clearing Corporation (CDCC), which is based here in Montréal.

The repo market is a major source of funds for financial institutions. By becoming the counterparty to all trades, a CCP minimizes counterparty credit risk and mutualizes losses. CCPs also promote robust risk-management practices and default-management mechanisms.

For financial institutions subject to regulatory capital and leverage requirements, CCPs improve balance sheet netting, which, in turn, should benefit other users through deeper and more liquid markets and better pricing.

The CDCC worked closely with the Investment Industry Association of Canada, stakeholders in the financial industry, the Bank of Canada and other regulatory authorities to create this new CCP, which began operating on a modest scale in February 2012.

A second phase of the CCP for repos was launched in December of 2012. It added the possibility for members to trade and clear "blind" repos. Since then, the clearing of cash trades has been added. And very recently, provincial securities have been included as well.

To increase the new CCP's share of overall repo activity, the CDCC and the industry have engaged in discussions with "buy-side participants" that are significant players in the Canadian repo market. Having these market participants join the repo CCP is important because it will enhance the resilience of this core funding market in times of stress. This is important to the Bank of Canada. In addition, greater participation would reinforce the overall benefits of the CCP since more members would generate higher clearing volumes, more market liquidity, broader ability to conduct term transactions and deeper netting opportunities.

The reality is that Canada is ahead of the world in this initiative. It is tough being in the lead, but we have done it before. We have an opportunity here to create a CCP model for others to follow. We are making good progress. Let's keep the focus.

Risk Disclosure, Governance and Culture

I know I have already asked for a lot from the private sector, but before I wrap up, I want to speak more directly to the private sector's responsibilities.

First, risk disclosure. Supervisors work with banks to assess riskiness. But it is equally important that markets have adequate information so that analysts can better evaluate risk themselves. That is why I welcome the report that the Enhanced Disclosure Task Force published last autumn.[1] This private sector effort, the result of a unique collaboration between users and preparers of financial reports, recommends that banks improve their disclosure of business models, key risks and risk-measurement practices. I strongly support OSFI in encouraging banks to implement these recommendations.

Second, risk governance. A peer review of risk management undertaken by FSB members and published earlier this year found that the private sector has been addressing the gaps in risk governance that came into glaring focus during the crisis. Increasingly, firms are:

- assessing the collective skills and qualifications of their boards of directors as well as board effectiveness;
- instituting stand-alone risk committees that are composed only of independent directors and operate with a clear definition of independence;
- establishing a group-wide chief risk officer (CRO) and risk-management function that is independent from revenue-generating responsibilities; and
- integrating the discussions among the risk and audit committees through joint meetings or cross-membership.

The report also made a number of recommendations to strengthen risk-governance practices, including:

- improving the skill sets of individuals appointed to boards of directors;
- holding board members accountable for oversight of risk governance;
- elevating the stature, authority and independence of the CRO; and
- obtaining an independent assessment of the risk-governance framework on an annual basis.

Third, and finally, the internal culture in financial institutions is critical. In the run-up to the crisis, banking became too much about banks connecting with other

[1] Enhanced Disclosure Task Force. 2012. Report: "Enhancing the Risk Disclosures of Banks" 29 October. Available at http://www.financialstabilityboard.org/publications/r_121029.pdf.

banks. Clients were replaced by counterparties, and anything that made good money and was legal was a good idea. Sadly, even some things that were not legal were considered a good idea. The focus needs to return to serving clients to support the real economy.

For companies, responsibility begins with their boards and senior management. They need to clearly define the purpose of their organizations and promote a culture of ethical business practices throughout.

Conclusion

The role of the financial sector is to channel savings to productive investment, and to help households and businesses manage the risks they face.

As long as there is leverage, maturity and liquidity transformation, and credit intermediation, there will be risk. Managing risk is at the heart of financial services. Sound risk management is also essential to the public good of financial stability.

A great deal has been accomplished to improve the resilience of the financial system since the first G-20 Leaders Summit in Washington five years ago.

But as the urgency of the crisis begins to fade in our collective memories, there is a risk that countries and institutions will stray from the common sense of purpose and determination that inspired the sweeping G-20 reform agenda. I have highlighted several areas where there is more work to be done by both the public and private sectors to complete the G-20 financial reforms. This is within reach. Let’s get it done.

Finally, let me draw a link to monetary policy. Risk management is also an important element in monetary policy. In our policy deliberations, we evaluate and assess the most important risks, both positive and negative, and strive to balance them.

The substantial progress achieved in implementing the G-20 financial reforms has made the global financial system safer. This has reduced the tail risk that a financial collapse somewhere in the world will affect the global and Canadian economies. Correspondingly, this risk is now weighing less on our monetary policy decisions. For me, at least, that’s one measure of progress.

Thank you.