10 YEARS AFTER THE FINANCIAL CRISIS

AN UPDATE ON SYSTEMIC RISKS

SENATE | SÉNAT
CANADA

REPORT OF THE STANDING SENATE COMMITTEE
ON BANKING, TRADE AND COMMERCE

The Honourable Senator Doug Black, Q.C., Chair
The Honourable Senator Carolyn Stewart Olsen, Deputy Chair

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TABLE OF CONTENTS

COMMITTEE MEMBERSHIP

The Honourable Senator Doug Black, *Q.C., Chair*
The Honourable Senator Carolyn Stewart Olsen, *Deputy Chair*

The Honourable Senators

Jean-Guy Dagenais
Joseph A. Day
Colin Deacon
Linda Frum
Marty Klyne
Sandra M. Lovelace Nicholas
Elizabeth Marshall
Pierrette Ringuette
David Tkachuk
Josée Verner, P.C.
Pamela Wallin
Howard Wetston

Ex-officio members of the committee:

The Honourable Senators Peter Harder, P.C., Diane Bellemare, Grant Mitchell, Larry W. Smith, Yonah Martin, Joseph A. Day, Terry M. Mercer, Yuen Pau Woo and Raymonde Saint-Germain.

Other senators who have participated in the study:

The Honourable Senators Larry W. Campbell, Michael Duffy, Paul E. McIntyre and Scott Tannas.

Parliamentary Information and Research Services, Library of Parliament:

Brett Stuckey, Analyst
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Senate Committees Directorate:

Lynn Gordon, Clerk of the Committee
Kalina Waltos, Administrative Assistant

Senate Communications Directorate:

Stav Nitka, Communications Officer

ORDER OF REFERENCE

Extract from the *Journals of the Senate*, Tuesday, October 17, 2017:

The Honourable Senator Day moved, seconded by the Honourable Senator Eggleton, P.C.:

That the Standing Senate Committee on Banking, Trade and Commerce be authorized to examine and report, from time to time, on issues pertaining to the management of systemic risk in the financial system, domestically and internationally; and

That the committee submit its final report no later than Friday, June 29, 2018, and that the committee retain all powers necessary to publicize its findings until 180 days after the tabling of the final report.

The question being put on the motion, it was adopted.

Clerk of the Senate

Nicole Proulx

Extract from the *Journals of the Senate*, Tuesday, June 5, 2018:

The Honourable Senator Black (Alberta) moved, seconded by the Honourable Senator McPhedran:

That, notwithstanding the order of the Senate adopted on October 17, 2017, the date for the final report of the Standing Senate Committee on Banking, Trade and Commerce in relation to its study on issues pertaining to the management of systemic risk in the financial system, domestically and internationally, be extended from June 29, 2018 to December 28, 2018.

The question being put on the motion, it was adopted.

Extract from the *Journals of the Senate*, Thursday, December 6, 2018:

The Honourable Senator Stewart Olsen moved, seconded by the Honourable Senator Seidman:

That, notwithstanding the order of the Senate adopted on October 17, 2017, the date for the final report of the Standing Senate Committee on Banking, Trade and Commerce in relation to its study on issues pertaining to the management of systemic risk in the financial system, domestically and internationally, be extended from December 28, 2018 to September 30, 2019.

The question being put on the motion, it was adopted.

Clerk of the Senate

Richard Denis

INTRODUCTION

On October 17, 2017, the Standing Senate Committee on Banking, Trade and Commerce (the committee) was authorized to conduct a study on issues pertaining to the management of systemic risks in the Canadian financial sector. As it has been 10 years since the global financial crisis, the committee was interested in learning about the success of measures that have been implemented since that time to manage systemic risks and any that may still exist in the financial sector.

The committee heard from representatives from the financial sector, the Department of Finance Canada (the Department), Canada Deposit Insurance Corporation (CDIC), Canada Mortgage and Housing Corporation (CMHC), the Bank of Canada, the Office of the Superintendent of Financial Institutions Canada (OSFI) and received written submissions from Professor Anita Anand and the Canadian Securities Administrators (CSA).

> ***"A systemic risk is "a risk of disruption to financial services that is (i) caused by an impairment of all or parts of the financial system and (ii) has the potential to have serious negative consequences for the real economy."***
>
> *Financial Stability Board, Report to the G-20 Finance Ministers and Central Bank Governors, October 2009*

The Global Financial Crisis

The Department described how the collapse of Lehman Brothers in 2008 and the ensuing global financial crisis showed vulnerabilities in the financial system. Excessive risk-taking behaviour of interconnected financial institutions magnified the crisis to create what was the largest economic downturn since the Great Depression. Many jurisdictions took extraordinary measures to prevent further damage to the global financial system, including using public funds for bank bailouts.

The global financial crisis was a period of extreme stress in global financial markets and banking systems. Consensus and coordination among agencies domestically and internationally was required to respond to the extreme nature of the crisis. Provincial and federal regulators in the securities and banking sector worked together to combat the systemic issues that arose in Canada. As a result, both of these coordinated efforts and the soundness of the Canadian financial system, no financial institution in Canada required a government bailout according to the Department.

Internationally, the G-7 took aggressive and coordinated policy action, led by the Financial Stability Board. These efforts were focused on three areas: increasing the resiliency of financial institutions; eliminating "too big to fail," or decreasing the reliance of large, interconnected financial institutions on public sector support; and decreasing risks in other segments of the financial system.

Canada in the Global Financial Crisis

According to the Department, Canada consistently ranks among the soundest financial systems internationally. The Department also noted that, not only were efforts to coordinate policy actions well-coordinated at a global level, but federal and provincial regulators also worked together to stem the effects of extreme turbulence in Canadian financial markets and to implement subsequent reforms.

The Office of the Superintendent of Financial Institutions spoke about the prominent leadership role that many Canadian regulators played internationally. According to the Superintendent, the most notable example was the appointment of Mark Carney, who was then the governor of the Bank of Canada, as the chair of the Financial Stability Board.

The Royal Bank of Canada (RBC) noted that Canada was more successful in minimizing the effects of the financial crisis than most other jurisdictions. In its view, the factors that contributed to this success include Canada's strong, national legislative framework for banks; its well-coordinated and consultative approach to regulatory oversight; its housing market structure and oversight; and, its economic and fiscal position at the time of the crisis.

OSFI spoke about the important role Canadian regulators played in the international efforts to stem systemic risks. It also pointed out that Canada is among the leaders in the implementation of initiatives, according to annual report cards from the Financial Stability Board. In its written submission, the CSA highlighted Canadian leadership through its participation in the International Organization of Securities Commissions, which sets global standards for securities regulation.

The Department noted that Canada's Senior Advisory Committee, whose membership includes the Department, OSFI, CDIC, the Bank of Canada and the Financial Consumer Agency of Canada, was established to promote collaboration and information sharing among agencies in order to provide advice to the Minister of Finance on vulnerabilities and risks related to the financial sector and financial stability. For example, efforts to manage housing-related financial system vulnerabilities were coordinated by this committee. Canada's Senior Advisory Committee also works with provincial securities regulators for issues related to capital markets. In order to inform the public of its work, Professor Anand suggested increased transparency would be beneficial from the Senior Advisory Committee and the Financial Institutions Supervisory Committee and could be achieved, for example, by publishing agendas and research.

1. FINANCIAL INSTITUTIONS

The Department spoke about the Financial Stability Board's efforts to increase the resiliency of financial institutions. This was achieved by introducing Basel III, which included improvements to Basel II, the international set of financial institutions regulatory standards at the time. For example, capital requirements were made more stringent; banks are now required to hold more and better-quality assets for the lending that they do. The Department further noted that Canada's financial institutions are recognized for meeting or exceeding all Basel III standards.

OSFI explained that it has new capital requirements for insurance companies, tailored to those in life and health, property and casualty and mortgage insurers, respectively. It also highlighted that insurance companies have new stress testing requirements and guidelines for potential losses resulting from operational risks, such as human error or external disruptions.

Other measures mentioned by witnesses that were introduced in Canada to address systemic risks include stress testing by systemically important banks (SIBs), or simulations that measure potential ramifications of given economic shocks; and the revision of the Bank of Canada's Emergency Lending Assistance policy to provide greater clarity and to allow more borrowing under the program.

According to Professor Anand, the additional oversight imposed on banks by OSFI and CDIC following the financial crisis ensures continued regulatory awareness of the banks' approaches to mitigating systemic risks, which is necessary given the significance of Canada's largest banks. Toronto-Dominion Bank (TD) concluded that OSFI has found a good balance between ensuring financial stability and giving banks the autonomy to do business.

Outstanding Risks

The Canadian Bankers' Association warned that, although measures that ensure the stability of financial institutions may decrease the risk of bank failures or bailouts, excessive regulations may also reduce the ability of Canada's financial institutions to compete globally and create economic growth in Canada. TD also cautioned that excessive capital requirements and regulation may also cause certain risky transactions to be transferred to the unregulated shadow banking sector, which could result in the financial system becoming less secure. However, it noted that the Bank of Canada and the Financial Stability Board have developed monitoring programs to identify risk in the shadow banking sector.

While OSFI expressed pride in Canada's banking system and its success during and after the financial crisis, it also recognized this past success may lead to complacency among regulators and institutions and cautioned that the sector must remain ever vigilant to unforeseen risks.

Officials also discussed a report written by Nicolas Le Pan that describes the lack of earthquake insurance in certain areas of Canada and the potential for such an event to pose risk to the financial sector. OSFI stated that it has taken note of the report and has increased its capital requirements with respect to earthquake insurance, although these measures are limited so as not to make the insurance prohibitively expensive. The Department also noted that it is investigating the implications of earthquakes for the financial sector.

2. "TOO BIG TO FAIL"

The Financial Stability Board's second area of focus concerned financial institutions that were considered "too big to fail," or sufficiently large and interconnected to pose systemic risks to the financial system in which they operate. The bailouts that occurred during the crisis demonstrated that governments were unwilling to allow certain large financial institutions to fail, creating a "moral hazard" problem. Banks could continue or increase the risky behaviour that led to the global financial crisis and assume further bailouts in the future. The aim of the Financial Stability Board's measures, according to the Department, was to decrease the reliance of these institutions on taxpayer support.

The Department explained that these measures included identifying SIBs, applying additional supervisory and capital requirements on them and implementing recovery and resolution plans with "bail-in" regimes. Bail-in regimes are frameworks for the resolution of a failing bank whereby creditors and shareholders, rather than taxpayers, bear the cost of recapitalizing the bank by converting some of the bank's debt to common shares.

While the Financial Stability Board focused on global SIBs, the Canadian Bankers' Association pointed out that it also encouraged national regulators, such as OSFI, to identify domestic SIBs. It highlighted that OSFI not only identified domestic SIBs but also treats them as stringently as global SIBs, with similar requirements for reporting and holding capital.

RBC indicated that in March 2013, OSFI designated the Canadian Imperial Bank of Canada, Bank of Montreal, Bank of Nova Scotia, the National Bank of Canada, TD and RBC as domestic SIBs, subject to a capital surcharge, enhanced supervision, recovery and resolution planning and increased disclosure requirements. Furthermore, it noted that in November 2017, RBC was added to the list of globally SIBs by the Financial Stability Board. According to RBC, the obligations imposed by OSFI prepared RBC well for its global designation. As well, Desjardins mentioned that the Autorité des marches financiers

designated it as a domestic SIB in June 2013 and imposed similar requirements to those of OSFI.

Other measures taken in Canada, in collaboration with the international financial community, focused on regulatory tools that could be used should one or more banks get into trouble. The CDIC noted that the Bank of Canada and CDIC have been designated as resolution authorities for payments and clearing settlement systems and banks, respectively.

The Bank of Canada discussed the resolution regime for Canada's financial market infrastructures (FMIs) – such as payment clearing and settlement systems – that is aligned with global principles set by the Financial Stability Board. The regime allows banks and authorities to allocate losses and to restore critical services provided by the FMI when it is unable to continue to provide its critical functions.

As well, CDIC spoke about its legislative power to transfer all or part of a failing bank's business to a "bridge bank" that is temporarily owned by CDIC. This authority is meant to "bridge" the gap between when a bank fails and when a private sector solution can be found. Canadian SIBs are also required to develop plans on how they would return to financial health or how they would be resolved following a situation in which they are unable to meet their obligations.

Another resolution measure taken by Canada since the financial crisis was to create a "bail-in regime" that is consistent with international standards. In Canada, CDIC has the power to take control and recapitalize a large bank that it considers to be close to failure. In such an instance, CDIC would use equity held by the bank's shareholders and certain creditors to recapitalize the bank, thus shifting the risk of failure away from depositors and taxpayers. In her written submission, Professor Anand questioned the plausibility of regulators using the bail-in mechanism during a crisis, as doing so could decrease public confidence in the institution and the system in general.

Outstanding Risks

The CSA was concerned that regulatory emphasis on domestic SIBs may leave out provincially/territorially regulated institutions as some provinces and territories have not yet established a framework for enhanced regulation and supervision of their SIBs. Professor Anand noted that, while British Columbia and Quebec have designated large, provincially regulated credit unions as systemically important with enhanced regulation and supervision, other provincial regulators such as Alberta, have not.

3. OTHER SEGMENTS OF THE FINANCIAL SECTOR

According to the Department, the Financial Stability Board's third area of focus dealt with risks to other segments of the financial sector. For example, it made recommendations with respect to non-bank financial activities. The Department noted that global over-the-counter derivatives reforms were developed to reduce systemic risks. As their name suggests, over-the-counter derivatives are contracts that are privately negotiated between two parties, without going through an exchange or intermediary, thus making them difficult to track and regulate. Global reforms included mandatory reporting and risk mitigation.

The CSA stated that it enforces internationally accepted reporting rules as well as mandatory clearing of specified over-the-counter transactions within the securities sector. Furthermore, it noted that that it now regulates certain credit rating organizations consistent with global principals and has introduced stricter requirements for short-term securitized asset-backed commercial paper.

Outstanding Risks

Witnesses identified several outstanding systemic risks for the Canadian financial sector with respect to cyber security, household debt, shadow banking and capital markets.

Cyber Security

All witnesses that spoke to the committee were concerned with cyber risks. They underscored the importance of looking to non-traditional and non-financial risks that arise from changes in the economy. They pointed out that technological advances in the financial sector may introduce unforeseen vulnerabilities and cyber security risks to the financial system and recommended that policy makers and regulators stay vigilant to these potential risks.

The Department spoke about the potential for cyber incidents aimed directly at financial system participants to create panic and disrupt the system. The Canadian Bankers' Association was also concerned with indirect cyber risks to the financial system, such as those directed at other critical infrastructure systems. It recommended that the federal government establish a set of standards for critical infrastructure systems in Canada to meet and report on regularly, given the reliance that the financial sector has on these systems.

Household Debt

One of the most significant factors contributing to the financial crisis in the United States was a sharp increase in mortgage defaults. Although Canada's housing market is significantly different from that of the United States, high levels of household indebtedness coupled with historically low interest rates has been an ongoing concern for policy makers in Canada. In response to these concerns, the Department has introduced several changes to mortgage lending practices since the crisis to reduce mortgage debt and to reduce the systemic risks associated with the mortgage industry. According to the Bank of Canada, these changes have reduced the proportion of mortgage loans that are made to the most highly indebted consumers. CMHC also noted that it is now overseen by OSFI. However, household indebtedness and the imbalance of housing markets continue to be the key source of domestic risk to the Canadian financial system and systemic risks in general, according to the Bank of Canada.

Shadow Banking

Shadow banking contributed to the global financial crisis through its role in creating securities from home mortgages which decreased in value as the crisis developed and further perpetuated contagion in financial markets. Following the crisis, the Financial Stability Board and international regulators focused on measures that would prevent such events in the future.

Shadow banking, also referred to as market-based finance and non-bank credit intermediation, conducts "banking-like activities," such as providing investment services, but is outside of the traditional regulatory environment in Canada. Examples of institutions in the shadow banking industry include investment banks, hedge funds and money market funds.

According to TD, growth in the shadow banking sector has led to financial crises in other jurisdictions. RBC was also concerned about the potential for some assets within the shadow banking sector to have "liquidity mismatches," whereby the liquidity being provided to unit holders is higher than that of the assets. In such cases, RBC noted that if large numbers of unit holders request payment, the fund(s) may be forced to sell assets at distressed prices, which could create a market downturn. However, the Bank of Canada indicated that the risks that the shadow banking sector could pose for Canada's financial system are limited as the sector has a relatively low level of leverage. Professor Anand stated that the Bank of Canada's ability to study the shadow banking sector continues to be hindered by legal and logistical obstacles in sharing data among authorities.

Capital Markets

Professor Anand explained that securities regulation in Canada is based on its constitutional framework, which divides the responsibility between federal and provincial authorities, with banks being federally regulated and securities markets being provincially/territorially regulated. Other firms, such as insurance companies, trust and loan companies, credit unions and pension plans can be incorporated and regulated at both the provincial/territorial and the federal level. She noted that new financial trends such as the emergence of the fintech and cryptocurrency sectors has given rise to jurisdictional confusion, regulatory overlap and inefficient regulatory resource allocation in the securities sector.

The CSA mentioned in its written submission that, as part of its role as the umbrella organization for provincial/territorial securities regulators, it created a Systemic Risk Committee in 2009. The Systemic Risk Committee's purpose is to identify, analyze and report on systemic risks stemming from capital markets. According to it, no new systemic risks were identified in its most recent risk assessment and over 80% of previously identified systemic risks have been mitigated or are in the process of being mitigated through policy development.

However, the Chief Executive Officer of the Capital Markets Authority Implementation Organization and Professor Anand expressed concern over the fact that Canada does not yet have a national securities regulator and pointed out that not only is Canada the only Organisation for Economic Co-operation and Development (OECD) country without a national securities regulator, there is no entity has the authority to collect data relating to systemic risks in capital markets on a national basis. They mentioned that a national securities regulator would protect investors, foster efficiency and innovation, and strengthen Canada's capacity to identify and manage systemic risks in capital markets on a national basis. According to the Department, the federal government is working with participating provinces and territories to establish a cooperative capital markets regulator system.

The Chief Executive Officer of the Capital Markets Authority Implementation Organization characterized his organization as "the interim authority and the forerunner to the proposed pan-Canadian securities regulator, the Capital Markets Regulatory Authority (the Authority)." He explained that the cooperative capital markets regulatory system is an initiative of the governments of British Columbia, New Brunswick, Ontario, Prince Edward Island, Saskatchewan and the Yukon along with the federal government, with an invitation to non-participating provinces and territories.

He also explained that while the CSA has been successful in facilitating cooperation among the regulators, in its view, it is limited by the design of the system as individual regulators ultimately make their own decisions. As a result, inefficiencies and frictions are present in

the Canadian securities market, causing it to be less adaptable to the increasingly fast pace of change in global markets.

The Capital Markets Authority Implementation Organization also discussed the Capital Markets Act, the proposed uniform securities act that would be passed by each of the participating provinces and territories, and the Capital Markets Stability Act, which would be federal legislation focused on systemic risks. The Authority would administer both acts. It pointed out that the timeline for the establishment of the Authority was in question due to a then-pending Supreme Court of Canada decision on securities regulation in Canada, which was expected to be issued sometime in late 2018.

According to the Department, the objectives of the proposed pan-Canadian securities regulator are to increase efficiency in the oversight of capital markets, strengthen enforcement and to better monitor systemic risks in capital markets. With respect to systemic risks, this initiative would provide powers to the Authority for data collection across a range of financial services and products and to take actions to mitigate identified systemic risks. The Capital Markets Authority Implementation Organization explained that the proposed Capital Markets Stability Act contains tools such as urgent order-making powers that would allow the Authority to take action should an unforeseen event occur that requires immediate action. More importantly, the Department indicated that it would allow for data collection so that actions could be coordinated among all regulatory authorities including OSFI, the Bank of Canada and provincial/territorial securities regulators, including those in non-participating provinces and territories.

The Capital Markets Authority Implementation Organization noted that the Authority would have dedicated resources and expertise specifically devoted to systemic risks in capital markets, with the potential for synergies between these resources and those devoted to day-to-day securities regulation.

At the time of the hearing, the Department indicated that it was waiting for the Supreme Court decision before introducing the proposed federal legislation.

THE COMMITTEE'S OBSERVATIONS

The committee applauds Canada's financial sector for its success in navigating a very challenging economic period and the various provincial and federal regulators' perseverance and vigilance in monitoring and addressing systemic risks as they arise. However, the committee stresses that Canada must maintain vigilance as systemic risks continue to exist and efforts to address them must be ongoing. Particular focus must be paid to cyber security, household indebtedness, shadow banking and insurance for catastrophic events.

Since the end of our study, the Supreme Court's decision concerning Canadian securities regulation was issued. In November 2018, the Supreme Court ruled in *Reference re Pan-Canadian Securities Regulation* that the proposed national cooperative capital markets regulatory system, as set out in the "Memorandum of Agreement regarding the Cooperative Capital Markets Regulatory System," is constitutional. It also found the draft federal legislation aimed at regulating systemic risks fell within Parliament's power over trade and commerce.

Systemic risks that may be present in the Canadian system due to a lack of coordination and data collection in the current securities regulation framework should be a concern for all levels of government. The committee encourages the federal government and participating provinces to move forward with their efforts to address the issues identified in this report.

APPENDIX A: WITNESSES WHO APPEARED BEFORE THE COMMITTEE

October 24, 2018

Canadian Bankers Association
Darren Hannah, Vice President, Finance, Risk and Prudential Policy

Desjardins Group
Antoine Avril, Vice President, Risk, Credit Granting and Special Loans

Royal Bank of Canada
Jason Drysdale, Executive Vice President, Retail and Commercial Risk

TD Bank Group
Kent Andrews, Senior Vice President, Regulatory Risk and Risk Capital Assessment

October 25, 2018

Bank of Canada
Ron Morrow, Advisor to the Governor

Canada Deposit Insurance Corporation
Dean Cosman, President and Chief Executive Officer

Canada Mortgage and Housing Corporation
Steven Mennill, Chief Risk Officer

Department of Finance Canada
Leah Anderson, Assistant Deputy Minister, Financial Sector Policy Branch

Office of the Superintendent of Financial Institutions Canada
Jeremy Rudin, Superintendent

November 1, 2018

Capital Markets Authority Implementation Organization
Kevan Cowan, Chief Executive Officer

APPENDIX B: WRITTEN SUBMISSIONS

As an individual

Anita Anand, J.R. Kimber Chair in Investor Protection and Corporate Governance, University of Toronto

Canadian Securities Administrators

Louis Morisset, Chair; President and Chief Executive Officer, Autorités des marchés financiers

Steven Weimer, Chair, Systemic Risk Committee

Capital Markets Authority Implementation Organization

Kevan Cowan, Chief Executive Officer