Rebuilding The Global Financial System: A QUESTION OF LEADERSHIP

AN ADDRESS BY

David Dodge
FORMER GOVERNOR OF THE BANK OF CANADA

THE THIRD ANNUAL THOMAS D’AQUINO LECTURE ON LEADERSHIP

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THE THIRD ANNUAL

Thomas d’Aquino

LECTURE ON LEADERSHIP

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Ivey

THIRD ANNUAL LECTURE
At a tribute dinner in Toronto, in 2006, attended by a thousand well wishers honouring Tom d’Aquino, one prominent Canadian leader said “No Canadian has done more over the past thirty years to shepherd Canadians in the way of wiser public policy.”

The achievements of Tom as a lawyer, entrepreneur, author, educator and strategist are well known. He is perhaps best known for his leadership of the Canadian Council of Chief Executives, our country’s premier business association composed of 150 chief executives and entrepreneurs. Member companies administer $3.2 trillion in assets, have a yearly turnover in excess of $750 billion and are responsible for the vast majority of Canada’s exports, investment, research and development, and training.

Under Tom’s leadership, the Council has played a highly influential role in the shaping of fiscal, taxation, trade, energy, environmental, competitiveness and corporate governance policies in Canada. He is acknowledged as one of the private sector architects of the Canada-United States free trade initiative and of the North American Free Trade Agreement. He is active in policy circles throughout the world and has been referred to as “Canada’s most effective global business ambassador”.

Tom is very proud of his roots in Western Canada. A native of Nelson, British Columbia, he was educated at the universities of British Columbia, Queen’s and London (University College and the London School of Economics). He holds B.A., LL.B. and LL.M. degrees and an Honorary Degree of Doctor of Laws from Queen’s University and from Wilfrid Laurier University.

Described as “a master of multidisciplinary skills”, Tom honed his experience in government, business and law. He has served as a Special Assistant to the Prime Minister of Canada and as a founder and chief executive of Intercounsel Limited, a firm specializing in the execution of domestic and international business transactions and the mentoring of chief executives on public policy strategies. He also served as an international trade lawyer and as an Adjunct Professor of Law lecturing on the law of international business transactions, trade and the regulation of multinational enterprise.

Tom currently serves on numerous boards including Manulife Financial Corporation and CGI Group Inc. He chairs the National Gallery of Canada Foundation and the Advisory Council of the Lawrence National Centre at the Richard Ivey School of Business.

A prolific writer and speaker, Tom is the co-author of Northern Edge: How Canadians Can Triumph in the Global Economy and he has addressed audiences in twenty-five countries and in over one hundred cities worldwide.

For thirty years, Tom has practiced leadership. For thirty years, he has been a close observer of leadership in others. Few Canadians are as well positioned as Tom to speak on the meaning of leadership.
It gives me great pleasure to welcome the presenter of The Third Annual Thomas d’Aquino Lecture on Leadership, David Dodge, O.C., Chancellor of Queen’s University and former Governor of the Bank of Canada.

Dr. Dodge is both an exemplary leader and a proven innovator. During a long and distinguished career in the federal public service, he developed solutions to some of Canada’s most vexing problems. In the process, he helped to transform Canada from an economic laggard into one of the industrialized world’s strongest performances.

Few Canadians of his generation have had such a profound impact on national public policy. His energy, drive and passion for excellence are second to none.

Dr. Dodge addresses the compounded effects of systemic weaknesses: macroeconomic, macrofinancial, regulatory, and management. He describes the persistent national savings deficiencies in the United States, and at the same time, the excess of savings in much of Asia and the Middle East. He advises on the lack of coordination of the financial stability activities of central banks and financial regulators, as well as on investors who do not actually understand the make up of the securities they own. Some firms over estimated the market’s capacity to absorb risk. Dr. Dodge stresses that while Canadian institutions do better than many of their international competitors, there appears to be a lack of a comprehensive approach to risk management.

In his description of solutions requiring leadership, Dr. Dodge describes the key short-run issue as being the maintenance of global demand. Furthermore, the key medium-term issue is the structuring of the “international rules of the macroeconomic game” that would facilitate economic adjustment, trade, and global growth. He concludes by emphasizing that it will be our national authorities that must devise and enforce new rules of the game, and that our own financial institutions must find improved ways to manage risk.

In this most thoughtful and stimulating presentation and discussion, Dr. Dodge challenges us as Canadians: “It is now only a question of leadership!” He compliments the Lawrence National Centre and Ivey in our goal to develop the next generation of business leaders who will strive to achieve more cooperation between government and business in support of Canada’s competitiveness agenda.
For his dedication to public service, incisive intellect, and unmatched expertise in domestic and international finance, David Dodge has earned the admiration of colleagues and associates across Canada and around the world.

A native of Toronto, Dr. Dodge earned a Bachelor’s degree (Honours) from Queen’s University, and a PhD in economics from Princeton. During his academic career, he taught economics at Queen’s; at the School of Advanced International Studies, John Hopkins University; at the University of British Columbia; and at Simon Fraser University. He also served as Director of the International Economics Program of the Institute of Research on Public Policy.

During a distinguished career in the federal public service, Dr. Dodge held senior positions in the Central Mortgage and Housing Corporation, the Anti-Inflation Board, and the Department of Employment and Immigration. After serving in a number of increasingly senior positions at the Department of Finance, including that of G-7 Deputy, he was appointed Deputy Minister of Finance in 1992 and Deputy Minister of Health in 1998.

On February 1, 2001, Dr. Dodge commenced a seven-year term as Governor of the Bank of Canada and Chairman of the Bank’s Board of Directors. He retired on January 31, 2008. He is currently Chancellor of Queen’s University and senior Advisor to Bennett Jones LLP, one of Canada’s leading business law firms. He is a member of the board of directors of Canadian Utilities Limited, the C.D. Howe Institute and the Canadian Institute for Advanced Research.

Throughout his career in the public service, Dr. Dodge was a tireless champion of reforms that were necessary to unlock Canada’s enormous economic potential. He played a key role in the elimination of the federal deficit, in securing the long-term sustainability of Canada’s public pension system, and in reforming the tax system.

Whatever the issue, his philosophy emphasizes openness and accountability, as well as the need for a well-functioning public sector to ensure the efficient operation of markets. At the Bank of Canada, he was a strong advocate for transparency in the conduct of monetary policy, in contrast to the days when central banking was often cloaked in deliberate secrecy.

Thanks to Dr. Dodge’s contribution, Canada today is a stronger and more confident country. He is one of the most influential and respected public servants of his generation, and an inspiration to all who follow in his path.

Throughout his career in the public service, Dr. Dodge was a tireless champion of reforms that were necessary to unlock Canada’s enormous economic potential.
INTRODUCTION
It is a pleasure and a distinct honour to have been asked to give this year’s Thomas d’Aquino Lecture on Leadership at the Richard Ivey School of Business. I commend Jack Lawrence and the Canadian Council of Chief Executives (CCCE) for initiating this annual lecture and the Richard Ivey School of Business for striving to be “on the cutting edge of the nexus between public policy and business strategy”. I thank the CCCE, the University of Western Ontario and all of you here today for the opportunity to speak to you on the topic of the global financial system.

My primary focus will be on the policy issues faced by the Leaders both of financial institutions and of governments and their emanations as they seek to rebuild confidence in the financial system. But before turning to possible prescriptions needed to restore the system to robust health, I want to begin with an analysis of the anatomy of the systemic weakness that has become painfully obvious over the last sixteen months or so.

Anatomy of Systemic Weakness
There is no single cause of the current financial system crisis. Indeed it is precisely because of the number of interrelated weaknesses in the global economic and financial system that our current problems are so severe. For simplicity of exposition, I will discuss each of these weaknesses individually but it is important to bear in mind that it is the compound effect of these weaknesses that makes the current crisis so difficult to deal with.

What are these weaknesses?

. **Macroeconomic:** Current account imbalances (which can be roughly categorized as persistent national savings deficiency in the United States and, after 1997, persistent excess saving in much of Asia and more latterly in the Middle East) were allowed to persist. Both national governments (including to a limited extent in Canada) and international institutions failed to come to grips with the problem.

. **Macrofinancial:** Particularly in the United States and Europe (but also in some Emerging Market Economies (EMEs) excessive leverage was allowed to build in systemically important parts of the financial system.

. **Regulatory:** Prudential regulatory and accounting systems encouraged excessive expansion of lending and deterioration of credit standards while oversight of securities and financial markets was weak or nonexistent.

. **Management:** There was a profound lack of attention to proper “over the cycle” risk management by financial institutions and investors themselves.

Let me quickly now address how these weaknesses evolved over the last few years. I do this not to assign blame or simply to add to the growing literature on “post mortems”. Rather, I think it is important to understand past weaknesses if we are to make improvements going forward.

Macroeconomic
In the decade from 1998 to 2007 we witnessed an enormous expansion of world trade as transportation and communications costs fell and as many countries around this world “emerged” as market economies. Labour productivity increased globally but particularly in a number of emerging economies as they increasingly relied on market forces to allocate production. The relatively strong global growth we experienced in this period – especially after 2002 – I believe can be attributed to the increased reliance on markets rather than governmental authorities to allocate labour and capital to productive use in emerging economies and to the further freeing up of these markets in developed economics through reduced regulatory burden.

As trade barriers and regulatory barriers to domestic competition were reduced, both international and domestic competitive pressures increased, spurring productivity and income growth\(^1\).

Generally speaking, this improved performance of the real economy of the world was enhanced by the adoption of improved budgetary and fiscal policies. Europe adopted the Maastricht treaty, emerging Asia and especially Latin America improved fiscal probity, and with the glaring exceptions of the United States and Japan\(^2\), other OECD nations – including Canada – reduced the burden of public debt.
Global inflation was markedly reduced over this period as increasingly independent central banks focused monetary policy on keeping inflation under control. Increased confidence in the future value of money encouraged investment worldwide by greatly reducing the inflation premium in longer term interest rates. This focus also meant that in developed markets and some (but not all) emerging markets, much greater exchange rate flexibility was permitted. This flexibility permitted more rapid adjustment to changing global demand and changing relative prices in some markets.

These macro developments were extremely positive for global growth and the welfare of our citizens. In the rush to deal with the current sharp economic slowdown, the positive contribution of freer trade, freer markets, and sound fiscal and monetary policy should not be lost. It is for that reason that I have started by noting the macroeconomic strengths of the last decade.

But there have been glaring weaknesses. Indeed, policies that led to persistent and growing global current account imbalances are a significant contributor to the current crisis. These imbalances arose in large part from the combination of:

- persistently expansionary fiscal monetary policies in the United States leading to national dissavings and;
- lack of flexibility in the exchange rates in Asia (particularly China) leading to excessive savings there as well as in the oil-producing nations of the Middle East.

These savings combined with low US policy rates resulted in low longer term interest rates, the “search for yield”, and contributed to excessive leverage in the global financial system. And just as the macroeconomic strengths should not be forgotten as we move forward, the weaknesses that led to global imbalances need to be corrected.

**Macrofinancial**

The Asian and Russian crises of 1997-98 highlighted the importance of the issue of financial stability. The international response was to create the Financial Stability Forum (FSF). And in the run-up to Y2K, central banks devoted somewhat greater emphasis to stability issues, especially on operational issues such as clearing and settlement. As a result of these efforts, the financial systems in a number of emerging economies were greatly strengthened and the operational robustness of systems in developing economies improved.

But, generally speaking, the financial stability functions of central banks in the OECD countries were under-resourced relative to the monetary policy functions. Regulatory agencies had no (or very little) macrofinancial analytic capacity. But the problem was made worse in most countries by the fact that there was little coordination of the activities of the financial stability arms of central banks with those of financial regulators (both prudential and market conduct).

Thus little attention was paid to building leverage in the financial system as a whole and to the increasingly levered positions of both financial institutions and households.

**Regulatory**

Financial markets can only function efficiently when there is reasonable symmetry of information available to both buyers and sellers. Since effective disclosure and transparency is fundamental to well-functioning markets, a core role of market regulators is to reduce information asymmetries. Many highly structured products at the centre of the market turmoil were far from transparent, and the disclosure of their originators was often wanting. In hindsight, we can see that many investors did not actually understand the characteristics of the securities they owned.

Investors used simple letter grades from credit rating agencies as a substitute for effective transparency. This reduced pressure for better disclosure, contributing to the broken markets we face today.

Financial institutions can only carry out their intermediation function if depositors, note holders and other creditors have confidence in the solvency and liquidity of the institution.
The role of the prudential supervisor is to set rules that provide reasonable assurance that institutions are solvent and adequately liquid. Some systemically important global financial institutions were poorly regulated by overmatched supervisors (e.g. investment banks by SEC or insurance companies and monolines by U.S. state insurance regulators). Others were outside the regulatory net (such as hedge funds and credit rating agencies).

Prudential regulation focused on institutions rather than the system, permitting the development of intense procyclicality in regulation of bank capital, accounting and risk management practices.

Failures of national regulation in key jurisdictions permitted the build-up of excessive leverage across systemic institutions. As a consequence, the system needs substantially more capital not only to replace losses from write-offs but also to delever the system. Liquidity management has been found wanting across a broad range of financial institutions. The liquidity shortfall in the system was related to the capital shortfall and to the lack of attention paid to liquidity by prudential supervisors.

Management

At the heart of an efficient financial market are strong institutions that manage risks well, ensure adequate liquidity, maintain confidence of depositors and exercise prudent in extending credit while finding innovative ways to improve efficiency. In the focus of strong economic growth and an environment of adequate liquidity earlier this decade, some firms overestimated this market’s capacity to absorb risk. Failures in risk management policies and procedures – in particular the failure to assess risk over the entire credit cycle – were evident in a number of systemically important international institutions. While Canadian institutions did better than many of their international competitors, a lack of comprehensive approach to firm-wide risk management meant that key risks (including liquidity risks) were not identified or effectively managed.

Compensation policies often exacerbated risk management weaknesses. The necessity to adhere to inappropriate accounting standards also produced incentives which exacerbate these weaknesses. Finally, the move to the originate-and-distribute model undermined the traditional attention paid to the quality of credit given by “traditional” commercial bankers.

Finally, let me note that the weaknesses identified in any one of these four areas alone would not have led to the economic and financial difficulty in which the world now finds itself. It is the combination of macroeconomic imbalances, macrofinancial weakness, and supervisory and institutional shortcomings that have acted in a reinforcing fashion to create the current crisis. To prevent future crises of this nature while simultaneously putting the global economy on a path for solid economic growth in the future will require significant action on all four fronts. Since political and institutional capacity for change and reform is always limited, it is important to concentrate on the most important issues in each of these four areas. In the next section of this lecture I will set out what I believe to be the key actions to be undertaken.

KEY ISSUES REQUIRING LEADERSHIP

Macroeconomic

At the macroeconomic level the key short-run issue is the maintenance of global demand. The key medium-term issue is the structuring of the international “rules of the macroeconomic game” that will facilitate economic adjustment, trade and global growth.

First, the key issue for 2009.

The global deleveraging of the financial system which must take place implies tighter global credit conditions and wide interest rate spreads in the short run. This means very weak household and business demand especially in North America and Europe where household balance sheets are weak. It also means weaker demand for the exports of emerging market economies and weaker investment in plant and equipment in these
countries. Thus, in all jurisdictions it is necessary to support domestic demand through expansionary fiscal policy in 2009 and 2010. Because the extent of expansion is somewhat constrained in countries which already have high ratios of public debt to GDP and current account deficits, it is very important that jurisdictions with strong fiscal or current account positions pursue very expansionary policy. In particular, it is important that the high savings nations in Asia expand domestic demand as rapidly as possible. Not only is this important for their own political and economic stability, but it will begin the process of reducing current account imbalances which have built up over the past decades.

There is also scope for further easing of monetary policy in many jurisdictions to offset the very wide spreads between interest rates paid by households and businesses and the risk-free rate on government securities. This is particularly true in the OECD area. In countries where policy rates are already close to zero, some form of quantitative easing may also be advisable for a period of time. There is also a need for monetary stimulus in some Asian countries although the form of that stimulus will depend on the characteristics of their financial systems. Generally speaking, however, as the world delevers, it is fiscal policy that is the more important tool to underpin demand.

Now and over the medium term what will be most important is that monetary and fiscal authorities of systemically important jurisdictions cooperate closely in the management of the global economic and financial system. National authorities must of course adopt macroeconomic policies that are appropriate for their own jurisdictions. Generally speaking, good domestic macroeconomic policies will add up to good global policy. But they will only add up satisfactorily if all systemically important authorities take appropriate account of the impact of their domestic policies on their trading partners.

To facilitate such cooperation we need a global “table” around which national authorities gather to discuss macroeconomic and macrofinancial issues. And to facilitate discussions around that “table”, a strong, trusted analytical “secretariat” is needed to provide the surveillance and comprehensive analyses on which those discussions can be based. This should be the role of a reformed and strengthened International Monetary Fund (IMF). But the IMF unfortunately does not have the trust of some important emerging market authorities (particularly in Asia and South America). This is because of past actions of the IMF and because these authorities do not have an appropriate voice at the table. And without that trust, the IMF cannot do its job of fostering the needed macroeconomic cooperation.

But it is not only the macroeconomic surveillance function of the Fund which needs strengthening. If the IMF is to do its job effectively, its capacity to carry out macrofinancial surveillance will have to be greatly strengthened. Perhaps this can be done by drawing on existing analytic capacity in the Bank for International Settlements (BIS) and the FSF. But, however it is done, it is imperative that it be done quickly if the IMF is to have the capacity to provide comprehensive analytic support necessary for credible and trusted surveillance of the global economic and financial system.

Canada has been a strong advocate for increasing the voice of systemically important emerging market authorities and for strengthening the surveillance capacity of the Fund. The current global economic crisis creates a propitious climate for IMF renewal. Canadian authorities should redouble their efforts to bring about such renewal. Strong leadership will be required to bring about renewal of the international financial institutions. Canada is well-positioned to provide such leadership.

Before turning to macroprudential issues let me say one quick word about Canadian monetary and fiscal policy in the short and medium ahead.

Monetary policy conducted within our inflation targeting framework will continue to serve as well. In the short term as inflation is poised to dip below the 2% target, there is room for further monetary easing as Governor Carney indicated last week. Of course, as the economy recovers (probably in late 2010 or 2011) prices will firm again and monetary policy will need to be tightened again. Fiscal policy poses a greater challenge. Revenues of federal and provincial governments will automatically fall this fiscal year and next, and some expenditures
(e.g. employment insurance) will automatically rise, plunging the federal and many provincial governments into deficit. This is entirely appropriate. Because the level of public debt in 2008 was reasonably manageable, governments should allow the automatic stabilizers to work.

The more difficult decision is whether to undertake discretionary fiscal stimulus, and if so, what and how much. If it is judged that the slowdown is likely to be prolonged and that a significant output gap is likely to remain for three or four years, then a good case can be made for governments undertaking significant investment in physical infrastructure over this period. While this is a difficult judgement call, on balance I would judge such an investment would make good sense as it would facilitate non-inflationary growth later in the decade while maintaining employment and output in the short run. Additional investment in human capital – especially professional and technical skills – also makes sense during a period when labour markets are less tight. But whatever discretionary action is undertaken in 2009 and 2010, federal and provincial governments should aim to have reduced the ratio of public debt to GDP (Gross Domestic Product) back to the 2008 ratio by 2012 or 2013, a time when large numbers of baby boomers will begin to leave the labour force.

**Macrofinancial**

Let me now turn to macrofinancial issues. In my brief analysis of the macrofinancial roots of the current crisis, I pointed out that the over-leveraging of the financial system this decade was in part due to the lack of attention paid to macrofinancial issues by all parties – governments, central banks, prudential and market conduct regulators, and financial institutions themselves. Market participants will always be subject to bouts of excessive exuberance and deep pessimism. Over- and under-reaction is inherent in financial markets. Market players inevitably look to the behaviour of other market players. If everyone else is betting on continuing asset price increases – and borrowing to purchase these assets – it is hard to resist doing the same thing. This is equally true for homeowners and sophisticated fund managers. For this reason, financial markets will always be characterized by successive waves of exuberance (bubbles) and pessimism (crashes).Crashes are not black swans but rather the inevitable outcome of a previous wave of exuberance.

While I do not believe it is the role of the central bank to target asset prices in setting monetary policy, as I said in my lecture last week, “some modest increase of the policy rate from the level that would otherwise be judged appropriate to stabilize output and consumer price inflation might be warranted in periods of rapid asset price inflation”. But the central bank does have an important role to play in improving macrofinancial stability even if it does not have microprudential supervisory powers.

The central bank is the lender-of-last-resort to the banking system and hence has a key responsibility to ensure that banks maintain adequate liquidity. And the current crisis has demonstrated that in some countries the central bank has become de facto the market maker of last resort for systemically important financial markets. Whether this should be the case de jure is a matter for further debate. But what is abundantly clear is that central banks need to devote more effort to monitoring and assessing financial market developments, including market and institutional liquidity issues, and to discussing these developments with other relevant agencies. Central banks are in the best position to assess and analyze macrofinancial developments and to make this analysis available to other agencies and the private sector.

The Bank of Canada has done this since 2003 through its semi-annual Financial System Review. The Bank cooperates very closely with its Financial Institutions Supervisory Committee partners – the Canada Deposit Insurance Corporation (CDIC), the Office of the Superintendent of Financial Institutions (OSFI) and the Department of Finance – but even closer cooperation is desirable going forward.

Some have argued that such cooperation is not enough, and that microprudential supervision should return to central banks. I do not believe this is necessary or necessarily desirable. But what is necessary is that
central banks have the capacity to absorb and make use of microfinancial data from regulatory agencies and that the regulatory agencies absorb and make use of the macrofinancial analysis provided by central banks.

Regulatory agencies do share with the central bank the responsibility for macrofinancial stabilization. Adjustment of the central bank’s policy rate alone cannot do the stabilization job alone. In both the design of the prudential framework, prudential supervisors must take into account what is happening “over the dyke” in markets beyond their regulatory fiat. Similarly, agencies responsible for the oversight of markets and market conduct need to have both the mandate and the capacity to ensure that basic principles of disclosure are applied in all financial markets and that the “mechanics” of markets are sound. Market conduct regulators need to cooperate with prudential supervisors, central banks and ministries of finance. While the Heads of Agencies meetings represent a first step in fostering such cooperation in Canada, clearly much greater effort is required.

In sum, I would argue strongly that all agencies with oversight responsibilities must assume some of the burden for stabilizing the financial system. In other words, agencies responsible for prudential regulation of financial institutions and oversight of mortgage and financial markets must have at least one eye focused on macrofinancial stabilization issues. And the management of financial institutions must assume greater responsibility for protecting the institutions and their clients against the risk of adverse outcomes. I will return briefly to the issue of management responsibility in a moment, but first a few words on the regulation of financial markets and institutions.

Regulation of Markets and Institutions

The role of good regulation is to provide the legal framework within which financial markets and institutions can allocate savings to the most productive use. Since markets only function efficiently when there is a reasonable symmetry of information, the most important role of market regulators is to set the basic principles of disclosure so that the purchaser of any financial asset has access to adequate information to form a judgement as to the financial position and credit worthiness of the issuer or borrower.

Securities regulators have carried out this role reasonably well for traditional equity and fixed-income markets, although there is always room for improvement. But to function properly, markets for swaps, derivatives of various types, Collateralized Debt Obligations (CDOs), etc., also require accessible information and oversight to ensure that basic principles of disclosure are applied. Thus, I believe that securities regulators will need to establish disclosure rules for structured products and derivatives to bring about much greater transparency with respect to the underlying credits.

Only with more adequate information will the purchasers of securities have the incentive and ability to assess the credit quality of the underlying financial assets and make a true assessment of the underlying credit risks involved, and especially the very low-probability, high-cost risks of counterparty default. By exposing information on underlying credits and counterparties, the procyclical tendency to ignore low-probability risks in times of exuberance is reduced. And in times of stress, the tendency of markets to freeze because of lack of information is also sharply reduced.

Because much “traditional banking business” is now conducted directly through financial markets, securities regulators have had thrust upon them a need for broadened financial market focus. At the moment, they are currently neither professionally equipped nor legally mandated to carry out this broadened focus. This needs to change. It is not enough to focus simply on disclosure documentation for complex products such as credit default swaps; continuous markets (eg., exchanges or clearing houses) for these products must be built and backstopped. In Canada, this complex task will require close cooperation between Finance, the Bank of Canada and the securities regulators – cooperation which would be much easier to achieve if Canada were to have a single securities regulator.

Accounting standards play a vital role in providing all market participants with consistent information about the
financial health of borrowers, issuers, and financial intermediaries. It is particularly important that standards are set in such a way as to convey the underlying financial health and profitability of financial intermediaries (banks, insurance companies, pension funds) if these institutions are to carry out their intermediation functions.

The essence of intermediation is providing for a mismatch between assets and liabilities at a point in time. Banks in essence borrow short and lend long. Pension funds and life insurance companies have very long-dated liabilities which they finance with assets which generally are held for long periods of time even though a substantial proportion of these assets can be traded daily in normally liquid markets. In addition, all three intermediaries hold assets which are not generally traded in continuous markets.

Mark-to-market accounting for these institutions creates spurious volatility in reported earnings and balance sheet positions. For banks, this creates market incentives for excessive risk-taking in the upswing of the credit cycle and excessive credit contraction on the downswing. For pension funds, it creates the incentive for contribution holidays on the cyclical upswing and excessive contributions in time of market stress. The almost religious zeal with which accounting standards bodies have foisted detailed rules requiring financial institutions to continuously mark assets to market for reporting purposes has been a major contributor to volatility over this decade. Financial institutions should smooth profits by setting aside reserves during good times when market prices are likely to exceed the long-run value of assets, and vice versa in bad times. Accounting standards bodies as well as prudential regulators have an important role to play in establishing general rules that provide appropriate incentives for financial institutions to set aside general reserves or increase measured capital during the upswing and to draw on those reserves during the downswing.

Even more important than finding appropriate accounting standards for financial intermediaries is the need for prudential regulators to adopt a regulatory framework that (more or less) automatically will require intermediaries to set aside more general reserves or increase capital during the upswing and allow them to draw on those reserves or capital during the downturn. At the bottom of the credit cycle when risky spreads are very wide and loan losses are high (as they are today), regulators should automatically reduce required capital ratios (or general reserve requirements) because new assets are being acquired at knockdown prices and loans are being made to only the highest quality borrowers. On the upswing and at the top of the credit cycle, the same principle applies in reverse. An automatic increase in required capital or general reserves is warranted as the quality of new loans deteriorates and assets prices balloon.

While the provision for risk-weighted capital under Basel II is a clear improvement in principle from Basel I, nevertheless the rules of Basel II remain procyclical in their effect. Redesign of these overly complicated rules is warranted. In the meantime, national supervisors have the latitude under pillar II of the Basel framework to apply judgement – judgement which should be exercised to reduce required capital at this point in time.

In Canada, OSFI appropriately exercised that judgement over the past few years to require Canadian banks and insurers to hold more capital and reserves than required under the Basel rules. That same judgement should be used now, and in the period ahead, to ease requirements.

Finally, let me re-emphasize that the build-up of excessive leverage earlier this decade was the fundamental cause of the problems we face today. Control of raw leverage ratios for all financial institutions is key to ongoing financial stability. OSFI’s 20-to-1 maximum ratio in normal times has served Canada rather well. Generally leverage ratios for investment banks and banks outside North America are much higher. We need a set of international principles on acceptable levels of leverage. Overall the principles governing internationally active institutions need to be structured to provide greater incentives for the prudent management of credit risk and constrained use of leverage on the upswing in the business and credit cycle, and to reduce the disincentive to extend credit at the bottom of the cycle.

The restructuring of the global system of markets and institutions will be arduous. Great leadership will be
required to secure agreement on the key principles I outlined above. And there will be a huge temptation to squander efforts on peripheral but politically popular issues. While we in Canada have missed some opportunities to improve our regulatory system, generally our regulatory structure has stood up well. Canadian authorities are in a position to exercise leadership in this domain. I hope they will seize the opportunity the current turmoil creates to exercise that leadership.

**Management**

Leadership by Canadian authorities is essential. But equally important is leadership by the Canadian private sector. Canadian banks and insurers appear to have managed risks reasonably well during the period of asset price inflation – certainly in comparison to many of their international peers. This puts the managers of Canadian institutions in a position to lead in crafting the principles of conduct and best practice for the management of risk in the financial services industry. I salute Rick Waugh for his leadership in this regard, and commend to you the Institute of International Finance’s July Report on Market Best Practices

**CONCLUSION**

As I said earlier, a very high degree of international cooperation will be required to forge a better framework for macroeconomic, macrofinancial and prudential policies. Central banks and prudential regulators have the Bank for International Settlements to foster and support effective cooperation. This forum could usefully be expanded to include securities regulators, such as the International Organization of Securities Commissions. But finance ministries are not present at BIS discussions. Thus, the IMF has a very important role to play, for it brings together finance ministers and central bankers. In the end, it will be governments that will have to cooperate to establish a stronger international monetary and financial structure. Canada has been a strong advocate for closer international cooperation and should continue to lead. And Canadian financial institutions should continue to lead in the IIF and other international private sector groupings.

But in the end, it will be our national authorities which must devise and enforce improved rules of the game. It will be our own financial institutions which must find improved ways to manage risk. I firmly believe Canadians are up to the task. It is now only a question of leadership.
The inability to reach a new multilateral trade agreement to further reduce trade barriers was, however, a major failure in this period.

Japan was dealing with a sharp economic slowdown in this period, however.

This problem was less severe in Canada than in most other OECD countries because the heads of the Bank of Canada, CDIC, OSFI, and the Department of Finance must meet regularly as the Financial Institutions Supervisory Committee to discuss macro and micro prudential issues.

See my March 30, 2006 lecture at Princeton

See my Benefactors Lecture, 18 November 2008


See for example Stanley Fisher (2008) p8

See LePan (2008)

I hasten to add however, that lower leverage ratios need to be phased in over time


References:


Dodge, David – 2008 – Central Banking at a Time of Crisis and Beyond, Benefactors Lecture, 18 November 2008


If we could really achieve more cooperation between government and business, we would see a quantum leap in economic performance and productivity.

JACK LAWRENCE

The Lawrence National Centre is committed to the development of sound public policy by providing a national forum for business, academia, and government to think globally, act strategically, and contribute to the societies in which they operate. The Centre creates dynamic networks that bridge business, academia, and government.

JACK LAWRENCE

Founder

LAWRENCE NATIONAL CENTRE FOR POLICY AND MANAGEMENT
The faculty, staff and students who contributed to the 2008 HBA Leaders Forum, at the Ivey School of Business, in which David Dodge was the Keynote speaker are as follows:

**LAWRENCE NATIONAL CENTRE FOR POLICY AND MANAGEMENT**

- Dianne Cunningham • DIRECTOR
- Katarina Wolff • RESEARCH AND PROJECT MANAGER

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