Annual Investment Outlook Luncheon

Outlook for Risks to Capital Markets for 2018

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Good afternoon. I’m delighted to join you again for the Annual Investment Outlook Luncheon. In my remarks today, I will take a different perspective and offer my views on the outlook for the risks to capital markets.

The consensus forecast this year calls for continued steady, modest economic growth, and stable capital markets, both globally and in North America. You will hear more on this today from the other presenters.

But global capital markets are acutely vulnerable to certain risks of disruption and dislocation, no matter the near-term outlook.

The global capital markets face:

The threat of market fragmentation.
The shortage of liquidity.
And the potential of being upturned by a significant shock.

I’d like to look at each of these risks in turn.

First, the potential for regulatory fragmentation. When individual jurisdictions impose different rules for similar market activities, it interferes with the flow of cross-border capital, resulting in higher costs and market inefficiencies to users and providers of capital. Fragmentation invites problems: one, regulatory arbitrage and unfair competition; two, it undermines the ability of financial institutions to conduct business, complicating trade and investment.

We have seen what happens when markets fragment. Consider the global over-the-counter derivatives market. The G20 leaders agreed in the wake of the financial crisis in 2009, to improve the integrity of OTC trading, clearing and reporting. But the regulators failed to coordinate rule-making with each other.

The result? Fragmented markets led to rule duplication and overlap for similar types of transactions. Derivative traders, subject to multiple regulatory regimes, were unable to execute transactions efficiently with foreign counterparties, and to clear securities through offshore clearinghouses.

Fluid global OTC markets transformed into balkanized markets. Derivatives investors were left with less choice, less liquidity and higher costs.

The key question is: Will the current trend to move away from cross-border regulatory cooperation lead to the same result?

The United States is now engaged in the process of financial deregulation, in marked contrast to most of the rest of the world. We see signs that the White House, the Treasury Department, and Congress are putting America first, and global regulatory cooperation last.

The Treasury Department has urged U.S. regulatory bodies to try to shape regulatory standards to meet domestic objectives rather than global concerns – the beginning of two distinct regulatory tracks, in which the U.S moves in the opposite direction to its principal trading partners.

For example, the Treasury has recommended delaying domestic implementation of two significant components of the Basel Committee reforms – i.e. provisions to ensure banks have a minimum amount of stable funding, and review of trading books to reduce potential trading risks to promote a more resilient global banking system.

Leading members of Congress have voiced resistance to the Federal Reserve Board involvement in negotiations on international regulatory standards and pursuit of global regulatory goals with international organizations, such as the Financial Stability Board and Basel Committee.

Members of Congress have called for a review of global institutions and past agreements in a wide range of areas – from bank capital, to insurance, to asset management.

While we are not likely to see a sweeping overhaul of U.S. financial regulation that was passed in 2010, aspects will certainly be reshaped and softened, such as criteria to determine whether banks are considered systemically important, and, as well, modifications to the Volcker Rule, that bans banks from engaging in proprietary trading and saddling taxpayers with potential massive losses.

We also see an increase in protectionism.

In the post-Brexit world, U.K. officials have signaled that they may develop a distinct regulatory framework, moving financial services regulation away from EU directives and regulations over time.

That would increase the potential for regulatory divergence, arbitrage and renewed financial instability. If the EU mandates trading marketplaces and CCPs to be based in the EU member countries, and outside London that would exacerbate fragmentation.

Here in Canada, we took a significant step away from fragmentation by establishing the Cooperative Capital Markets Regulatory System.

But, the CCMRS encompasses only five provinces and one territory. A little more than half the provinces and territories remain outside the cooperative regulator. Moreover, it will be at least another year before the CCMRS is operational.

Ours is still the only industrialized country lacking a single body to regulate its securities markets.

Meanwhile, regulators across the Canadian financial sector have identified significant regulatory gaps in disclosure and market conduct in the provision of financial advice and investment products. These gaps will have to be addressed through greater regulatory coordination.

The second threat that our capital markets face is the risk of illiquidity. Liquidity is essential to facilitate trade flows. Investors will buy only if they are sure they can sell, and they can sell only if there are buyers.

The decline in liquidity in global markets is particularly noticeable in times of stressed markets when market-makers pull back sharply from dealing activity. The liquidity problem can be traced to various factors, from narrower dealing spreads to more expensive capital. Weak liquidity is a serious risk as it results in less efficient pricing of new offerings of securities, and leaves markets more vulnerable to external shocks.

The third threat we face is increased risk of sudden shocks to the financial system, and our ability to respond to them. Our financial markets are especially vulnerable because of the growth in exchange-traded funds (ETFs).

Increasingly, investors are putting their money in diversified index funds – buying the market rather than individual companies – to reduce costs and preserve capital. Increasingly, large institutional funds and asset managers are also investing in ETFs.

According to Bank of America Merrill Lynch, ETFs now make up one-quarter of U.S. stock trading volume and three-quarters of traded single stocks. Five years ago, ETFs accounted for just one-sixth of U.S. stock market trading volume.

Meanwhile the percentage of equity mutual fund assets jumped from 19% in 2009 to 37% in 2017, according to Bank of America. While the figures are not as high in Canada, increasingly, what we have is a market of markets, rather than a market of individual companies.

The large, concentrated holdings of index-linked products and mutual funds in individual and institutional portfolios are vulnerable to asset price declines synchronized right across the market and highly exposed to external shocks from macro factors, such as rising inflation rates, change in the direction of monetary policy, or major geo-political events.

The consequent downward asset price adjustment could be faster, more correlated and more intense than adjustments in markets driven by fundamental factors.

The potential is there for an unprecedented herd mentality, leaving market-makers with limited scope to absorb panic selling.

Another potential shock could come from the lack of cyber resilience or proper cyber defense. The increased sophistication and frequency of cyber-attacks, not only cause financial loss and breach of confidentiality, but interfere with trading venues and capital markets.

That risk is amplified by the significant outsourcing by investment dealers and asset managers to enhance efficiencies, compensate for scale and reduce costs. Firms' standards of financial integrity and cyber security may not be matched by these third-party vendors.

How do we guard against all these risks?

One, we need better regulatory coordination.

Regulators from different capital markets and jurisdictions need to coordinate more effectively with each other across borders. We see some positive examples of this.

Regulators around the world, including Canadian regulators are focusing on increasing the cyber resilience of financial systems.

The International Organization of Securities Commissions (IOSCO) plans to undertake a comprehensive study of cyber outsourcing services and related risks, and develop a template for due diligence and oversight to manage risk. The Financial Stability Board is developing a work plan to address weak corporate governance of financial institutions.

Regulators within a country or jurisdiction also need to cooperate and coordinate with each other across the domestic financial sector, involving insurance, banking and securities firms. In Canada, we have seen two positive examples of this. The Financial Consumer Agency of Canada (FCAC) recently entered an information-sharing Memorandum of Understanding with the Investment Industry Regulatory Organization of Canada (IIROC), setting a framework to facilitate compliance with, and enforcement of rules and requirements of the respective organizations.

This formal cooperation suggests a more active rule-making and requirement regime at the FCAC. This rule-making will in turn require greater inter-action between bank and securities regulators.

The newly established Financial Services Regulatory Authority in Ontario will develop detailed regulations for the insurance industry and other financial institutions operating in Ontario. It is important that these banking and insurance regulators cooperate with securities regulators to ensure similar rules for similar retail activities.

For example, the securities regulators led by the CSA have made great strides in strengthening market conduct rules for advisors and the transparency of the investment process. Regulators outside the domestic investment industry should take note.

Here’s the second way we can guard against risks. We need a careful disciplined approach to regulation, finding the appropriate and most cost-effective rules to guide financial advice and market dealing. We have made good progress, but need to rely even more on evidence-based analysis, and more extensive cost-benefit work.

Third, non-bank institutions in the financial sector, while not themselves systemically important, their participation in stressed financial markets could contribute to a systemic market impact. We may need to strengthen the underpinnings of these institutions, notably some of the large asset managers, through increased liquidity cushions and tighter leverage requirements.

Ladies and gentlemen, a decade out of the financial collapse, the capital markets are healthy, but they have within them inherent risks.

We must guard against market fragmentation through better regulatory coordination; we need to take greater care in the rule-making process; and we need to limit the potential for market shocks as best we can.

The risks are there. We must be mindful of them and we must address them.

Thank you.