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Regulating Systemic Risk in Canada

Anita Anand and Maziar Peihani

The effects of the global financial crisis (GFC) were profound: stock prices plummeted, investors tried to liquidate their holdings, financial institutions teetered on the brink of bankruptcy and credit markets froze as liquidity vanished from financial markets. Systemic risk that may have seemed obvious to market observers was realized when Lehman Brothers filed for bankruptcy on September 15, 2008. Just prior to this filing, the Dow Jones Index suffered the largest loss since September 11, 2001, plummeting more than 500 points. With this decline, US$700 billion in value vanished from retirement plans, government pension funds and other investment portfolios.[1] World markets only started to stabilize after the announcement of the US$700-billion Troubled Asset Relief Program and similar massive bailouts by governments around the world.[2]

1 Financial Crisis Inquiry Commission, *The Financial Crisis Inquiry Report: Final Report of the National Commission on the Causes of the Financial and Economic Crisis in the United States* (January 2011) at 356, online: <www.gpo.gov/fdsys/pkg/GPO-FCIC/pdf/GPO-FCIC.pdf>.

2 George Walker, "Credit Contraction, Financial Collapse and Global Recession: pt 1" (2009) 1 JIBFL 5; A Cohen, "Global Financial Crisis – Timeline" (2009) 1 JIBFL 10.

The GFC led to an unprecedented wave of structural and regulatory reforms internationally and within the Group of Twenty (G20) countries.[3] Building on existing literature regarding systemic risk and financial policy, this chapter examines the Canadian financial system and assesses the structural and regulatory reforms that have followed the GFC. The chapter analyzes the post-crisis regulatory regime based on its ability to detect, prevent and address sources of systemic risk in the financial system. We adopt a broad notion of systemic risk that goes beyond the commonly held view that systemic risk arises from the widespread distress caused by failure of individual financial institutions, often referred to as the domino effect.[4] Rather than concentrating exclusively on contagion or chains of failures, we believe that systemic risk can also arise from the common exposure to macroeconomic factors across sectors and institutions in the financial markets.[5]

This chapter acknowledges that a multiplicity of factors contributes to the resiliency of a financial system. In Canada's case, for example, these factors include stronger bank capital ratios, stricter mortgage underwriting requirements, law reforms and new resolution tools. We argue that heightened leverage in the financial system, which is reflected in high household debt and inflated house prices, remains an important source of vulnerability across Group of Seven (G7) economies and especially in Canada. We contend that Canadian regulators' ability to address systemic risk is limited by the structure of the regime, built on a sector-by-sector model, without any one institution responsible for comprehensively regulating the financial system. The regulatory regime is a partial consequence of the historical evolution of financial markets in Canada and their constitutional underpinnings.

As the Canadian case study reveals, diffusion of regulatory oversight can lead to failures in addressing system-wide issues, as well as poor communication and coordination among various bodies, all of which may fail to contain systemic risk. One possible solution, advocated in international assessments as well as academic literature on systemic risk, is to establish a macroprudential regulator to monitor the entire financial system.[6] As will be explained, whereas this approach has been adopted in other jurisdictions, such as the United States and the United Kingdom, it is unlikely to gain momentum in Canada, given the reality of path dependency in regulatory policy making.

3 See G20 Information Centre, "Global Plan for Recovery and Reform" (Statement issued by the G20 leaders, London, 2 April 2009), online: <www.g20.utoronto.ca/2009/2009communique0402.html>; G20 Information Centre, "Global Plan Annex: Declaration on Strengthening the Financial System" (Statement issued by the G20 leaders, London, 2 April 2009), online: <www.g20.utoronto.ca/2009/2009ifi.html>. L

4 For an example of this view, see Steven L. Schwarcz, "Systemic Risk" (2008) 97 Geo LJ 193, which focuses on "economic shock," "failure of a chain of markets or institutions" and "a chain of significant losses to financial institutions" as key concepts in defining systemic risk.

5 Claudio Borio, "Towards a macroprudential framework for financial supervision and regulation?" (2003) Bank for International Settlements (BIS) Working Paper No 128 at 5–7, online: <www.bis.org/publ/work128.pdf>; see also Anita Anand, Michael Trebilcock & Michael Rosenstock, "Institutional Design and the New Systemic Risk in Banking Crises" in Anita Anand, ed, *Systemic Risk and Institutional Design* (Oxford, UK: Oxford University Press, 2016) [Anand, *Systemic Risk*].

6 As we will discuss later in this chapter, both the International Monetary Fund (IMF) and the Financial Stability Board (FSB) have made such a recommendation to policy makers. For notable examples in the literature that are in line with this view, see Paul Jenkins & David Longworth, "Securing Monetary and Financial Stability: Why Canada Needs a Macroprudential Policy Framework" (2015) CD Howe Institute Commentary No 429 at 10–11, online: <www.cdhowe.org/sites/default/files/attachments/research_papers/mixed/commentary_429.pdf>; Samuel Howorth et al, "Improving Canada's Financial Stability Governance Regime" CIGI, Special Report, 22 November 2016 at 6–7, online: <www.cigionline.org/publications/improving-canadas-financial-stability-governance-regime>; Paul Tucker, "The Design and Governance of Financial Stability Regimes" CIGI, Essays on International Finance, vol 3, September 2016, online: <www.cigionline.org/sites/default/files/financial_essay_vol.3_web.pdf>.

The absence of a formal macroprudential regulator does not prevent Canadian regulators from working collaboratively toward more effective management of systemic risk. This goal can be achieved by establishing financial stability as an overriding priority for inter-agency regulatory groups. These bodies should extend their membership to include all key federal and provincial regulators and establish a robust working plan for monitoring system-wide vulnerabilities, which would ensure timely attention and action on problems by competent authorities. This chapter offers specific recommendations to enhance coordination among different policy-making bodies in the financial markets.

We begin by discussing the modern financial and regulatory landscape in Canada and then examine the structural and regulatory reforms that were undertaken after the GFC. We focus on three areas of reform, namely: bank regulatory reforms; housing market measures; and securities law reforms, in particular the recently proposed Capital Markets Stability Act. The chapter then assesses the challenges of systemic risk oversight followed by reform suggestions that can help to establish a more integrated framework for systemic risk oversight.

The Canadian Financial Landscape

Canada has a sophisticated financial system that provides liquidity for participants alongside prudential oversight and stability for depositors. With more than 10 years having passed since the GFC, it is appropriate to examine the current state of Canada's financial system in order to assess its ability to respond to systemic risks. This section highlights the core characteristics of Canada's financial system and provides an overview of its regulatory framework.

Canada's financial system is dominated by a handful of key players in most financial subsectors. Cumulatively, their assets total approximately 500 percent of Canada's GDP.[7] Three particular market constituent groups — banks, insurance companies and pension funds — wield significant market influence, given their assets and market functions.

The country's banking sector is highly concentrated, with the six federally chartered banks — the Royal Bank of Canada, Toronto Dominion, Bank of Nova Scotia, Canadian Imperial Bank of Canada (CIBC), Bank of Montreal and National Bank of Canada — holding 93 percent of the country's total bank assets in aggregate.[8] These banks primarily engage in household lending, corporate lending, wealth management and trading.

As of February 2018, Canada's total household credit stood at $2.1 trillion,[9] of which 71 percent comprised residential mortgages and 28 percent comprised consumer credit such as personal lines of credit and credit cards.[10] Chartered banks account for 77 percent and non-bank firms, such as trust and loan companies and credit unions, account for 19 percent of Canada's total household credit.[11] Particularly problematic in this debt-heavy environment is the existence of the shadow

7 IMF, *Canada: Financial Sector Stability Assessment* (2014) IMF Country Report No 14/29 [IMF, *FSSA*] at 8, online: <www.imf.org/external/pubs/cat/longres.aspx?sk=41299.0>.

8 *Ibid* at 11.

9 All dollar figures in Canadian dollars unless otherwise noted.

10 BoC, "Household Credit: Overview of Total Household Credit" (2018), online: <https://credit.bankofcanada.ca/householdcredit#1>.

11 BoC, "Household Credit: Sources of Household Credit" (2018), online: <https://credit.bankofcanada.ca/householdcredit#1>.

banking industry, which consists chiefly of credit intermediation outside the traditional banking system.[12] The Bank of Canada (BoC) estimates that its credit value amounts to $1.1 trillion, roughly half of the $2.1 trillion of traditional bank liabilities.[13] The most important components of shadow banking are investment funds (46 percent) followed by repo (repurchase agreement) and securities lending transactions (29 percent). These figures are considerable, engaging the interests of diverse financial market participants, including individual investors, smaller lending operations, and the various intermediaries and counterparties relying on shadow banking activities for their business. These sizeable loans present systemic risk challenges by increasing consumer debt loads on those borrowers who may be more vulnerable to an increased interest rate.

The insurance sector forms the second of the three constituent groups, wielding significant influence on Canada's financial market. Indeed, Canada's insurance sector accounts for 16 percent of the country's financial sector assets. The industry is broadly divided in terms of life insurance and property and casualty insurance specializations. Three domestic firms (Sun Life Financial, Great-West Life and Manulife Financial) hold three-quarters of life and health insurance assets in Canada.[14] In contrast, the property and casualty insurance sector is highly competitive and includes a number of foreign-owned companies that collect more than half of the premiums earned in Canada.[15]

Beyond the two insurance lines, mortgage insurance forms a major portion of Canada's total insurance sector value. Mortgage insurance coverage is provided by the Canada Mortgage and Housing Corporation (CMHC), a federal Crown corporation, and two private insurance firms.[16] All federally regulated lenders must obtain mortgage default insurance for home buyers with less than a 20 percent down payment. As of March 2015, government-backed insurance covered 56 percent of all outstanding residential mortgages.[17]

Lastly, Canadian pension funds occupy a unique position as significant players in Canadian and global financial markets. Their investment capacity is broad, their influence is significant and their diverse asset classes offer enviable returns while mitigating risk. These funds hold approximately 15 percent of the country's total assets in the financial system. Of this 15 percent,

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12 For the definition of shadow banking, see FSB, *Shadow Banking: Strengthening Oversight and Regulation – Recommendations of the Financial Stability Board* (FSB, 2011) at 3, online: <www.financialstabilityboard.org/wp-content/uploads/r_111027a.pdf>.

13 See Bo Young Chang et al, *Monitoring Shadow Banking in Canada: A Hybrid Approach* (BoC, 2016) at 28, online: <www.bankofcanada.ca/wp-content/uploads/2016/12/fsr-december-2016-chang.pdf>.

14 IMF, *FSSA*, *supra* note 7 at 58. See also Department of Finance Canada, *Supporting a Strong and Growing Economy: Positioning Canada's Financial Sector for the Future* (Department of Finance Canada, 2016) [Department of Finance Canada, *Supporting a Strong and Growing Economy*] at 13, online: <www.fin.gc.ca/activty/consult/ssge-sefc-eng.pdf>.

15 As of 2016, there were 74 foreign incorporated property and casualty insurers operating in Canada, with assets of $35 billion. See Department of Finance Canada, *Supporting a Strong and Growing Economy*, *supra* note 14 at 14; FSB, *Peer Review of Canada: Review Report* (FSB, 2012) at 9, online: <www.fsb.org/wp-content/uploads/r_120130.pdf>.

16 Namely Genworth MI Canada and Canada Guaranty. See Department of Finance Canada, "Overview: Lender Risk Sharing for Government-Backed Insured Mortgages" (21 October 2016), online: <www.fin.gc.ca/n16/data/16-136_1-eng.asp#_ftn1>.

17 *Ibid*. In the event a mortgage insurer is unable to make an insurance payout to the lender, the federal government backs 100 percent of the CMHC's liability as well as the private insurers' liability (subject to a 10 percent deductible). See Department of Finance Canada, *Supporting a Strong and Growing Economy*, *supra* note 14 at 15.

the eight largest public pension funds control two-thirds of this share, with more than $1 trillion in net assets under management.[18]

Canada's capital market activity is concentrated, with banks playing a dominant role through their subsidiaries. Indeed, the six largest securities dealers are owned by the big six Canadian banks. In 2015, bank subsidiaries underwrote 61 percent of all deals, accounting for 64 percent of the value of the issued securities.[19] The three most prominent exchanges in Canada are the Toronto Stock Exchange, the Bourse de Montréal and the TSX Venture Exchange. The clearing, settlement and recording of financial transactions are undertaken by financial market infrastructures, three of which have been designated as systemically important.[20] Given the integrated and concentrated financial system, it is unsurprising that Canadian financial markets can be exposed to systemic risks. The structure of a regime, in our view, is itself a vulnerability. We turn now to examine the regulatory characteristics of this regime in greater detail.

The Regulatory Regime of Canada's Financial Market

This section examines the composition of Canada's financial market in terms of regulators that have some role in managing or overseeing systemic risk. Fundamentally, Canada's regulatory system is based on a complex constitutional framework that divides the responsibility for supervision of the financial markets between federal and provincial governments and their designated agencies. The ramifications of this divided regulatory approach is that financial institutions are federally regulated while securities markets, including public companies, are regulated at the provincial level.[21] Firms in other sectors, such as insurance companies, trust and loan companies, credit unions and pension plans, can be incorporated and regulated at both the provincial and federal levels.[22]

Thirteen provincial and territorial regulatory authorities regulate the securities markets across Canada. The provinces of Alberta, British Columbia, Ontario and Quebec supervise about 95 percent of the country's capital markets.[23] While each regulator is operationally independent and administers a separate set of laws and regulations, they have experienced moderate success in harmonizing their policies and supervisory practices.[24] However, in certain areas involving new

18 These pension funds are the Canada Pension Plan, Caisse de dépôt et placement du Québec, the Ontario Teachers' Pension Plan, the Public Sector Pension Investment Board, the British Columbia Investment Management Corporation, the Alberta Investment Management Corporation, the Healthcare of Ontario Pension Plan and the Ontario Municipal Employees Retirement System.

19 See also IMF, *FSSA*, *supra* note 7 at 10.

20 *Ibid.* These are the Large Value Transfer System, CDX and Canadian Derivatives Clearing Service.

21 Office of the Superintendent of Financial Institutions (OSFI), *Supervisory Framework* (April 2014), online: <www.osfi-bsif.gc.ca/Eng/fi-if/rai-eri/sp-ps/Pages/sff.aspx>.

22 See OSFI, "Who We Regulate" (23 October 2014), online: <www.osfi-bsif.gc.ca/Eng/wt-ow/Pages/wwr-er.aspx?sc=1&gc=4#WWRLink14>; IMF, *FSSA*, *supra* note 7 at 21.

23 IMF, "Canada: Financial Sector Assessment Program: IOSCO Objectives and Principles of Securities Regulation – Detailed Assessment of Implementation" (March 2014), IMF Country Report No 14/73 [IMF Country Report] at 8, online: <www.imf.org/external/pubs/ft/scr/2014/cr1473.pdf>.

24 Harmonization has been facilitated by the Canadian Securities Administrators (CSA), the umbrella organization for provincial and territorial securities regulators that seeks to improve, coordinate and harmonize regulation of capital markets in Canada. See CSA, "Who We Are", online: <www.securities-administrators.ca/aboutcsa.aspx?id=77>. We discuss the role of the CSA in enacting securities regulatory reforms in more detail below.

financial developments such as fintech (for example, robo advisers) and cryptoassets, the non-centralized regulatory structure creates jurisdictional confusion for regulated parties, regulatory overlap and inefficient regulatory resource allocation.

The exclusively provincial and territorial nature of Canadian securities regulation has been confirmed in two landmark decisions handed down by the Supreme Court of Canada.[25] These cases upheld the constitutional division of powers in Canada's federal system, ultimately deferring to the status quo of provincial oversight of securities markets. They also recognized the federal government's jurisdiction on matters of genuine national importance and scope going to trade as a whole, including management of systemic risk and national data collection, as distinct from provincial concerns.[26]

Apart from the regulation of capital markets, the responsibility for financial market oversight is shared at the federal level among the Ministry of Finance (MoF), the BoC, the Office of the Superintendent of Financial Institutions (OSFI), the Canada Deposit Insurance Corporation (CDIC) and the Financial Consumer Agency of Canada (FCAC). The MoF is headed up by the elected member of Parliament who has been designated to be the minister of finance by the prime minister. This ministry oversees the federal regulators and is in charge of all matters relating to the financial affairs of Canada not assigned to the Treasury Board or another minister. The BoC derives its authority from the Bank of Canada Act and oversees Canada's payment, clearing and settlement systems. The BoC is also the lender of last resort and is in charge of price stability in the financial system. OSFI is governed by a number of legislative frameworks and serves as the prudential regulator. The CDIC provides insurance against the loss of deposits of member institutions. Lastly, the FCAC is responsible for protecting consumers and informing them of financial products and services.

In a discussion of systemic risk, OSFI's role deserves particular attention because its primary responsibility is the supervision of the domestic systemically important banks (D-SIBs), which dominate financial intermediation in the Canadian economy. OSFI's approach to supervision is aligned with international standards, in particular the Basel Core Principles of Supervision, which serve as a basic reference for banking supervisors around the world.[27]

OSFI's approach to regulatory supervision over federally regulated financial institutions (FRFIs) enables the office to enact meaningful policy initiatives aimed at mitigating systemic risk. In March 2013, OSFI designated Canada's six largest banks (Royal Bank of Canada, Toronto Dominion, Bank of Nova Scotia, CIBC, Bank of Montreal and National Bank of Canada) as D-SIBs.[28] This designation subjects these banks to continued intense supervision and requires them to comply with stricter capital and disclosure requirements.[29] Furthermore, the CDIC has been named as the resolution authority for D-SIBs and has begun recovery and resolution planning for them. Taken together, the additional layer of prudential oversight ensures continued

25 *Reference re Securities Act*, 2011 SCC 66; *Reference re PanCanadian Securities Regulation*, 2018 SCC 48 (CanLII).

26 *Ibid*.

27 OSFI, *Supervisory Framework* (Ottawa: OSFI, 2010) at 1, online: <www.osfi-bsif.gc.ca/Eng/fi-if/rai-eri/sp-ps/Pages/sff.aspx>. See also BIS, Basel Committee on Banking Supervision, *Core Principles for Effective Banking Supervision* (BIS, 2012), online: <www.bis.org/publ/bcbs230.htm>. See also Anita Anand & Andrew Green, "Regulating Financial Institutions: The Value of Opacity" (2012) 57:3 McGill LJ 399.

28 OSFI, "The OSFI Pillar" (Spring 2013) at 1, online: <www.osfi-bsif.gc.ca/Eng/Docs/op_2013_sp.pdf>.

29 OSFI, *OSFI Annual Report 2013-2014* at 10, online: <www.osfi-bsif.gc.ca/eng/docs/ar-ra/1314/eng/ar1314.pdf>.

regulatory awareness of the banks' approaches to mitigating systemic risks. This high degree of scrutiny is sensible, given Canada's market concentration and the corresponding influence of such significant market participants.

As outlined above, Canada's federal regulatory organizations each has a distinct legal mandate, yet together they seek to achieve cooperation and coordination through a number of fora, including:

- the Financial Institutions Supervisory Committee (FISC), the primary forum through which the Department of Finance (DoF), OSFI, the CDIC and the BoC exchange information on banks and coordinate intervention for troubled banks; [30]
- the Senior Advisory Committee (SAC), a forum with the same membership as FISC, through which these bodies deliberate on financial policy issues, including proposed legislation, financial stability and regulatory frameworks;[31] and
- the Heads of Agencies Committee (HoA), which serves as an informal forum for policy coordination among the securities regulators and federal agencies. It includes chairs of the four largest securities commissions in Canada, as well as the BoC governor, the superintendent of financial institutions and senior officials from the DoF.[32] Following the GFC, the HoA's work focused on implementing G20 commitments, in particular those with respect to systemic risk.[33]

Holistically, these fora offer general integration among the various regulatory and advisory bodies. This institutional integration is beneficial from a risk-management perspective in that specialized bodies can share information with their peers and coordinate with market participants such as banks and other FRFIs. To date, this framework succeeds in ensuring that Canadian financial institutions meet or surpass the various international financial metrics relating to liquidity, capital requirements and stress indicators. As argued below, these fora also offer an important venue for dialogue and leadership on surveillance of system-wide vulnerabilities that may not be otherwise captured under the sector-by-sector regulatory model. Nevertheless, the fragmentary nature of this structure may expose the markets to systemic risk, whatever measures may be taken toward coordination.

30 See Office of the Auditor General of Canada, *2010 Fall Report of the Auditor General of Canada* at para 5.16, online: <www.oag-bvg.gc.ca/internet/English/parl_oag_201010_05_e_34288.html>. The FISC's meetings are chaired by OSFI and held quarterly. See also OSFI, "Opening remarks by Assistant Superintendent Carolyn Rogers to the Standing Senate Committee on National Finance, Ottawa, Ontario, May 17, 2017" [Carolyn Rogers, "Opening Remarks"], online: <www.osfi-bsif.gc.ca/Eng/osfi-bsif/med/sp-ds/Pages/cr20170517.aspx>.

31 Office of the Auditor General of Canada, *supra* note 30 at para 5.17. The SAC is chaired by the deputy minister of finance. The meetings are held three to four times a year.

32 IMF Country Report, *supra* note 23 at 41.

33 Over-the-counter (OTC) derivatives, shadow banking, hedge funds and financial benchmarks were among the themes being considered: *ibid* at 42. While the HoA meets quarterly, there has not been any recent public update on its work agenda or priorities: see Carolyn Rogers, "Opening Remarks", *supra* note 30.

Structural and Regulatory Reforms Following the GFC

In the post-GFC financial market, policy makers and market participants are vigilant about understanding risk in all its permutations, especially as it affects the broader financial system. According to a survey of financial institutions in Canada by the Global Risk Institute, the most significant risk concerns today are increased frequency and sophistication of cyber attacks, over-heated housing markets, ever-rising consumer debt and mounting geopolitical uncertainties around the globe.[34] The GFC and its aftermath serve as a useful case study of potential regulatory responses to the contagion that spread after the market for collateralized debt obligations collapsed. This section focuses on those responses, including reforms that are important from a systemic risk perspective.

In the banking sector, Canadian policy makers have implemented the Basel III capital and liquidity reforms that represent a central part of the G20 post-crisis reform agenda.[35] Under the new regulations issued by OSFI, banks are required to hold common equity tier one (CET1) of at least seven percent and a total capital buffer of at least 10.5 percent against risk-weighted assets.[36] Canadian banks are also expected to meet a leverage ratio of at least three percent.[37] OSFI determines the leverage ratio for individual institutions on a bilateral basis, which remains confidential.[38] The six largest Canadian banks have also been named by OSFI as D-SIBs. This designation means that these institutions are subject to enhanced disclosure requirements and intense supervision and must hold an additional one percent of CET1 capital.[39]

Another important reform concerns systemically important financial institution resolutions. In line with the Financial Stability Board's (FSB's) key attributes, Canada has introduced important changes to its bank resolution regime.[40] The CDIC has been designated as the resolution authority for Canadian D-SIBs through its Complex Resolution Division, which develops and maintains resolution plans for D-SIBs.[41] In the event that a D-SIB becomes, or is about to become, unviable, the governor-in-council will appoint the CDIC as the receiver

34 Global Risk Institute, "2017-2018 Risk Outlook Survey Results" (2018) Global Risk Institute White Paper, online: <http://globalriskinstitute.org/publications/2017-2018-risk-outlook-survey-results/>.

35 An important example is the capital adequacy requirements guideline through which OSFI implements Basel III capital rules. See OSFI, *Capital Adequacy Requirements (CAR)* (Ottawa: OSFI, 2018), online: <www.osfi-bsif.gc.ca/Eng/fi-if/rg-ro/gdn-ort/gl-ld/Pages/CAR18_chpt1.aspx#1.2>.

36 *Ibid* at para 55.

37 OSFI, *Leverage Requirements Guideline* (Ottawa: OSFI, 2014), online: <www.osfi-bsif.gc.ca/Eng/fi-if/rg-ro/gdn-ort/gl-ld/Pages/LR.aspx>.

38 *Ibid.*

39 OSFI, *Domestic Systemic Importance and Capital Targets - DTIs* (Ottawa: OSFI, 2013). See also OSFI, *OSFI Annual Report 2016-2017* (Ottawa: OSFI, 2017) at 10, online: <www.osfi-bsif.gc.ca/Eng/Docs/ar-ra/1617/eng/ar1617.pdf>. In a related development, the FSB named the Royal Bank of Canada a global systemically important bank (G-SIB). The G-SIB designation also subjects banks to additional regulatory and supervisory requirements, although such requirements can even go beyond the D-SIB framework due to the risks that the firm can pose to *global* financial stability. See FSB, Press Release, 43/2017, "FSB publishes 2017 G-SIB list" (21 November 2017), online: <www.fsb.org/2017/11/fsb-publishes-2017-g-sib-list/>; OSFI, News Release, "OSFI confirms Royal Bank of Canada designation as a global systemically important bank" (21 November 2017), online: <www.osfi-bsif.gc.ca/Eng/osfi-bsif/med/Pages/nr20171121.aspx>.

40 FSB, "Key Attributes of Effective Resolution Regimes for Financial Institutions" (FSB, 2014), online: <www.financialstabilityboard.org/2014/10/r_141015> [FSB, *Key Attributes*].

41 See CDIC, "Resolution Division", online: <www.cdic.ca/en/about-cdic/organization/Pages/crd.aspx>.

and can carry out necessary transactions for restructuring the bank's business.[42] The CDIC has a vast resolution tool kit that includes far-reaching powers such as disposing the bank's shares and subordinated assets or amalgamating the failing bank with another solvent institution.[43] Furthermore, the CDIC can sell all or part of the bank's assets and liabilities or create a bridge bank to take on systemically important functions until a more permanent solution is found. If the closure of a failing bank is not desirable, but resolution tools such as forced sale or a bridge bank cannot be used, the CDIC can keep the bank open by providing financial assistance in the form of deposits, loans, advances and guarantees.[44]

Securities Law Reforms

The Canadian Securities Administrators (CSA) have played an important role in reforming Canadian securities law. Much like the many federal regulatory institutions coordinate their efforts through the fora listed above, the provincial securities regulators communicate and coordinate policy choices through the CSA.[45] This umbrella organization introduced changes to the regulation of the OTC derivatives market. The reform agenda, which is carried out by the CSA and coordinated through the HoA,[46] has primarily focused on central clearing of OTC derivatives, enhancing market transparency through trade repositories, and migration of standard transactions to exchanges and trading platforms. Similar to the banking sector reforms, these measures largely follow the work carried out by transnational bodies such as the FSB and the International Organization of Securities Commissions (IOSCO).[47]

Following the GFC, the CSA established a systemic risk subcommittee in 2009. The move was influenced by IOSCO's recommendation that a securities regulator "should have or contribute to a process to monitor, mitigate, and manage systemic risk, appropriate to its mandate."[48] Similarly, the Ontario Securities Commission (OSC) has established a new Risk Committee to strengthen its capability to detect and manage systemic risk. The Commission took on promoting financial stability as a new organizational role.[49] The mandate of the Ontario Securities Act was amended to include systemic risk as a focal point in addition to investor protection and market efficiency.[50]

42 See OSFI, *Guide to Intervention for Federally Regulated Deposit-Taking Institut*ions, online: <www.osfi-bsif.gc.ca/Eng/fi-if/rai-eri/sp-ps/Pages/gid.aspx?pedisable=true>; *Canada Deposit Insurance Corporation Act*, RSC 1985, c C-3, s 39.13-14 [*CDIC Act*].

43 *Ibid*, s 10.

44 *Ibid*, s 39.

45 See CSA, "Who We Are", *supra* note 24.

46 The HoA is a systemic oversight committee comprised of OSFI, the BoC, the DoF, the CSA chair and four provincial securities regulators. Its primary mandate is to exchange information among members and coordinate on issues of mutual importance. See IMF, *FSSA*, *supra* note 7 at 26.

47 FSB, *Review of OTC derivatives market reform: Effectiveness and broader effects of the reforms* (FSB, 2017), online: <www.fsb.org/2017/06/review-of-otc-derivatives-market-reform-effectiveness-and-broader-effects-of-the-reforms/>; IOSCO, *Report of the Basel Committee on Banking Supervision and the Board of IOSCO* (18 March 2015) [IOSCO, *Report*], online: <www.iosco.org/publications/?subsection=pr&id=480>.

48 IOSCO, *Report*, *supra* note 47, referencing Principle 6.

49 See Anita Anand, "Is systemic risk relevant to securities regulation?" (2010) 60:4 UTLJ 59; Anita Anand, ed, *Systemic Risk, Institutional Design, and the Regulation of Financial Markets* (Oxford, UK: Oxford University Press, 2016). See also Mary Condon, "Canada's Role in Expanded IOSCO Principles" (Address delivered at the Toronto Securities Leadership Seminar, 9 July 2012), online: <www.osc.gov.on.ca/en/NewsEvents_sp_20120709_canada-role-iosco-principles.htm>; Ontario Securities Commission (OSC), *Challenging the Status Quo: Annual Report 2017*, online: <www.osc.gov.on.ca/documents/en/Publications/Publications_rpt_2017_osc-annual-rpt_en.pdf>.

50 *Ontario Securities Act*, RSO 1990, c S.5, s 1.1.

The most ambitious institutional reform on systemic risk, however, came in August 2014 when the federal government proposed the Capital Markets Stability Act (CMSA).[51] The move came after an earlier failure to establish a national securities regulator. In *Reference Re Securities Act*, discussed above, the Supreme Court deemed the Canadian Securities Act to be outside the federal government's purview.[52] The court, however, recognized federal jurisdiction on matters of genuine national importance, including management of systemic risk and national data collection.[53] Following the Supreme Court's judgment, the federal government published a consultative draft of the CMSA that was subsequently revised in January 2016.[54]

The Capital Markets Regulatory Authority (CMRA) is the new body that would administer the new framework proposed in the CMSA. The CMRA would deal with systemic risk in the capital markets, defined as "a threat to the stability of Canada's financial system that originates in, is transmitted through or impairs capital markets and that has the potential to have a material adverse effect on the Canadian economy."[55] The CMRA can designate a product, service or benchmark as systemically important, although it does not have any entity-level designation powers. It can also issue regulations or orders on entities. However, all regulations are subject to agreement by the Council of Ministers, comprised of ministers of participating provinces responsible for the capital markets regulation as well as the federal minister of finance.[56] As these individuals are elected officials, the initiative is inevitably subject to the political process.[57] Taken together, this approach to securities market regulation bolsters the individual influence of securities regulators across provinces and territories, and emphasizes the importance of coordination among these regulatory bodies in anticipation of financial crises.

Household Debt: Mortgages and Market Stability

Beyond the regulation of capital markets, a number of measures have been taken to address increasing household debt and housing imbalances. These elements present another area of systemic risk that challenges the stability of Canada's financial market. Indeed, Canada has one of the highest levels of household debt among G7 countries, with the household debt-to-income ratio reaching almost 170 percent in 2017.[58] The bulk of household credit growth comes from mortgages and home equity lines of credit.[59] Housing prices continue to grow at a faster

51 See DoF, "Capital Markets Stability Act – Draft for Consultation" (2014), online: <www.fin.gc.ca/drleg-apl/2014/cmsa-lsmc-l-eng.asp>. See also Anita Anand, "After the Reference: Regulating Systemic Risk in Canadian Financial Markets" in Anita Anand, ed, *What's Next for Canada: Securities Regulation After the Reference* (Toronto: Irwin Law, 2012).

52 *Reference re Securities Act*, *supra* note 25.

53 *Ibid*.

54 See CCMRS, *Capital Markets Stability Act – Draft for Consultation* (January 2016), online: <http://ccmr-ocrmc.ca/wp-content/uploads/cmsa-consultation-draft-revised-en.pdf>.

55 *Ibid*, art 3.

56 *Ibid*, s 76; *Memorandum of Agreement Regarding the Cooperative Capital Markets Regulatory System*, art 3(iv), online: <http://dev.ccmr-ocrmc.ca/wp-content/uploads/MOA-English.pdf>.

57 Anita Anand, "What About the Investors?" (2017) Canadian Foundation for the Advancement of Investor Rights White Paper, online: <http://faircanada.ca/wp-content/uploads/2017/05/170505_FAIR-Anand-White-Paper-FINAL.pdf>.

58 IMF, "Canada – 2013 Article IV Consultation Concluding Statement of the Mission" [IMF, "Article IV Consultation"] at 3, online: <www.imf.org/en/News/Articles/2015/09/28/04/52/mcs112613>.

59 BoC, *Financial System Review* (November 2017) at 4, online: <www.bankofcanada.ca/wp-content/uploads/2017/11/fsr-november2017.pdf>.

pace than justified by fundamental economics, with Toronto and Vancouver dominating the housing price acceleration. For example, housing prices in Toronto surged by 32 percent from 2016 to 2017.[60] In Vancouver, housing prices grew by more than 50 percent from mid-2013 to mid-2016. While the slowdown of housing activity and the introduction of a 15 percent property tax on non-resident buyers caused a short pause to this trend, prices in Vancouver picked up shortly thereafter.[61]

Against this background, Canadian authorities have sought to enhance the resiliency of the banking system in the midst of a housing downturn and to enhance the rigour of mortgage underwriting practices. OSFI's Guideline B-20 requires that mortgage decisions be made based on an assessment of the borrower's background as well as their willingness and capacity to service debt.[62] The guideline advises banks to conduct in-person appraisal of the property and recommends those using third-party appraisal to ensure that appraisers operate "independent[ly] from the mortgage acquisition, loan processing and loan decision process."[63]

These provisions are complemented by Guideline B-21, which sets out further requirements regarding due diligence on lenders' underwriting practices, portfolio management and stress testing, and portfolio risk management and stress testing.[64] Since 2008, the federal government has also gradually tightened mortgage insurance rules, including reducing the maximum amortization period for insured mortgages from 40 to 25 years, introducing a minimum credit score of 620 as well as a minimum down payment of five percent for new mortgages,[65] and reducing the loan-to-value ratio for insured refinanced mortgages from 100 percent to 80 percent.[66]

The BoC has weighed in on the issue by noting that the Canadian housing market, with its debt ramifications, has market-wide problems. Indeed, Canada's housing market has often been described as overheated.[67] The increased cost of housing has coincided with a nearly decade-long period of cheap consumer credit. Consequently, Canadian households have become significantly indebted by borrowing against their home equity.

In particular, the BoC is concerned about Canadians using home equity lines of credit to increase their borrowing capacity to very risky levels. BoC Governor Stephen Poloz explicitly noted that 40 percent of all housing-backed loans are now blended home equity lines of credit, on which borrowers can choose to pay interest only and no principal. The risk of this high household debt

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60 BoC, *Financial System Review* (June 2017) at 12, online: <www.bankofcanada.ca/wp-content/uploads/2017/06/fsr-june2017.pdf>.

61 *Ibid.*

62 See OSFI, "Guideline B-20: Residential Mortgage Underwriting Practices and Procedures", online: <www.osfi-bsif.gc.ca/Eng/fi-if/rg-ro/gdn-ort/gl-ld/Pages/b20_dft.aspx>.

63 *Ibid.*

64 OSFI, *Residential Mortgage Insurance Underwriting Practices and Procedures* (November 2014), online: <www.osfi-bsif.gc.ca/Eng/fi-if/rg-ro/gdn-ort/gl-ld/Pages/b21.aspx>.

65 If the purchase price exceeds $500,000, the minimum down payment for the portion of the house price over $500,000 will be 10 percent. See CMHC, "What are the General Requirements to Qualify for Homeowner Mortgage Loan Insurance?", online: <www.cmhc-schl.gc.ca/en/co/moloin/moloin_003.cfm>.

66 *Ibid.* See also IMF, "Article IV Consultation", *supra* note 58, Annex III.

67 "The end of Canada's housing boom?", Editorial, *The Economist* (18 May 2017), online: <www.economist.com/news/americas/21722249-american-protectionism-not-only-threat-economy-end-canadas-housing-boom>.

level makes Canadians more exposed to falling home prices and higher interest rates.[68] As a result of these risks, the BoC has consistently warned Parliament and the public about the risk of higher household debt levels.[69] While the housing market is cooling on a general level, the risk of high household debt coupled with likely increases in interest rates can exacerbate the stresses on systemic stability.

Limitations of a Sector-by-sector Regulatory Model

The GFC raised the persistent issue of how to ensure effective oversight of systemic risk in a financial system. As discussed above, Canada mainly follows an institutional approach to regulation whereby separate agencies are entrusted with regulating different institutions and functions. While OSFI regulates federally incorporated banks and insurance companies, securities regulators oversee issuers of securities and investment firms. As Anita Anand, Michael Trebilcock and Michael Rosenstock note, different regulatory objectives can also underpin each regulatory domain.[70] For example, whereas OSFI's primary goal is to promote solvency among financial institutions, the FCAC and securities regulators are particularly concerned with the conduct of business, aiming to protect investors and consumers in the marketplace. This type of regulation in "silos" can prove difficult in times of financial market crisis, where regulatory coordination is warranted.

The recent experience of Home Capital, an alternative mortgage lender that experienced financial distress following a mortgage fraud scandal, highlights the challenges that an institutional or sector-by-sector model faces in regulating today's interconnected markets. Although Home Capital had broken ties with brokers and underwriters involved in fraudulent mortgage practices, it was accused by the OSC of publicly hiding the incident and its impact on its mortgage business. Following escalating tension with the OSC, Home Capital issued subsequent statements to meet its disclosure obligations. However, these statements led to a significant loss of market confidence and raised uncertainty over the health of the broader housing market.[71] Following a press release on March 27, 2017, which acknowledged the mortgage fraud incident, Home Capital shares plunged by more than 75 percent from $27.72 on March 27 to $5.85 on May 5, and depositors withdrew more than $2 billion from the lender.[72] Faced by a significant liquidity crunch, Home Capital took on an emergency line of credit from a major Canadian pension fund, followed by additional equity financing and a

68 Poloz summarized these dangers in the following terms: "It's time to remind folks that prices of houses can go down as well as up" (*ibid*). See Janet McFarland & Justin Giovannetti, "BoC's Poloz issues warning about speculation in Toronto housing market", *The Globe and Mail* (12 April 2017), online: <www.theglobeandmail.com/real-estate/the-market/toronto-and-hamilton-home-prices-soar-to-march-record/article34679288/>.

69 David Cochrane, "Household debt, home prices biggest risk to Canadian economy, Bank of Canada says", *CBC News* (28 November 2017), online: <www.cbc.ca/news/politics/bank-of-canada-household-debt-1.4422623>.

70 Anita Anand, Michael Trebilcock & Michael Rosenstock, "Institutional Design and the New Systemic Risk in Banking Crises" in Anita Anand, ed, *Systemic Risk, Institutional Design, and the Regulation of Financial Markets* (Oxford, UK: Oxford University Press, 2017) 1 at 25.

71 Home Capital Group Inc., *2017 Annual Report* (2017) at 21, online: <www.homecapital.com/annual_reports/2017/HomeCapitalAnnualReport2017.pdf>; Home Capital Group Inc., *2017 Second Quarter Report* (2017) at 3, online: <www.homecapital.com/quarterly_reports.asp>.

72 Armina Ligaya & Barbara Shecter, "'Like the perfect storm': An FP Investigation into the events that took Home Capital to the brink", *Financial Post* (22 Sept 2017), online: <http://business.financialpost.com/news/inside-the-rise-and-fall-of-home-capital>.

$2-billion line of credit from Berkshire Hathaway. More recently, the firm managed to secure a smaller credit facility on more favourable terms from two Canadian banks.[73]

Although the Home Capital episode did not lead to significant financial market contagion, it nonetheless illustrates the challenges involved in coordinating regulatory oversight and enforcement. Whereas the mortgage fraud was initially seen as a disclosure failure within the OSC's jurisdiction, the OSC's enforcement came to bear upon the firm's solvency, an imperative beyond the OSC's mandate. Indeed, the firm's press releases, which came after significant pressure from the OSC, triggered a massive depositor run and undermined the market confidence in both Home Capital and even the broader alternate mortgage sector.[74] Arguably, the OSC's enforcement actions fell perfectly within its mandate. However, it is unclear whether the regulator sought to communicate and coordinate with OSFI before intervention. As the next section suggests, similar challenges also surfaced earlier in the asset-backed commercial paper (ABCP) crisis, although the implications were much larger this time.

The ABCP Crisis Revisited

Canada's institutional regulatory approach came under significant pressure in the ABCP crisis. Fears of contagion arising from potential exposure to US subprime mortgages, combined with uncertainty about the underlying assets and the associated leverage, led to a rush by investors to exit the market. At the centre of the crisis was $35 billion in non-bank, or third-party, sponsored ABCP that was frozen because of the inability of conduits to roll over the papers.[75] Due to different regulatory requirements for ABCP sponsorship, conduits sponsored by the Canadian banks were monitored by OSFI, whereas third-party conduits sponsored by foreign banks, such as Deutsche Bank, were regulated only by their home authorities. These banks, which did not have retail operations in Canada, refused to provide liquidity support for their conduits when the crisis unfolded. The conduits themselves were assumed to be governed by securities law. In a parliamentary hearing, Julie Dickson, then superintendent of OSFI, said: "People are covered. If you are an investor in a security in Canada, you are covered by the securities commissions. My job is to look after banks and bank depositors. If you're an investor, you're covered by securities commissions."[76]

However, third-party conduits were, in fact, exempted from prospectus requirements, as their debt notes had received gold-plated credit ratings; investors were not covered by securities regulators.[77] During this period, ABCP was distributed almost exclusively in the exempt market,

73 James Bradshaw, "Home Capital taps banks to replace Buffett credit line", *The Globe and Mail* (16 May 2018), online: <www.theglobeandmail.com/business/article-home-capital-secures-new-credit-line-to-replace-buffett-funding/>.

74 Daniel Tencer, "As Home Capital Crisis Deepens, Some Talk Openly of Canada-Wide 'Contagion'", *Huffington Post* (1 May 2017), online: <www.huffingtonpost.ca/2017/05/01/home-capital-contagion-financial-system-canada_n_16365938.html>.

75 IMF, *Canada: Financial Sector Assessment Program – Crisis Management and Bank Resolution Framework – Technical Note* (March 2014), IMF Country Report No 14/67 at 18, online: <www.imf.org/en/Publications/CR/Issues/2016/12/31/Canada-Financial-Sector-Assessment-Program-Crisis-Management-and-Bank-Resolution-Framework-41403>; see also John Chant, "The ABCP Crisis in Canada: The Implications for the Regulation of Financial Markets" (2008) Expert Panel on Securities Regulation.

76 House of Commons, Standing Committee on Finance, "Evidence", 39th Parl, 2nd Sess, No 50 (16 June 2008) (Julie Dickson), online: <www.ourcommons.ca/DocumentViewer/en/39-2/FINA/meeting-50/evidence>.

77 Paul Halpern et al, *Back from the Brink: Lessons from the Canadian Asset-Backed Commercial Paper Crisis* (Toronto: Rotman-UTP Publishing, 2016) at 23–24.

a market in which securities regulators permit issuers to distribute securities without a full-blown prospectus or, in the case of the short-term debt exemption that was used to distribute ABCP, any disclosure at all.

So, in the years preceding the crisis, the third-party ABCP market expanded aggressively on a fragile business model while the risks it posed to the broader financial system grew and were generally unmonitored by any of the regulators. Then, when the crisis finally hit, the federal and provincial governments ultimately provided a $14-billion liquidity facility to restore trust in the ABCP market and support restructuring of the papers.[78]

Five originating factors can help explain the magnitude of this crisis. First, ABCP issuers were exempt from securities law prospectus requirements, which would have mandated a certain level of disclosure with respect to the notes or commercial paper being issued.[79] As John Chant observes, the disclosure that accompanied ABCP failed to communicate the associated risks; for example, information relating to the quality, mix and weighting of the assets underlying the notes (including highly leveraged exposure to derivatives) or the contingency of liquidity provision agreements that would have been useful information for investors in these securities.[80]

Second, sponsors of ABCP issuers, or their activities in respect of them, were in many cases not subject to regulatory supervision. Banks treated their sponsorship of ABCP conduits as an off-balance-sheet activity, which allowed them to evade regulatory capital requirements and other prudential requirements.

Third, these domestic and foreign banks, as well as non-bank financial institutions, also acted as a source of liquidity for the ABCP conduits, providing them with standby lines of credit. Many such liquidity providers were not subject to capital requirements and were otherwise minimally regulated (i.e., if the provider was not a financial institution).

Fourth, the conduct of rating agencies (in this case the Dominion Bond Rating Service) was unregulated, yet these were the agencies that were endorsing the securities for distribution.[81] The use of the short-term debt exemption effectively delegated responsibility for oversight of the ABCP market from securities regulators to rating agencies.

Fifth, the risks borne by ABCP were passed on to the public by investment dealers and salespeople who are subject to "know your client" and "suitability" rules administered by the Investment Industry Regulatory Organization of Canada (IIROC), but not to any explicit fiduciary duty.[82] These salespeople did not understand the products they were selling,[83] and

78 IMF, "Canada: Financial System Stability Assessment – Update" (February 2008), IMF Country Report No 08/59 at 22, online: <www.imf.org/en/Publications/CR/Issues/2016/12/31/Canada-Financial-System-Stability-Assessment-Update-21710>.

79 Anita Anand, "Is Systemic Risk Relevant to Securities Regulation?" (2010) 60:4 UTLJ 941 at 954 (Anand, "Systemic Risk"). Our discussion of these factors builds on the work of Chant, *supra* note 75 at 9.

80 Chant, *supra* note 75 at 10–12, 23. See also Scott Hendry, Stéphane Lavoie & Carolyn Wilkins, *Securitized Products, Disclosure, and the Reduction of Systemic Risk* (BoC, 2010), online: <www.bankofcanada.ca/wp-content/uploads/2011/12/fsr-0610-hendry.pdf>.

81 OSC, *Designated Rating Organizations, Related Policies and Consequential Amendments*, OSC NI 25-101, online: <www.osc.gov.on.ca/en/28587.htm>.

82 Chant, *supra* note 75 at 15.

83 IIROC, *Regulatory Study, Review and Recommendations Concerning the Manufacture and Distribution by IIROC Member Firms of Third-Party Asset-Backed Commercial Paper in Canada* (October 2008) at 74.

dense disclosure meant that investors had little hope of understanding the securities they were purchasing, even if they tried.

Collectively, these factors suggested weaknesses in the fragmented regulatory regime. Regulatory authorities failed to act in a coordinated manner, which perhaps allowed the ABCP crisis to evolve more quickly and to reach greater proportions than if regulators had worked together to forestall it.[84] In other words, the diffusion of regulatory oversight (i.e., different bodies overseeing different aspects of the same market) reduced the ability of these bodies to appreciate the size and scope of the crisis and to act effectively *ex ante* to contain its effects.[85]

In the aftermath of the GFC, various regulatory initiatives sought to incorporate some of the lessons from the ABCP experience. Legislative changes recognized the capacity of systemic risk to negatively impact the broader economy. For instance, Ontario's Securities Act now contains an objective "to contribute to the stability of the financial system and the reduction of systemic risk."[86] Although not yet in force, the draft CMSA adopted as a core objective the "effective detection, prevention and management of systemic risk to Canada's financial system."[87]

Yet the CMSA embodies a sectoral approach to systemic risk: because of constitutional limitations, it is concerned only with capital markets rather than the entire financial system. Furthermore, the administration of the legislation has been assigned to the CMRA, which is not a stand-alone federal regulator but a cooperative body whose jurisdiction reaches only the participating provinces and territories.

In its recent decision on *Reference re Pan-Canadian Securities Regulation*, the Supreme Court upheld the constitutionality of the proposed cooperative capital markets regulatory system (CCMRS).[88] Nevertheless, the new national regulator will likely face challenges in securing necessary cooperation in data collection and systemic risk oversight from provinces, in particular Alberta and Quebec, which have refused to join the cooperative scheme.[89] A notable challenge will be the oversight of derivatives markets, which falls within the provinces' mandate of "day-to-day" regulation of securities markets. At the same time, derivatives trading constitutes a meaningful source of systemic risk.[90] To what extent the new national regulator could effectively oversee the developments in the derivatives markets, therefore, remains an important question.

84 Chant, *supra* note 75 at 40.

85 Although Chant does not explicitly advocate consolidation of financial regulation in Canada, he notes that "[w]ith consolidation, the regulator would be able to take a broad view and consider the overall effects of the measure and respond appropriately. The case for consolidation would be strengthened if there is evidence that communication between different parts of a single agency proves more effective than communication among agencies" (*ibid*).

86 *Securities Act (Ontario)*, RSO 1990, c S.5, s 1.1.

87 See the Preamble in CCMRS, *Capital Markets Stability Act – Draft for Consultation* (January 2016), online: <http://ccmr-ocrmc.ca/wp-content/uploads/cmsa-consultation-draft-revised-en.pdf>.

88 *Reference re Pan-Canadian Securities Regulation*, 2018 SCC 48 at paras 81–85.

89 See Harvey Naglie, "Not Ready for Prime Time: Canada's Proposed New Securities Regulator" (2017) CD Howe Institute Commentary No 489 at 18, online: <www.cdhowe.org/public-policy-research/not-ready-prime-time-canada percentE2 percent80 percent99s-proposed-new-securities-regulator>. Note that Alberta and Quebec have not joined the CMRA; see CCMRS, "The Cooperative Capital Markets Regulatory System" (2018), online: <http://ccmr-ocrmc.ca/>; Anita Anand, "Canada's new securities regulatory structure is a disservice to investors", *The Globe and Mail* (31 May 2017), online: <www.theglobeandmail.com/report-on-business/rob-commentary/new-securities-regulatory-structure-a-disservice-to-investors/article35167692/>.

90 *Reference re Securities Act*, *supra* note 25 at para 125; see also Anita Anand, "Supreme Court Opens the Door to a New Model of Securities Regulation", online: <www.cdhowe.org/intelligence-memos/anita-anand-supreme-court-opens-door-new-model-securities-regulation>.

Toward a More Integrated Approach to Systemic Risk

The absence of a macroprudential regulator may undermine efforts to monitor and take action on systemic risk. Both the IMF and the FSB have recommended assigning a macroprudential mandate to a single body that could take a "comprehensive view of systemic risk across all financial institutions and markets in Canada."[91] This recommendation is consistent with post-crisis reforms in other jurisdictions that have overhauled their institutional architecture to close regulatory gaps and facilitate financial sector-wide oversight of vulnerabilities. In the United States, for example, the Dodd-Frank Act has created the Financial Stability Oversight Council (FSOC), which is responsible for identifying systemic threats and recommending appropriate regulatory response.[92] The FSOC collects data on systemic risk through the Office of Financial Research, facilitates information sharing and cooperation among regulators, and can designate non-bank firms and financial market infrastructure as systemically important.[93]

In the United Kingdom, the Financial Services Act (2012) established a twin-peaks regime that moved the overall responsibility for financial stability to the Bank of England.[94] The Prudential Regulatory Authority, a subsidiary of the bank, regulates all systemically important financial institutions in banking, insurance and capital markets.[95] The bank's Financial Policy Committee (FPC) "identifies, monitors and takes action to remove or reduce systemic risks" with a comprehensive view of the UK financial system.[96] While the FPC does not have direct regulatory authority over financial institutions, it can issue directions and recommendations to the relevant authorities.[97] Finally, the European Union has established the European Systemic Risk Board (ESRB), which is tasked with macroprudential oversight of the financial system across the whole Union.[98] The ESRB can identify significant risks to financial stability and issue warnings and recommendations for remedial action.[99]

Canadian authorities, however, have indicated that they will not pursue the recommendation to establish a macroprudential regulator. Unless the CMRA is created under the CCMR, the responsibility for systemic risk will remain with the array of organizations discussed above, including OSFI, the BoC, and the provincial and territorial securities regulatory authorities.[100] The reluctance to establish a new macroprudential regulator can be explained by path dependency and an ongoing, unrelenting resistance of the existing regulatory regime to

91 See IMF, *FSSA*, *supra* note 7 at 25; FSB, *Peer Review of Canada: Review Report* (2012) at 36, online: <www.fsb.org/wp-content/uploads/r_120130.pdf>.

92 12 USC § 5323.

93 US Department of the Treasury, "Financial Stability Oversight Council", online: <www.treasury.gov/initiatives/fsoc/about/Pages/default.aspx>.

94 *Financial Services Act 2012* (UK), s 9.

95 *Ibid*, s 2(A)&(B).

96 *Ibid*, s 9(C).

97 *Ibid*, s 9(G)&(H).

98 *Regulation (EU) No 1092/2010 on European Union macro-prudential oversight of the financial system and establishing a European Systemic Risk Board* [2010] OJ, L 331, art 3(1).

99 *Ibid*, art 16(1).

100 IMF, *Canada: 2017 Article IV Consultation – Press Release and Staff Report* (Washington, DC: 2017) at 2, 13, 74, online: <www.imf.org/en/publications/cr/issues/2017/07/13/canada-2017-article-iv-consultation-press-release-and-staff-report-45074> [IMF, *2017 Article IV Consultation*].

transformative changes, given the costs and resources involved in such a transition.[101] Generally, path dependency can refer to decisions that may have been efficient *ex ante,* but that do not turn out to be efficient *ex post*. According to Stan Liebowitz and Stephen Margolis, an original decision and its consequences may have been an inferior option in hindsight; however, these qualities are unknowable at the time the decision is made.[102] At a later stage, it becomes clear that an alternative decision or path would have been more efficient, but the original decision is carried out due to continued commitment of resources. As they state, "there is a dependence on past conditions that leads to outcomes that are regrettable and costly to change."[103]

Institutional structures can be self-reinforcing, remaining on a given course in response to significant fixed costs associated with change, "learning effects" that reward knowledge of a particular practice, and expectations or preferences that solidify around the status quo.[104] The self-reinforcing tendency implies increasing returns to institutional structures, practices or norms, while switching costs associated with institutional reform can be expected to rise over time. Paul Pierson explains that increasing returns mean that small events at "critical junctures" can have significant long-term consequences.[105] Timing and political "inertia" are central, but change will usually be incremental.[106]

Anand, Trebilcock and Rosenstock have argued that while the GFC may have indicated that some type of reform to the complement of regulators governing Canada's financial system is necessary, arguments from path dependency suggest that "grand transformative changes are unlikely — or at least uncertain — and not necessarily a function of the severity of the GFC or the country at issue."[107] However, we maintain the possibility of incremental reforms, including changes to the legal mandates of existing regulatory institutions.[108] Similarly, while path dependency creates inertia against institutional change, Mariana Prado and Michael Trebilcock argue that path dependency can clarify what has happened in the past and also can be used to inform the feasibility of institutional reforms.[109]

Specific to the Canadian securities regulatory system, path dependency refers to the durability of the regime and the importance of history in fashioning a reform agenda. In particular, path dependency helps to explain the current structure of the regime that has resulted from the development of Canadian constitutional law and province-based institutions (for example, legislatures and securities commissions) that have charge over the development of securities legislation. Together, the jurisprudence and relevant institutions stand as historical constraints on the ability to achieve an efficient securities regulatory regime in this country.[110]

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101 Anand, Trebilcock & Rosenstock in Anand, *Systemic Risk, supra* note 5.

102 Stan J Liebowitz & Stephen E Margolis, "The Fable of the Keys" (1990) 33:1 J L & Econ at 18.

103 *Ibid.*

104 *Ibid* at 351; see also Paul Pierson, "Increasing Returns, Path Dependence, and the Study of Politics" (2000) 94:2 Am Pol Sci Rev 251 at 254.

105 See Mariana Prado & Michael J Trebilcock, "Path Dependence, Development and the Dynamics of Institutional Reform" (2009) 59 UTLJ 342 at 357.

106 Paul Pierson, *Politics in Time* (Princeton, NJ: Princeton University Press, 2004) at 44, 153.

107 Anand, Trebilcock & Rosenstock in Anand, *Systemic Risk*, *supra* note 5.

108 *Ibid.*

109 Prado & Trebilcock, *supra* note 105 at 353.

110 See generally Anita Anand & Peter Klein, "Inefficiency and Path Dependency in Canada's Securities Regulatory System: Towards a Reform Agenda" (2005) 42:1 Can Bus LJ 41.

Nevertheless, whereas a complete institutional overhaul may never gather sufficient momentum in Canada, incremental reforms to achieve better regulatory outcomes are feasible. The absence of a formal macroprudential regulator does not prevent the existing authorities from working collectively to promote financial stability as a common good.[111] Indeed, most international bodies that have been leading post-crisis regulatory reforms, such as the Basel Committee on Banking Supervision or the FSB, operate outside the formal law-making processes.[112] These bodies are not the product of treaties and they lack any formal powers to impose rules on sovereign nations, but their standards have been enormously influential and have been largely followed by domestic jurisdictions.[113]

In a similar vein, Canadian regulators can seek to achieve communication and coordination through informal bodies, and the existing institutional flexibility can indeed facilitate regulatory experimentation in the face of complexity and the rapid pace of change in financial markets.[114] However, effective oversight of systemic risk requires establishing a robust agenda with clear goals and processes. First and foremost, a comprehensive picture of interlinkages and system-wide trends needs to be further developed. The BoC's *Financial System Review* can be an important stepping stone in this respect as it provides many important insights on systemic vulnerabilities. The BoC's analysis can be further complemented with input from the CMRA, which has both the authority and mandate to collect and analyze data on systemic risk in capital markets.

Conclusion

The GFC triggered an unprecedented wave of regulatory reforms that continue to unfold more than a decade later. While some substantive reforms, such as the Basel III requirements, have been relatively similar across jurisdictions, institutional and structural reforms remain widely uneven. Some jurisdictions have established new institutions with specific mandates for financial stability, however Canada continues to have a patchwork of regulators in charge of different segments of the financial system. The costs and resources involved in transformative changes, reinforced by the unique constitutional characteristics of Canada, can help to explain the inertia against institutional overhaul.

The fragmented nature of the existing regulatory model undermines systemic risk oversight and severely strains regulatory communication and coordination. Risky products and practices can build up outside the individual purview of regulators, such that their systemic implications go

111 On financial stability as a common good, see Tucker, *supra* note 6 at 21–22.

112 For further discussion on transnational regulatory networks and the rising prominence of soft law in global finance, see Anne-Marie Slaughter, *A New World Order* (Princeton, NJ: Princeton University Press, 2004) at 14; Anne-Marie Slaughter & David Zaring, "Networks Go International: An Update" (2006) 6:12 Ann Rev L & Soc Sci 215 at 215; Chris Brummer, *Soft Law and the Global Financial System: Rule Making in the 21st Century* (Cambridge, UK: Cambridge University Press, 2012) at 63–64.

113 See BIS, *Basel Committee Charter* (5 June 2018), art 3, online: <www.bis.org/bcbs/charter.htm>; FSB, *Charter of the Financial Stability Board*, art 23, online: <www.fsb.org/wp-content/uploads/FSB-Charter-with-revised-Annex-FINAL.pdf>; see also Joost Pauwelyn, Ramses A Wessel & Jan Wouters, "The Exercise of Public Authority through Informal International Lawmaking: An Accountability Issue?" (2011) Jean Monnet Working Paper 06/11, New York University School of Law at 13.

114 See Eilís Ferran & Kern Alexander, "Can Soft Law Bodies be Effective? Soft Systemic Risk Oversight Bodies and the Special Case of the European Systemic Risk Board" (2010) University of Cambridge Faculty of Law Research Paper No 36/2011, online: <https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1676140>.

unaddressed. When this happens, it will only take an unpredictable trigger, such as refusal to extend liquidity to non-bank conduits in the ABCP episode, to cause a crisis to erupt. Regulators may then find that they have little choice but to bail out the failing institutions.

Since a complete institutional overhaul seems unfeasible, we argue for incremental reform and improvements to the existing institutions and cooperation channels for better oversight of systemic risk. In the absence of the CMRA taking shape, we recommend that high-level inter-agency groupings such as SAC take a leadership role on systemic risk management and mitigation. These institutions should establish a clear mission and agenda to promote financial stability, ensuring that system-wide vulnerabilities are detected and addressed in a timely and comprehensive fashion.

Further attention also needs to be paid to the connections between different policy domains and the vulnerabilities that can arise outside the traditional prudential domain. One important area is the interlinkage between monetary policy and financial stability. In the aftermath of the GFC and Canada's 2014 oil shock, interest rates have remained at historically low levels.[115] The prolonged low interest rates, which reflect the central bank's struggle to bring inflation back to target, have aimed to stimulate economic activity and growth.[116]

At the same time, however, loose monetary policy has led to the buildup of leverage in the financial system, which has translated in the Canadian context into increasing household debt and elevated housing prices.[117] As a result, both households and financial institutions are highly exposed to the risks of rising interest rates, income shocks and deflating asset prices.[118] It is therefore important not only to consider financial stability in the conduct of monetary policy but also to deploy macroprudential tools, such as a strong leverage ratio for financial institutions and loan-to-income ratios for households to limit leverage in the system.[119] Such measures could help to enhance resilience against the deflation of housing prices and insolvencies ensuing from fire sales that often accompany a "leverage cycle crash."[120]

Finally, monopolistic emphasis on D-SIBs' regulation is insufficient, as it excludes systemically important institutions that are chartered at the provincial level. Although some provinces, such as British Columbia and Quebec, have designated their large credit unions to be systemically

115 BIS, Committee on the Global Financial System, "Financial stability implications of a prolonged period of low interest rates" (2018) CGFS Papers No 61 at 1, online: <www.bis.org/publ/cgfs61.pdf>; for the historical trend of interest rates in Canada, see Trading Economics, "Canada Interest Rate" (2018), online: <https://tradingeconomics.com/canada/interest-rate>.

116 Timothy Lane, "Monetary Policy and Financial Stability – Looking for the Right Tools" (Remarks delivered at HEC Montreal, Montreal, 8 February 2016), online: <www.bankofcanada.ca/2016/02/monetary-policy-financial-stability-looking-right-tools/>.

117 *Ibid*.

118 In its economic outlook, the Organisation for Economic Co-operation and Development (OECD) notes that housing prices in Canada are both overvalued and rising, noting that the economy is vulnerable to both income shocks and higher borrowing costs. See OECD, "Focus on house prices" (2017), online: <www.oecd.org/eco/outlook/focusonhouseprices.htm>.

119 As John Geanakoplos notes, "The best way to stop a crash is to act long before it occurs, by restricting leverage in ebullient times." See John Geanakoplos, "The Leverage Cycle" (2010) Cowles Foundation Discussion Paper No 1715R at 4, online: <https://cowles.yale.edu/sites/default/files/files/pub/d17/d1715-r.pdf>; see also Emilios Avgouleas, "Bank Leverage Ratios and Financial Stability: A Micro- and Macroprudential Perspective" (2015) Levy Economics Institute of Bard College Working Paper No 849 at 23–24, online: <www.levyinstitute.org/pubs/wp_849.pdf>.

120 Ana Fostel & John Geanakoplos, "Reviewing the Leverage Cycle" (2013) Cowles Foundation Discussion Paper No 1918 at 28, online: <www.dallasfed.org/~/media/documents/research/events/2013/uncertaintygeanakoplos.pdf>.

important institutions,[121] others, such as Alberta, have not yet established a framework for enhanced regulation and supervision of their systemically important institutions.[122] This lack of multi-jurisdictional regulatory coordination creates regulatory gaps that threaten the stability of Canada's financial system.

Further effort is required to identify obstacles that hinder sharing data and communication among regulators, and to address them, whether through existing channels for cooperation or through legislative changes, if necessary. For example, the BoC's ability to build a comprehensive picture of the shadow banking system has been hindered by legal and logistical obstacles in sharing data among relevant authorities.[123]

At the heart of this chapter is a desire to enhance Canada's risk mitigation capacity by reflecting upon the lessons of the GFC. Canada may have fared well in the events of the GFC relative to most other economies. However, complacency in the face of systemic risks may undermine the country's prospective preparedness.

Authors' Note

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121 Notable examples are Desjardins Group and Central 1 Credit Union, both of which have been designated as systemically important.

122 Specifically, Alberta Treasury Branches (ATB), a deposit-taking institution with more than $48 billion in assets and $33 billion in deposits, has not been designated as a systemically important institution. As a Crown corporation, the ATB enjoys full backing by the government and is directly connected to the province's financing. See ATB, "ATB 2017 Financial Report" (2017) at 35, online: <www.atb.com/SiteCollectionDocuments/About/annual_reports/atb_2017_annual_report.pdf>; Nicholas Le Pan, "Opportunities for Better Systemic Risk Management in Canada" (September 2017) CD Howe Institute Commentary No 490 at 12, online: <www.cdhowe.org/public-policy-research/opportunities-better-systemic-risk-management-canada>.

123 See Timothy Lane, "Shedding Light on Shadow Banking" (Remarks delivered at the CFA Society, Toronto, 26 June 2013), online: <www.bankofcanada.ca/2013/06/shedding-light-shadow-banking/>.