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International Prudential Standards in a World of Growing Nationalism and Protectionism

Progress in establishing international standards that promote trade, investment and prosperity is facing headwinds from the global rise of nationalism and populism. Standard setters for financial services should adapt to the evolving international cooperation cycle.

Mark Zelmer and Jeremy Kronick

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The Study In Brief

With nationalism and protectionism on the rise globally, it may be tempting to conclude that the momentum for international regulatory reform is waning. This *Commentary* offers some suggestions to maintain the momentum for reform in the face of rising protectionist challenges. As is often the case with cross-border concerns, we in Canada and our counterparts abroad have found that working together to set international standards often delivers socially beneficial outcomes for all of us.

At the same time, it is important to be humble about how much can be accomplished by such standards. This is particularly true in the financial services arena. Such standards are harder to agree on and less likely to be useful for services and markets that are more domestic in nature, especially in cases where important institutional features vary significantly across borders.

This *Commentary* begins with a reminder of why international standards are useful. We then explain how such standards can be created and implemented outside of the usual legal processes that govern relations among countries. Against this background, we review how Canada has balanced its specific domestic interests in the banking and insurance arenas with international standards set by bodies of which Canada is a member. We conclude with some thoughts on priorities for these financial-sector standard setters in a world where international cooperation, for the time being, may have receded from its peak.

To summarize, our recommendations include the following:

- As it becomes more challenging to reach international agreements, international standard setters might want to focus more on working with their member countries, individually or in a group setting, to help them coordinate domestic initiatives. This approach would reduce the risk of local initiatives unintentionally working at cross-purposes with the global financial system, especially in times of stress;
- International standard setters should tread cautiously in setting minimum standards and ensure they accommodate differences in domestic institutional settings;
- As a result of the first two recommendations, more stringent and transparent public disclosure requirements would be required so that private stakeholders can understand how differences in institutional settings are affecting the measurement and management of risk at financial institutions as well as the calculation of regulatory capital and liquidity ratios; and
- Standard setters may want to place more effort on encouraging member countries to fully and consistently implement agreed-upon standards before seeking to introduce new reforms.

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International standards help make Canada a more prosperous society. The news media are full of stories these days about how some parts of the world are becoming more nationalistic and protectionist.

With Brexit, growing trade disputes with our neighbours south of the border, and the election of populist leaders in Europe, there appears to be a growing threat to the international order we have become accustomed to. Regardless of how much stock one puts in these global events, it is easy to lose sight of why something as basic as international standards are a good thing. A succinct rationale comes from the International Organization for Standardization (ISO): international standards make things work.

International standards provide world-class specifications for products, services and systems to ensure quality, safety and efficiency. These specifications are instrumental in facilitating international trade.[1]

We would go a step further and argue that they also help enable international investment. History has shown time and again that international trade and investment are necessary ingredients if a society is to progress and achieve higher living standards over time. Or, as Harry Dexter White (one of the principal architects of the Bretton Woods System), put it, "The absence of a high degree of economic collaboration among the leading nations will . . . inevitably result in economic warfare that will be but the prelude and instigator of military warfare on an even vaster scale" (Campbell et al. 2010 p.11).

Indeed, we need not look too far back to see a recent example of successful economic collaboration in the face of a severe global challenge, specifically the coordinated G20 response to the global financial crisis. It is worth also remembering that our society is built on many widely accepted standards. Issues as fundamental as weights and measures, communication protocols, and product safety and reliability require good standards. If we want to harness the benefits of international trade and investment, then international standards play an important role in delivering those benefits.

Of course, in many aspects of life countries have chosen to apply standards nationally, not internationally. For example, while most of the world has adopted the metric system, the US and, to a certain extent, the UK retain the imperial system. That requires some mental gymnastics when crossing the Canada-US border, but at least there is a well-enforced measurement standard in each country. Similar drawbacks apply in many other areas of cross-border activity: think clothing and shoe sizes. Such challenges are also evident in accounting and actuarial standards and practices,

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1 See ISO website at: http://www.iso.org/iso/home/about.htm.

where both the standards and how they are implemented differ significantly across countries.

One reason these differences exist is because the benefits of an international standard cannot always be justified, given the costs associated with imposing greater consistency on a diverse group of stakeholders. Among other things, these costs likely include changing long-standing and well-entrenched national customs and practices.

Perhaps a more fundamental reason for national differences lies in different national business models. Insurance is a good example. In contrast to banking, where international capital standards have been in place for 30 years, an international capital standard for insurance companies remains a work in progress that will likely still take many years to implement. It has been hard to develop common standards for insurance accounting, actuarial practices and prudential requirements because insurance products and the companies that offer them differ significantly across countries.

For example, the long-dated life insurance and annuity contracts that have been sold in North America for many years are simply not offered in many other markets. As a result, the financial structure and risks that characterize North American life insurers are very different from those of their counterparts in many other jurisdictions.

The result of such product uniqueness is individualized domestic regulations. For example, take Canada's new Life Insurance Capital Adequacy Test (LICAT) implemented by Canada's Office of the Superintendent of Financial Institutions (OSFI). In replacing the previous Minimum Continuing Capital and Surplus Requirements Guideline, OSFI noted that LICAT "represents a more advanced and risk-sensitive approach to capital that reflects lessons learned from the financial crisis, significant changes in the nature and management of risk within the life insurance industry, and international advancements in solvency frameworks."[2]

Still, there are many areas where greater standardization across national boundaries is worthwhile. International standard setting is a bit of a cottage industry. Standard setters have proliferated like rabbits, and most of them are busily engaged in creating new standards. Byres (2017) notes that the ISO has more than 20,000 different international standards covering an incredibly diverse range of topics and activities.[3] It currently is developing more than 500 new standards in information technology alone. Like other standard setters, the ISO does not unilaterally decide to develop standards; it simply responds to demands from member countries. Clearly, the appetite for new standards remains healthy.

International standards promote more effective prudential regulation

Let's drill down further on the financial services sector. We mainly use the banking sector to illustrate our points, because the development of international prudential standards is more advanced for banks than for insurance companies and securities dealers. This fact is due to the larger systemic risks and more homogenous nature of banks and bank products internationally. That said, the international standard-setting process is broadly similar for all three industries.

The main standard setter for the prudential oversight of internationally active banks is the Basel Committee on Banking Supervision or BCBS. Established in 1974, the BCBS consists of senior officials from central banks and bank supervisory

2 See http://www.osfi-bsif.gc.ca/Eng/osfi-bsif/med/Pages/LICAT18_nr.aspx.

3 See Byres (2017) at www.apra.gov.au.

agencies from 26 countries plus the European Union and the Hong Kong Special Administrative Region. Senior officials from three other countries participate as observers as do representatives from the Bank for International Settlements, the Basel Consultative Group (which represents the interests of non-member countries), the European Banking Authority, and the International Monetary Fund (IMF). The Bank for International Settlements hosts the BCBS secretariat.

The BCBS mandate is to strengthen the regulation, supervision and practices of banks worldwide with the goal of enhancing financial stability.[4] As noted in Goodhart (2011), the need for international minimum standards and cooperation in this respect arises from the fact that finance and financial markets have become global in scope whereas the regulation, supervision and control of financial systems remain national, subject to national legislation and jurisdiction. The global financial crisis was an unfortunate reminder that while global banks may be international in life, they are always national in death.

Goodhart notes that this basic contrast has led to tensions about competition among financial institutions based in different countries (e.g., the level playing field issue), about the supervision scope for internationally active banks, about the relative responsibilities of home versus host regulators/supervisors, and so on. As a result, financial regulation needs to be coordinated at an international level to avoid undue distortions to the relative competitive positions of internationally active banks and banking systems. In turn, such coordination helps promote the acquiescence of the nationally regulated institutions to international standards, which is needed, at least up to a point, for regulation to be effective.

Over the years, the BCBS has issued a plethora of minimum standards, guidelines and best practices to promote sound governance and risk management of banks and to encourage them to hold adequate capital and liquidity commensurate with the risks they manage. Perhaps the BCBS's most important accomplishments have been its Accords on Capital Adequacy – commonly known as Basel I, Basel II and, in the wake of the global financial crisis, Basel III – plus its Core Principles for Effective Bank Supervision (BCPs).

The first capital accord arose from the need to combat the excessive erosion in capital levels that was taking place in the 1960s and 1970s as banks competed to lend money across borders. Major European and North American banks were striving to reduce their cost of funds by taking on more leverage (smaller capital cushions) so that they could respond to competition from Japanese banks that operated with very small capital cushions. The latter could do so because they benefited from the strong presumption (subsequently validated) that their depositors and creditors would be bailed out by the Japanese government in the event of a bank failure.

Basel II was implemented just before the global financial crisis struck in 2007. It expanded on the first accord in a couple of important ways. It allowed banks more freedom to use their own risk models to measure credit and operational risk in the calculation of bank regulatory capital, subject to supervisory approval of those models. And it introduced the three-pillar concept: Pillar 1, which sets minimum industry-wide public capital requirements for the three primary bank risks (credit risk, market risk and operational risk); Pillar 2, which allows supervisors to apply additional capital requirements to banks tailored to

4 Further details on the BCBS mandate and institutional features can be found on the Bank for International Settlements website at www.bis.org/bcbs. In addition, a comprehensive history of the BCBS early years can be found in Goodhart (2011).

the specific risks carried by those banks; and Pillar 3, which introduced a comprehensive set of bank public disclosure requirements to facilitate more market discipline in the oversight of banks by other market participants.

Basel III, meanwhile, is notable for its focus on reforms that address various macro-prudential issues. The global financial crisis was a good reminder of the negative externalities that arise when major global banks fail. It brought into stark reality the impact the banking system has on the economy and the types of regulation that will succeed in protecting both.

One of Basel III's accomplishments has been to designate some major global banks, including RBC in Canada, as a global systemically important financial institution (G-SIFI)[5] because a failure of one or more of those banks could seriously damage the global financial system. These banks are now subject internationally to more stringent capital requirements plus more intrusive supervision and disclosure requirements than other banks. G-SIFI banks are also expected to prepare rigorous recovery and resolution plans and have provisions in place to convert some of their senior unsecured debt obligations into capital in the event the bank ceases to be viable.

In Canada, domestic systemically important financial institutions (D-SIFI), which include all six major banks, are broadly subject to similar prudential requirements as G-SIFI financial institutions.[6] Indeed, in RBC's case, its G-SIFI designation will not result in any change to its risk-adjusted regulatory capital requirements, though it will eventually be subject to a tougher (3.5 percent) leverage ratio requirement than OSFI's current minimum 3 percent.[7]

The lessons regulators around the world learned during the financial crisis were important both in terms of regulatory outcomes, as well as the emphasis on the need for continued learning and understanding of systemic risks. The challenge regulators face now is balancing the desire to keep perfecting their regulations with the need to get agreed-upon requirements implemented across jurisdictions.

In general, not only have the Basel Accords led banks to carry larger capital and liquidity cushions, they are leading to more international consistency over time in the measurement of bank capital and liquidity positions – a feature that makes it easier for bank creditors and other stakeholders to assess and compare the financial condition of individual banks.[8] By the same token, the BCPs have played an important role in helping bank supervisors around the world up their game.[9]

A review of these Basel Accords begs the obvious questions: on what legal basis does the BCBS issue standards and ensure they are enforced?

The simple answer is none. The BCBS does not have any legal powers whatsoever. Its decisions require consensus among its members who are then responsible for implementing them through their own regulatory/legislative processes.

5 As of November 2017, there were 30 G-SIFI banks. See http://www.fsb.org/wp-content/uploads/P211117-1.pdf.

6 See Ligaya (2017). In 2017, RBC was deemed a G-SIFI and placed in the lowest capital surcharge bucket, resulting in a surcharge of 1 percent of common equity as a percentage of risk-weighted assets. Major Canadian banks face the same surcharge as a result of their Canadian D-SIFI designation.

7 See Basel Committee on Banking Supervision (2017). The 3.5 percent comes from the fact that a G-SIFI's leverage ratio will include the 3 percent minimum plus 50 percent of the capital surcharge, which in RBC's case is 1 percent.

8 While it has led to more international consistency, it is important to note that the standards agreed to are considered minimums, meaning domestic regulators have the option of adopting more stringent requirements should they wish.

9 For example, the IMF has noted Canada's compliance with the BCPs as well as OSFI's proactive response to the international regulatory reform agenda. See, for example, IMF (2014).

The BCBS reports to the Basel Committee's Group of Governors and Heads of Supervision (GHOS), which must endorse all major decisions. The GHOS approves the BCBS charter and any subsequent amendments to it, provides general direction for the BCBS work program and appoints the BCBS Chair from among its members.

Jurisdictions are incented to implement the Basel Accords, or other such standards, because:

- adhering to these standards contributes to their reputation as a sound financial centre, which can help attract foreign investment and facilitate the expansion of their domestic banks into foreign markets;
- it helps promote a level playing field for institutions from a competitive perspective;
- all jurisdictions benefit from resilient global funding markets and the containment of the systemic risks associated with major global banks;
- and failing to do so would likely undermine their credibility and influence in future standard-setting discussions.

Implementation of the Basel Accords is also supported by a formal peer review process whereby the committee assesses each member jurisdiction's execution, flags any deviations and awards an overall grade. The resulting review reports are published on the BCBS website so that the whole world can see which jurisdictions have been naughty or nice. That way, stakeholders can appreciate the extent to which reported bank regulatory capital ratios have been distorted by deviations in reporting rules across jurisdictions.

Interestingly, most member jurisdictions, including Canada, have fully implemented the Basel Accords. The notable exceptions, however, are the two most important banking markets – the European Union and the United States.[10] Smaller jurisdictions have the most to gain from implementing the agreed standards for the reasons set out above, whereas the two largest jurisdictions are perhaps important enough and sufficiently less dependent on the rest of the global financial system that they feel they have more freedom to decide which features of the standards are in their best interest to implement – and which are not.[11] This is certainly a concern, as differences in compliance distort competition across jurisdictions through the unlevel playing field such actions create. While there are good reasons for Canada to implement the Accords regardless of what the EU and US do (see Dickson 2013 for more), it is critical that OSFI continues to monitor the impact of non-compliance on the part of these jurisdictions in assessing the safety and soundness of Canadian branches and

10 The Basel Committee graded the EU as "materially non-compliant" mainly due to its failure to implement some of the capital requirements related to derivatives transactions as well as for its more lenient treatment of loans to small- and medium-sized enterprises (not just for those enterprises based in Europe but rather, cheekily, for those located in other parts of the world, too). Meanwhile, the Basel Committee found the US "largely compliant" with the accords because its deviations were considered not material in terms of their impact on publicly reported regulatory capital ratios.

11 Interestingly, negotiations between the EU and US on the proposed Transatlantic Trade and Investment Partnership agreement have involved discussions around the inclusion of the financial services sector. Most trade agreements contain a prudential carve out, allowing jurisdictions to take measures that are prudential in nature but do not necessarily conform to their trade agreement commitments. The EU wants to include the financial services sector to improve its access to the US market. The US, on the other hand, does not want this sector included as it believes this will lead to downward regulatory pressure, given the regulatory measures the EU has adopted post-financial crisis. See Quaglia (2016) for more.

subsidiaries of banks from those jurisdictions.[12]

What about the Core Principles for Effective Bank Supervision?

As for the BCPs, the IMF assesses and grades each jurisdiction's adherence (jointly with the World Bank in the case of emerging market and developing countries) through its regular surveillance of members in what are called Financial Sector Stability Assessments.[13] These reports are also made public on the IMF website. Canada has fared very well in the BCP portion of the assessments.

However, these assessments of Canada's financial services sector have suggested areas for improvement, including the sharing of data across regulators, both by function and geography, given existing fragmentation. It is concerning that there is not already more coordination among relevant federal and provincial agencies in the monitoring of system-wide risks and in implementing actions to address them. Gaps arise with fragmentation and while there are constitutional reasons why Canada is unlikely to go to a national single or twin (prudential and market conduct) financial sector regulator(s), this should not prevent a continued evaluation as to how systemic risk can be better managed (see Le Pan 2017 for additional suggestions).

Notwithstanding the systemic risk concerns, from a banking perspective international standard setters like the BCBS – despite not operating with any legal foundation – have been very successful at disseminating minimum standards that are voluntarily adopted by member jurisdictions and even many non-members. That may in fact be one of the strengths of the process. Standard setters can operate more nimbly in addressing technical issues than if such issues had to be sorted out through more formal legal processes.[14]

Canada derives important benefits from international standards

International financial standards are a public good that offer some important benefits for Canada. First, they make it easier for Canadian banks and insurers to fund themselves and to expand abroad. Canadian financial institutions have a long history of accessing the savings of foreigners to support their own operations abroad, and also to

12 Indeed, OSFI already does that with respect to foreign bank branches. OSFI must approve the setting up of a foreign bank branch through an assessment of whether the branch is capable of acting in full compliance with Canadian law. It must also decide whether the bank the branch is affiliated with is regulated in an acceptable manner in its own jurisdiction. And, even once approval occurs, a foreign bank branch remains subject to regular OSFI examinations and must have capital-equivalency deposits in Canada to help offset Canadian liabilities. Specifically, foreign branches must maintain assets on deposit equal to the greater of 5 percent of branch liabilities or $5 million.

13 Similar assessments are conducted by the IMF and World Bank for other parts of the financial system using standards and codes produced by other standard setters such as the International Association of Insurance Supervisors and the International Organisation of Securities Commissions.

14 Since standard setting is a fairly technical exercise, the work of standard setters usually operates below politicians' radar screens. The global regulatory reform agenda for the financial services industry has been an important exception in this regard due to the macroeconomic damage caused by the global financial crisis. This led the Financial Stability Board to play a more active role in coordinating the work of international standard setters in the wake of the crisis and G20 leaders endorsing specific reform initiatives such as Basel III. The FSB has also been working closely with international standard setters in several critical areas of financial services, particularly shadow banking and systemically important financial institutions.

help finance and insure Canadians and Canadian companies. The credibility that comes from being seen to adhere to international standards allows Canadian banks and insurers to access global funding markets and compete in other jurisdictions to an extent, and at a price, not possible if we sought to operate a system that was purely "made in Canada" and, therefore, foreign to foreigners.

Second, Canada benefits from the adherence of others to those standards. The global financial crisis was a good reminder that our financial system is not an island onto itself. We are but a small component of a large highly connected global network – a network that is only as strong as its weakest link. As we saw in 2008, Canadian financial institutions, and the Canadian economy, are not immune when global funding markets suffer stress. As a medium-sized economy that is very dependent on international trade and global financial markets, we have a strong interest in a well-functioning global financial system. We, too, benefit when our partners abroad adhere to international standards.

Having said that, Canada has strived to ensure that international standards respect the Canadian financial system's institutional features. For example, the OSFI and the Bank of Canada were actively engaged in the Basel III discussions and succeeded in making sure that the new regulatory capital standards respected the fact that, in Canada, a large portion of the credit risk associated with residential mortgage lending is borne by the federal government through its mortgage insurance program, not by the banks themselves.[15] Indeed, credit losses on Canadian bank mortgage portfolios have been much smaller historically than those in the US (Figure 1). Requiring banks to carry more capital for risks that are ultimately borne by someone else (the government) is a recipe for encouraging banks to lend even more aggressively so that they can earn satisfactory rates of return on their capital.[16]

Credit cards are another example where credit risk experience varies across countries. While credit card issuers like VISA and MasterCard operate in many jurisdictions, the card features can vary significantly. In Canada, the major card issuers have not been able to penetrate the debit card market due to the dominance of the bank-sponsored Interac network. So, instead, they offer very generous points programs to encourage Canadians to use their credit cards for routine payment purchases that in other countries might be handled by debit cards. These point programs are very popular, and Canadians have thus been more inclined than their foreign counterparts to use their credit cards as payment cards. In turn, this has resulted in significantly lower credit card losses in Canada compared to other jurisdictions like the US and UK (Figure 2).

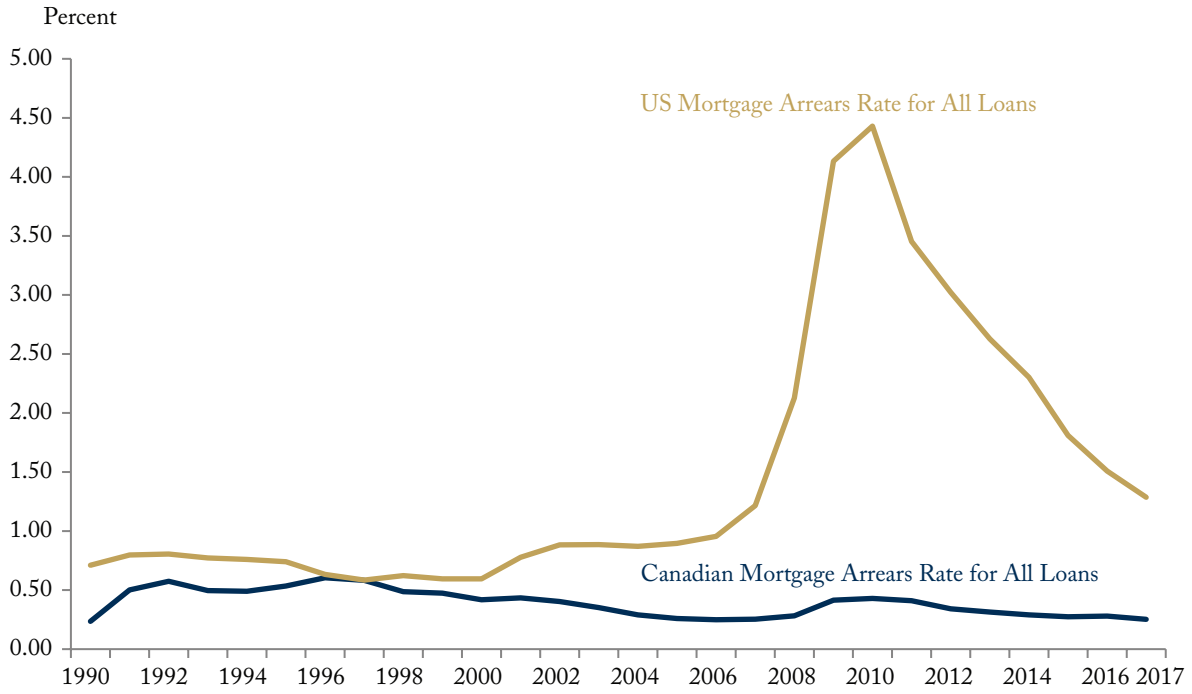
International bank capital standards need to be sensitive to these kinds of institutional differences. The final Basel III agreement recognizes that fact by setting lower capital requirements for card balances that are routinely paid in full each month.

Other countries have similar issues because the institutional details surrounding how credit is extended to households and to small- and medium-sized businesses vary markedly. This makes it rather challenging to reach agreement on suitably prudent minimum standards that can be applied globally

15 OSFI's Capital Adequacy Requirements for banks, drawn from the Basel framework, state that, "Mortgage insurance in Canada is considered a guarantee and institutions may recognize the risk-mitigating effect of the guarantee." (See http://www.osfi-bsif.gc.ca/Eng/fi-if/rg-ro/gdn-ort/gl-ld/Pages/CAR17_chpt3.aspx.)

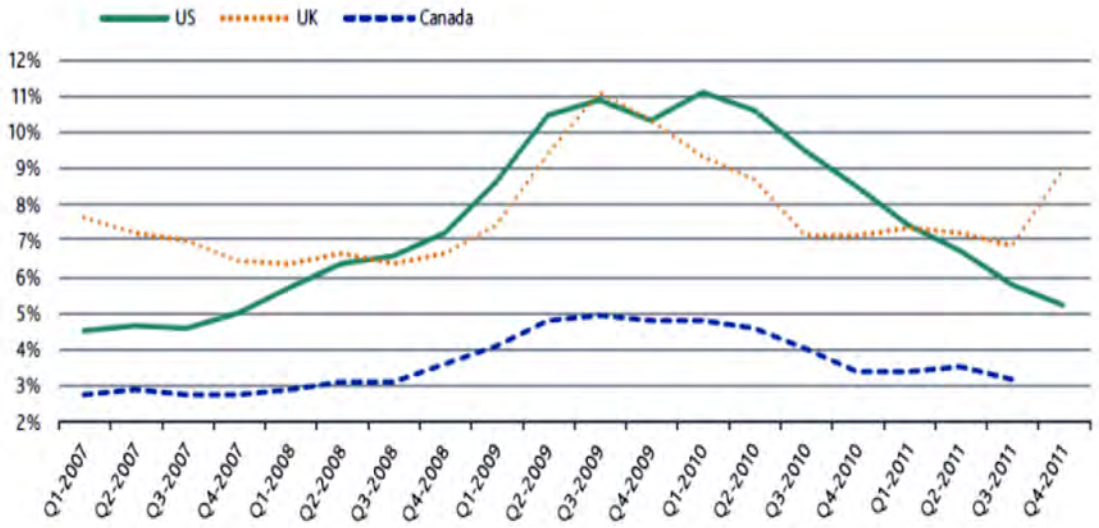
16 Of course, there are downsides to having government offer 100 percent guarantees to lenders on high loan-to-value (80 percent or higher) mortgages. For example, it incentivizes lending to the mortgage market, removing at least some funds that might otherwise be allocated to the more productivity-enhancing business sector.

Figure 1: Mortgage Arrear Rates on Residential Mortgages – Canada and US, 1990-2017



Source: Canada Mortgage and Housing Corporation.

Figure 2: Average Quarterly Credit Card Charge-offs – Canada, US and UK, 2007 – 2011



Source: Moody's Investors Service.

and helps explain why it was difficult to reach agreement on the final chapter of Basel III in 2017. The lesson from this experience is that international standard setters should tread cautiously when setting benchmarks for activities that are more national in nature.

Even when standards are agreed upon, Canada has taken care to implement them thoughtfully and has been prepared to publicly deviate from them when necessary. A good Basel III example is the terms and conditions surrounding the treatment of non-viable contingent capital. Basel III includes a set of rules around non-common equity capital instruments in determining which ones are eligible for inclusion within a bank's Tier 1 regulatory capital base. To be considered Tier 1 regulatory capital, all non-common equity regulatory capital instruments are expected to contain a provision that requires them to be converted into common equity should an institution no longer be deemed viable and/or if its Common Equity Tier 1 risk-weighted capital ratio declines below 5.125 percent.

A controversial issue for Canada is the fact that OSFI does not agree with setting a capital ratio floor for triggering conversion of preferred shares into common equity. Such a mechanistic requirement could potentially make it harder for banks to recover in times of stress.[17] More generally, there is a risk that the presence of such a requirement could potentially fetter OSFI's ability to take control of an institution that is no longer viable but still posting a risk-weighted capital ratio in excess of 5.125 percent.[18]

By the same token, OSFI has exercised its discretion and has not applied all aspects of Basel III to smaller banks that operate solely in Canada. Instead, it is applying only those features that it believes make sense in a Canadian context. A good example is the public disclosure requirements associated with Basel III. In this regard, OSFI has sheltered smaller banks from some of the more onerous requirements in consideration of the questionable marginal utility of the additional disclosure requirements and the greater regulatory burden they impose.

Despite a final agreement on Basel III, there are two important topics that were left either incomplete or are likely to become even more difficult for domestic regulators to find international agreement on in a world of growing nationalism. These are better alignment of capital with the location of risks and making sure capital buffers can be used appropriately when needed (see Rudin 2017 on capital buffers). On the former, despite Basel III's completion, the rise of nationalism may set the stage for jurisdictions to set more favourable capital rules within their borders, or at least work at cross-purposes. If that occurs, Canadian regulators will be forced to assess whether they need to adopt similar measures to prevent an exodus of capital. We discuss below ways in which international standard setters can mitigate some of this concern, but the reality is the protectionist environment may breed this type of behaviour, which will require vigilance on the part of domestic regulators.

On the latter, making sure capital buffers serve a useful function, while we want capital buffers that allow for sufficient room to absorb losses, the ability to use up some of that capital in bad times, i.e., dip into the buffer, should be an appropriate first step to recapitalization. Otherwise, confidence in the system will be undermined as households and businesses expect massive deleveraging through asset fire sales or severe reductions in lending.

17 The challenges faced by Deutsche Bank in early 2016, when its regulatory Common Equity Tier 1 capital ratio was declining and approaching trigger points, are an example of how such triggers can place even further stress on a bank. See, for example, Thomas Hale, Martin Arnold and Laura Noonan (2016).

18 See Basel Committee on Banking Supervision (2014).

It may be necessary to tackle these issues alone if international agreements cannot be reached or enforced, but against the backdrop of a more protectionist environment we encourage continued assessment of their competitive impact. And if the decision is taken to go at it alone, it is imperative to clearly communicate what our policies are in order to distinguish them from what might be expected in other countries.

Standard setters need to adapt to growing nationalism and protectionism

What we have discussed so far speaks to the past and the present, but what about the future? How should international standard setters such as the BCBS, of which Canada is a member, adapt to a world where international cooperation is waning and seems likely to continue in this direction for the foreseeable future?

It is tempting to think that the growing nationalism and protectionism in some of our trading partners is a recent phenomenon. It is not. Concerns about globalization have been sprouting like bad weeds for more than 20 years. Financial crises in the 1990s led many emerging market economies to increase their own foreign reserves and reduce their reliance on the IMF and other international institutions to support them in times of stress.

Meanwhile, the global financial crisis added further fuel to the fire when, as mentioned above, policymakers were reminded to their dismay that while financial institutions are global in life they are local in death. This led to some lively discussions about how to distribute the losses across borders when institutions failed. The British anger at Iceland's refusal to stand behind the obligations of Icelandic banks to foreign depositors is perhaps the most obvious example.[19]

The crisis experience validated Canada's longstanding policy of not allowing foreign bank branches to gather deposits from Canadian households or participate in Canadian financial infrastructure and safety nets like the payment and deposit insurance systems. It also confirmed the benefits of Canada seeking prudential carve-outs in free-trade agreements so that Canadian prudential regulators are not forced to rely on foreign regulators in the oversight of Canadian branches of foreign banks and insurers, something that is done within the EU and caused so much grief for the British when dealing with Icelandic banks.

Internationally, the global financial crisis led some jurisdictions like the US and EU to introduce measures like intermediate holding companies for the local operations of foreign banks and apply domestic capital and liquidity requirements to those holding companies and other local entities. Such actions are intended to help ensure that there are enough financial resources available locally to support the local operations of a foreign bank. They also allow local authorities to reduce their dependency on the consolidated resources of the global banking parent and the quality of oversight by the global bank's home supervisor.

While such measures may be prudentially sound from a purely domestic perspective, there is a risk that they could unduly impede global capital flows

19 Billions of dollars' worth of deposits from British and Dutch savers were lost when Icelandic financial institutions, in particular, Landsbanki bank, went bust in 2008. The Icelandic government would not cover the losses of the bank's foreign clients, forcing Britain and the Netherlands to do so, before sending the bill back to Iceland. After government negotiations and referendums in Iceland, the Icelandic Supreme Court deemed Landsbanki's collapsed estate responsible for paying back London and The Hague. (See https://www.theguardian.com/business/2016/jan/13/britain-has-been-fully-reimbursed-for-icesave-bank-collapse-iceland-says.)

and, hence, undermine global economic prosperity, if taken too far. For example, in cases where foreign financial institutions represent a significant share of local financial systems, local authorities could be tempted to hide behind the cloak of systemic importance to subject those institutions to more onerous prudential requirements than other local entities.

To be fair, this issue is well known by standard setters. They have been actively engaged on a variety of fronts to foster international cooperation in the oversight of G-SIFI financial institutions. Some examples in this regard include the establishment of international crisis management groups to help guide the ongoing oversight of those institutions and designing bail-in debt features in a way that can help each jurisdiction replenish the capital resources of a global bank's local entity to protect it from creditor claims when the global parent bank encounters stress. At the margin, initiatives like these may help to foster more coordination among bank supervisors and resolution authorities when a global bank encounters stress.

But there is more that could be done by the international standard setters themselves. First, standard setters must recognize and accept that the world of international cooperation in which they have thrived for many years is changing. Given the growing challenges in reaching international agreements, jurisdictions will likely have to rely more on their own domestic processes to pursue regulatory and supervisory reforms instead of achieving them under the auspices of an internationally agreed-upon agenda.

An example, as discussed above, would be acting alone on the issues of alignment of capital with location of risk and ensuring capital buffers are available when needed. In general, going solo is bound to include more focus on domestic legal entity capital and liquidity requirements as supervisors place less faith in the fungibility of those items in a less cooperative world.

Standard setters thus may be better off working with their members, individually or in a group setting, to help them coordinate domestic initiatives to reduce the risk of them unintentionally working at cross-purposes to the smooth functioning of the global financial system, especially in times of stress.

Second, as mentioned before, standard setters would be well advised to tread cautiously when setting minimum prudential standards in areas that are more domestic in nature. Greater respect should be given to the cross-border institutional differences that exist.

This could be done in several ways.

- As new regulatory issues emerge for activities that are more domestic in nature, greater attention could be paid to developing principles and best-practice compendiums tailored by national authorities to their own institutional settings. This might enable international standard setters to set more demanding goals and respond more nimbly to emerging issues.
- In the current environment, international consensus on principles and best practices should be easier and quicker to reach than on more rule-oriented minimum standards. But implementation will be key. That will likely require more expertise and judgment in future evaluations to encourage jurisdictions to faithfully implement the principles and best practices in a way that is respectful of the local institutional setting and stage of development of the financial system in question.
- More attention could also be paid to reciprocity agreements as countries pursue their own reforms domestically. For example, international standard setters could build on a precedent from the Basel III countercyclical capital buffer reciprocity

rules[20] to agree that regulators and supervisors of parent banks and insurance companies will respect local requirements for risk exposures.[21]

It is important to recognize, however, that more deference to domestic authorities will blur international comparisons among banks and insurers. It may also open the door for jurisdictions to try and undercut each other as they try to support the competitiveness of their home-based financial institutions.

As a result, more stringent public disclosure requirements will be required so that private stakeholders can understand how differences in institutional settings are affecting the measurement and management of risk at financial institutions and the calculation of their regulatory capital and liquidity ratios.[22] Standard setters and other international institutions like the Financial Stability Board and the IMF may also wish to consider conducting more evaluations of the operational practices in each jurisdiction. This would provide private stakeholders a better understanding of how regulatory and supervisory requirements vary across jurisdictions, and whether the differences are prudent and truly reflect differences in institutional settings.

Third, and finally, standard setters should consider taking the long view and accept that there are cycles to international cooperation and the appetite for regulatory reform. As Byres (2017) notes, memories of the global financial crisis are fading and international standard setting is getting tougher as consensus is becoming harder to find. In such an environment, standard setters may want to place more effort in encouraging members to fully and consistently implement the standards that have already been agreed to before seeking to introduce any other major reforms. Perhaps the time has come to reduce some of the regulatory uncertainty that has been at the forefront of the financial services industry (for good reason) these past 10 years.

As international standard setting becomes more difficult, jurisdictions will start implementing regulations they feel appropriately fit their domestic environment. One potential benefit is this will provide test cases for what works and what does not when contemplating future international standards.

Conclusion

As some of our trading partners turn inward, it is important that we in Canada not lose sight of the prosperity provided by international cooperation. We need to continue supporting the international standard-setting process if we are to fully realize the benefits that come from being a medium-sized participant in the global financial system. At the same time, however, international standard setters need to accept there are limits as to how far they can go in setting standards when it comes to products, services and markets that are more domestic in nature. They also need to adapt to the evolving international cooperation cycle and make sure current standards are fully and consistently implemented before seeking out new standards to introduce.

20 The rules allow foreign jurisdictions to impose higher buffer requirements on those exposures, but they cannot impose lower requirements than those demanded by the local jurisdiction.

21 Other analyses on reciprocity agreements, building on precedents from the Basel III countercyclical capital buffer, include Longworth (2010).

22 On Feb. 27, 2018, the BCBS issued a consultation on Basel III disclosure requirements, which appears to be a step in the direction of what we are suggesting. (See https://www.bis.org/bcbs/publ/d432.htm.)

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