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LETTER FROM THE PRESIDENT

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Have we reached the high water mark of global reform?

HIGHLIGHTS:

After eight years of intense and almost frenzied rule-making, there is growing consensus that regulators need to look back and assess the impact of these rules on market liquidity and economic activity. The new Trump Administration will be a catalyst adding momentum to this review.

Global rule-making has been focused primarily on making the banking system more resilient to economic and financial shocks, and tightening the trading and clearing rules for OTC derivative securities. Much progress has been achieved. However, concerns have arisen that these rules have handicapped bank lending and securities dealing, and undermined liquidity in debt markets.

Rule-making will undoubtedly continue apace, focused on refining existing rules to ensure systemic risks are properly mitigated (e.g. reviewing regulations governing large asset managers), and on ensuring transparency and market conduct rules effectively balance investor/market protection and robust market liquidity/capital-raising.

Introduction

The aftermath of the 2007-2008 global financial crisis was an intensive period of financial regulatory reform across the developed world. At the G20 Summit in Pittsburgh in September 2009, political leaders undertook to reform the market for over-the-counter (OTC) derivatives. In particular, they jointly declared that all standardized OTC derivatives be traded on exchanges or electronic trading platforms, and cleared through central counterparties.

Another implementation of the G20 Pittsburgh Summit was the MiFID II Directive which proposed reforms in investor protection, transparency and supervisory requirements for financial products and services provided by banks.

In the U.S., the Dodd-Frank legislation was passed into law on July 21, 2010. It was hailed as the most sweeping financial services regulatory reform legislation in decades, covering issues ranging from systemic supervision, changes to the regulation of investment advisors, the regulation of OTC derivatives and measures aimed at improving consumer protection.

In many cases, the reforms, notably the Dodd-Frank legislation and the MiFID reforms in the EU, were triggered by tumultuous global markets, and the vulnerabilities of the large banks. In some cases, the reforms began before the financial crisis, for example, the U.K. Retail Distribution Review was launched in 2006 by the Financial Services Authority and was aimed at improving transparency and fairness in the investment industry. A set of new rules came into effect at the start of 2013.

In Canada, the reforms in the retail markets had their origins in the Stromberg Report in the mid-1990s, and the Ontario Securities Commission's (OSC) Fair Dealing Model in the early 2000s, both of which focused on reforming the way the retail investment industry is regulated. The Canadian regulators have had their shoulders to the wheel of retail reform for more than twenty years.

Recent developments in global capital markets suggest securities reform may now have reached its high water mark, and the pace of rule-making will slow and, in some cases, reverse direction.

1. Trump Administration roll-back of Dodd-Frank

U.S. President-elect Trump has signalled there will be a "roll-back" of at least parts of the Dodd-Frank legislation. His choice for Treasury secretary, Steven Mnuchin said "the number one problem with Dodd-Frank is that it's way too complicated and cuts back lending."

The Republican-led Congress is likely to push back on the U.S. Department of Labor fiduciary standard, given impracticalities and prospect of unintended consequences, and the Securities and Exchange Commission's (SEC) ongoing efforts to conduct a cost-benefit analysis of the uniform fiduciary standard for registered investment advisors (RIAs) and FINRA-registered broker-dealers may be sidelined.

The U.S. authorities may also push back on some of the Basel III capital and liquidity rules, as well as the impending "Basel IV" risk weight plans that will limit bank flexibility to model their own risks.

2. Basel Committee faces rule push-back from banks and some governments

The EU policymakers, led by the Bundesbank, have already signalled opposition to the general implementation of proposed changes in the Basel III rules that restrict independent bank assessment of risk. The imposition of the so-called Basel IV provisions would result in higher capital and liquidity requirements for the European banks, hindering their ability to fund economic expansion. If the Trump Administration, with the support of Congress, mandate regulators not to implement the proposed Basel IV rules, this would place added pressure on the European regulators and governments to follow suit with the Basel IV rules.

3. FSB policy recommendations will carry weight in rule review

The Financial Stability Board (FSB) is engaged in an assessment of the capital/liquidity provisions for the European banking system, and regulations governing the large asset managers. It brings together macro-prudential analysis, and the impact on the functioning and liquidity of the bond markets.

The intense debate on bond market liquidity and increased risks to a downturn in bond prices, especially corporate bonds, will influence the FSB conclusions. The eventual findings and decision of the FSB will carry significant influence on the positioning at the Bank for International Settlements and the Basel Committee on Banking Supervision, and among individual national jurisdictions.

4. Eroding bond liquidity forces regulators to rethink regulatory measures

Over the past years, an interesting dichotomy has emerged between the vies of the regulatory community and market practitioners on the extent of deterioration of bond market liquidity, notably in the U.S., the UK and Europe.

The regulators, as well as analysis by the U.S. Federal Reserve and International Organization of Securities Commissions (IOSCO), have been relatively sanguine about the erosion in bond market liquidity, while the private sector, led by extensive analytical work by PwC and Oliver Wyman, have interpreted the evidence more negatively. Part of the difference in view relates to the difficulties in aggregating the information and the weight given to certain liquidity indicators.

There is mounting evidence that despite varying interpretations of conventional indicators of liquidity, the macro-prudential reforms covering bond inventories and collateral in repo and securities lending transactions have altered trading patterns in terms of reducing transaction size, and the increased difficulty executing trades, at least on a timely basis. Moreover, there is general recognition that bond liquidity is a relatively thin veneer, leaving markets more vulnerable and exposed to external shocks. The thirty-year bull market for bonds may be coming to an end, resulting in a downward trajectory for bond prices, particularly if rebounding growth and resurgent inflation are sustained as the new U.S. Administration introduces a more pro-growth policy agenda. This outcome could buttress the case for adjustments in capital/liquidity rules, and for greater caution in implementing bond transparency rules.

5. European Commission calls for evidence

In the wake of the financial crisis, more than 40 new pieces of EU legislation were adopted to restore financial stability and market confidence. The Commission launched the so-called “Call for Evidence”, a public consultation, to obtain feedback and empirical evidence on the benefits, unintended effects, consistency and coherence of the financial legislation adopted in response to the financial crisis.

On November 23, 2016, the European Commission released the findings from its Call for Evidence. Overall, the majority of respondents signalled support for the financial reforms, however, they also provided examples of possible frictions, overlaps and unintended interactions between different regulations. The European Commission noted that it would pay greater attention to areas where the rules may be impeding the flow of finance to the economy; focus on enhancing proportionality in the regulatory framework to better balance financial stability and growth objectives; reduce red-tape and design rules that achieve their objectives at minimum cost for firms and clients; ensure consistency of the overall framework; address remaining risk in the financial system; further enhance investor and consumer protection; and keep the regulatory framework up to speed with technological developments.

The Commission will take a number of specific actions and will publish its findings and next steps before the end of 2017. It is important to note that as concerns rise about unintended consequences, jurisdictions are likely to deviate from the Basel proposals as well.

Complementing the follow-up to the Call for Evidence, the Commission also published a report on the review of the European Market Infrastructure Regulation (EMIR), looking at how rules for over-the-counter derivatives, central counterparties and trade repositories should be improved.

6. Codes of conduct as an alternative to formal rule framework

The Bank of England, HM Treasury and Financial Conduct Authority (FCA) launched the Fair and Effective Markets Review (FEMR) in June 2014 to conduct a comprehensive and forward looking assessment on the way the wholesale Fixed Income, Currency and Commodities (FICC) markets operate in the wake of a number of scandals (e.g. Libor fixing) in both the UK and global financial markets. To tackle this project, the Review created a new FICC Markets Standards Board (FMSB). The outcome of the Fair and Effective Market Review was to establish the FICC Markets Standards Board to develop standards of conduct to improve the quality, clarity and market-wide understanding of wholesale FICC trading practices.

The FMSB has created a non-profit corporation funded by 36 member financial institutions (25 sell-side and 11 buy-side firms) operating through various standing sub-committees to identify standards of conduct for specific practices in FICC markets. To date, the FMSB has published, for comment, transparency draft standards on 'Reference Price Transactions in Fixed Income Rates Markets' and 'Binary Options in Commodities Markets'. The FMSB also provided input to the work being undertaken to create a Global FX Code for currency dealing. The reliance on compliance with agreed-upon rules of conduct is considered as a cost-effective alternative to specific rules, giving firms flexibility in complying with the standards.

The FMSB has plans to achieve the internationalization of standards for consistent dealing practices across the global market. The success of the FMSB standards, and take-up by foreign jurisdictions, may encourage regulators to consider codes of conduct as an alternative to a formal rule framework.

7. Regulators learn from mistakes

Regulators have recognized the disjointed and uneven implementation of the OTC derivatives trading and clearing rules, encouraged by the benefit from "first mover" status in some jurisdictions and rule-making inertia in others, resulted in disjointed and duplicative rules, and disruptions in capital flows across jurisdictions. In an effort to avoid those mistakes in the future, rule-making is likely to proceed at a much slower, more deliberate and coordinated pace, benefitting from IOSCO consultations.

8. Canadian regulators likely adopt measured pace of reform

In Canada, the pace of rulemaking is likely to be more measured in the next few year, with the likelihood of some retrenchment in the proposed rules.

First, the Canadian banking regulators will be monitoring the adoption of the Basel rules across foreign jurisdictions, notably the likely push back by U.S. and EU regulators of the Basel III and Basel IV rules, and the BIS proposal to remove individual firm risk weightings in the application of the capital and liquidity rules. The Canadian regulators will be ready to make adjustments to capital and liquidity proposals to ensure the Basel rules for Canadian banks will correspond closely to U.S. and EU banking rules in order not to interfere with the competitiveness of the Canadian banks.

Second, Canadian securities regulators have committed to a comprehensive post-implementation review of the CRM1 and CRM2 rules. Since these rules were imposed without formal cost-benefit analysis, there will likely be some modification to the existing rules.

Lastly, recent quantitative analysis undertaken by the investment industry indicates the proposed "targeted reforms" will result in substantial increases in compliance costs for large and small firms. The findings will encourage an extensive consultation process with market practitioners in an effort to construct practical and cost-effective rules related to the detailed obligations for investment advisors.

Conclusion

In 2008, the global banking and financial system came close to a complete meltdown. Bank balance-sheets had ballooned, but too little capital was set aside to absorb losses. When asset prices collapsed, the results were catastrophic. It took massive taxpayer-financed bail-outs to shore up the industry and forced restructuring.

In the eight years since the financial crisis, banking and securities regulators have been in overdrive, focused on building a more resilient financial system through capital and liquidity protections, greater transparency and better rules for market conduct.

The urgency and extent of reform, particularly in the early years, laid the ground for excessive and unintended consequences. There is a growing consensus that the pendulum has swung too far. Regulators in many jurisdictions are taking stock of the impact of reform on markets and on the economy. The weakened liquidity in markets, and pernicious slow economic growth, have added urgency to these investigative efforts to avoid unduly handicapping capital raising and secondary market trading.

We expect that an ongoing review of the reform impact and rising compliance costs for the financial sector will slow the rulemaking process, roll back certain rules, and increase reliance on industry best standards and tougher enforcement.

We have probably reached the high water mark of reform. However, this does not mean the water will recede quickly. Further reforms to regulation and adjustments to existing rule books will proceed slowly and carefully.

Yours sincerely,

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