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Calm coming over the national regulator

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Last September, the federal government released draft legislation, termed the Capital Market Stability Act (CMSA), to oversee and impose regulations to address systemic risk in national capital markets. The draft document unleashed a firestorm of protest among key financial players. Critics were quick to point out the prospect of inefficiencies arising from regulatory duplication and oversight, as designated authorities already regulated various entities and activities in Canadian markets. It was also unclear how the cooperative securities regulator would interact with existing regulators in times of crisis. Canada’s largest pension fund managers went as far as to say the Act gave the federal regulator “unbelievable” powers that no other regulator in the world had.

It is logical that federal legislation aimed at addressing systemic risk would include systemically important non-bank and non-insurer institutions. The real question is whether these large financial institutions are a systemic risk in and of themselves. Can their potential collapse or disorderly failure cause significant disruption to the wider financial system and global economic activity?

The Financial Stability Board (FSB) and the International Organization of Securities Commissions (IOSCO) had signalled that certain large non-bank non-insurer asset managers were systemically important and issued consultative document in the spring to determine methodologies to identify these institutions. Not surprisingly, the ensuing consultations ignited an intense debate — many market participants, including many large fund managers, argued that large asset managers are not systemically important based on historic precedent, the irrelevance of asset size and/or nature of the business structure. It was, however, conceded these institutions could contribute to system-wide market risk, as institutional portfolios adjust through asset sales in time of severe market downturn, thereby aggravating a collapse in asset prices. The market impact would, of course, depend on the extent of asset exposure, leverage and liquidity for asset management entities. The solution here, however, is not to impose institution-specific rules on the larger players, but ensure the regulations are effective to limit asset exposure, leverage and maintain adequate liquidity.

In recent months, the multinational regulators have concluded the systemic risks related to large asset managers flow from their potential system-wide impact on capital markets, not from failure of the particular institution. Given the recent decision of the multinational authorities — the FSB and the IOSCO — it is likely Canada will reach a similar conclusion. This would mean removal of large Canadian financial institutions from inclusion in the CMSA and eliminate concerns about excessive regulation.

> *“The systemic risks related to large asset managers flow from their potential system-wide impact on capital markets”*

The federal government and the Capital Markets Regulatory Authority need to provide greater clarity on how the CMRA or cooperative securities regulator would interact with other federal and provincial/territorial regulators to assess the adequacy of existing regulations for bank and non-bank financial institutions to mitigate potential system-wide market risks. It is presumed the cooperative securities regulator would become a member of the Financial Institutions Supervisory Committee (FISC), joining the Bank of Canada, the Office of the Superintendent of Financial Institutions, the federal Department of Finance, the Canada Deposit Insurance Corporation and the Financial Consumer Agency of Canada.

FISC would deliberate on the need and format of new rules and protocols at all Canadian financial institutions and the trading and clearing centres and, if crisis conditions warrant, make appropriate rule changes. The central premise is that the federal and provincial/territorial regulators, other government authorities, and the cooperative securities regulator — each responsible for designated financial institutions — would implement the necessary regulatory amendments. The federal government would discharge its obligations for systemic risk through its involvement in the cooperative securities regulator under the provisions of the CMSA, and participation in the FISC, relying on independent regulators to implement agreed-upon rules to mitigate systemic risks in the marketplace.

The draft CMSA legislation had the misfortune to be released before the multinational institutions concluded that non-bank asset managers were not systemically important. Greater clarity on the designation of capital markets and the banking system as systemically important, and not the non-bank non-insurer financial institutions per se, will allay concerns about duplicative and inefficient regulation. The federal government should also clarify how independent regulators in the financial sector would coordinate actions in the event of an impending crisis.

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