INVESTMENT
INDUSTRY ASSOCIATION
OF CANADA

*Letter from the President*

# Global Reform – Its Prospects: Takeaways from the ICSA Annual Meeting

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The Canadian securities industry is represented in the discussions on international regulatory reform and capital markets issues through the International Council of Securities Associations (ICSA). The Investment Industry Association of Canada is a member/participant in the four-country ICSA Advisory Committee. In the past two years, ICSA has made representations on developing global reform initiatives, arguing for cost-effective, practical and harmonized reforms that will not interfere with efficient and well functioning global capital markets. It has mainly put forward its views to the multi-national Financial Stability Board (FSB) and IOSCO, the International Organization of Securities Commissions.

ICSA recently held its AGM in Istanbul on May 9-13, 2010. The IIAC participated in these meetings together with other member associations from the developed and developing countries, including our Canadian self-regulatory body, IIROC. Representatives from FINRA, IOSCO and the International Swap Dealers Association made presentations at the conference.

This President's Letter provides my thinking and perspective on the state of global regulatory reform, the global industry, and market impact on some proposed initiatives, particularly in the developed country jurisdictions such as the United States, Europe and Japan, and the likely direction of reform over the next few years. The key challenges for regulators and the G20 governments are threefold: (i) a recognition that the conventional economic paradigm that markets are efficient, rational and self-equilibrating can no longer be accepted at face value. This forces policy-makers to rethink conventional regulatory solutions, not be constrained by over-simplified theories and be open to a variety of new insights; (ii) strive for uniformity in regulation to promote open and competitive capital markets; and (iii) keep the reform process at the top of the policy agenda, complementing the management of fiscal and monetary policies. The dilemma for regulators is to balance greater need for market intervention than conventionally thought necessary, reflecting the inherent instability of markets, against the risks of unintended market consequences.

## The Financial Crisis: Pointing to Some Remedies

The problems exposed by the financial crisis demand regulatory solutions. These solutions include remedying the securitization process that effectively separated securitized products from the risks of underlying assets – causing investors to disastrously underestimate credit, modeling, liquidity and counterparty risks inherent in asset-backed securities. The obsession with yield in a low-interest environment and excessive reliance on rating agencies due to the complexity of these securities, resulted in an appalling misjudgment of underlying risks, even by sophisticated investors.

Remedies include, first, much greater transparency, clearinghouses for the settlement of securities, greater transparency for over-the-counter (OTC) securities, and the regulation of credit rating agencies. Second, the financial crisis pointed to the need for revamped capital and liquidity rules, particularly to address the failure of backward-looking VAR models, higher liquidity standards and tougher accounting and legal rules to mitigate asset disaggregation to off-balance sheet entities. Third, the crisis pointed to a massive failure to effectively supervise, notably in the United States and the United Kingdom, requiring increased resources and expertise among regulators, along with a tendency to become overly aggressive. Fourth, regulators and governments must address the pro-cyclicality of regulatory policies to prevent asset bubbles. This means addressing fundamental global imbalances and the influence of fair value accounting that contribute to pro-cyclical behaviour.

## Regulatory Reform: Achievements and Roadblocks

Despite nearly two years since the financial crisis, the regulatory reform has advanced far more slowly than the urgency of the crisis suggest would be required. Many proposals have come forward from multi-lateral organizations such as the Financial Stability Board, Basel Committee on Banking Supervision (BIS/BCBS), international organizations such as IOSCO and the International Association of Insurance Supervisors, and regulatory bodies such as the EU, FSA, Canadian and U.S. regulators, and others to address key issues.

The BIS has made great strides in proposing enhancements to Basel II, abolishing discretionary VAR calculations, and imposing tougher rules for cash and derivatives trading, liquidity requirements, leveraged ratios and legal and accounting rules to prevent off-balance sheet transfers by financial institutions. Some industry concerns with these rules are the balance sheet leverage restrictions, the disallowance of "netted" securities for the purposes of capital calculations and restricted definitions of liquid assets. Testing of these proposed rules are now underway. It is acknowledged that these capital-liquidity reforms are complex. At the same time, market risks are not fully understood. In this regard, the minimal objective is to create sufficient capital buffers to provide for a high margin of error in the event of future shocks.

The FSB is working in tandem with the BIS/BCBS on these capital and liquidity standards. The FSB is also engaged in a wide range of reform initiatives in various stages of development. The key initiatives under discussion and analysis include: (i) addressing systemic risks of large institutions through such techniques as capital/liquidity surcharges, taxes, leverage limits and supervisory activities; (ii) revising compensation practices; (iii) raising international supervisory and accounting standards (IFRS); (iv) implementing transparency and clearing-houses for OTC derivatives; and (v) imposing oversight on credit rating agencies and regulatory proposals for hedge funds.

The problem is these proposals are driven by the political agendas of individual governments participating in the reform process. Accordingly, different governments have differing views on regulatory priorities and remedies – including the regulatory treatment of derivatives, solutions to address systemic risk – particularly taxes on capital markets activity and institutions – and compensation restrictions. The need for consensus on international rules slows the reform process.

The BIS/FSB liquidity reforms have the greatest probability of broad acceptance and implementation in international markets. Second, it appears the IFRS accounting rules will be adopted by most jurisdictions. Finally, clearinghouses for CDSs and other OTC derivatives will be implemented in some format in Europe, North America and Japan in the not too distant future.

## What is Canada Doing?

Canada has been an active participant in these reform deliberations. The Bank of Canada, OSFI and the Canadian banks are involved in the BIS/BCBS discussions to enhance capital and liquidity standards. Canada has also committed to in-depth research of the OTC derivatives market and development of a regulatory framework harmonized with U.S. and EU legislation. A CCP netting facility for repo transactions will be completed by year end and plans are underway to extend the CCP to other OTC securities such as swap transactions.

IFRS accounting rules will be implemented in Canada in January 2011. Canadian regulators have also committed to publish rules for the oversight of credit-rating agencies and will require the registration of hedge funds and consider information requirements and oversight. Finally, the Canadian government has a major initiative underway to create a Canadian securities regulator to strengthen system-wide oversight.

## The U.S. Takes the Lead

The U.S. Administration and Congress are implementing independent regulatory reforms in tandem with extensive reform efforts at the multi-lateral level. Despite the sporadic law-making process in Congress, reflecting political gridlock and constituency backlash against Wall Street, eventual U.S. banking legislation will likely outpace the international agenda and have a bearing on the evolution of international reforms. International regulators are closely monitoring the U.S. reform initiatives.

Proposed U.S. banking legislation embraces revised capital rules for trading cash and derivatives, regulations for OTC derivatives (transparency and clearinghouses), proposals to address systemic risks and a financial consumer agency. Much debate is focused on the "too big to fail" problem, driven by public outrage over the large taxpayer funded bailouts of major financial institutions. The overriding concern in Congress is to design initiatives that prevent recurrence of these financial bailouts. Measures range from enhanced bankruptcy laws that enable the full takeover of failing institutions (and commensurate losses to shareholders) and the orderly wind-down of assets and liabilities; to restrictions on derivative and proprietary trading for banks; and specific limits and caps on the size of banking institutions.

### Conclusion: Impact of Reforms and Stimulus?

The G20 countries have engaged in a massive effort to reform global financial markets to restore efficient functioning of markets and investor confidence and prevent a repetition of the financial crisis. This process has advanced slowly as individual countries, in consultation with each other, make independent decisions on the efficiency of proposed reforms. A key question is whether this reform process will ultimately be decided by individual governments, and whether it will achieve sufficient uniformity and not interfere with the efficient flow of capital in global markets, critical to the success of the global recovery. Evidence suggests the regulation of OTC derivatives, credit rating agencies, supervision and accounting standards will achieve sufficient convergence to preclude barriers to markets.

The extensive fiscal and monetary stimulus invested to prevent a meltdown of the global financial system and a global depression has stabilized markets and bolstered investor confidence, and built a foundation for economic recovery. The fiscal costs of bailing out the global system, however, has been high – by example, the U.S. and U.K. debt to GDP ratios have risen 40-50 percentage points. Moreover, the global slowdown following the crisis has exacerbated the fiscal predicament for many countries, particularly in Europe. Collapsing revenue from the slowdown in growth has collided with structurally high spending levels. The escalating debt burden in the United States is particularly serious as related fiscal constraints, combined with a deleveraging consumer, will impair the U.S. economic recovery. Moreover, fiscal concerns in Europe have stymied the ongoing devaluation of the U.S. dollar necessary for improving global trade balances.

The fundamental question that still remains to be answered is whether the stimulus measures and ongoing efforts at financial reform will provide sufficient catalyst and support for sustained global recovery. Alternatively, will the impact of unprecedented indebtedness in the developed countries overwhelm well-intentioned efforts and condemn the global economy to a more feeble recovery?

Yours sincerely,

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