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Remarks by Superintendent Julie Dickson
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Good morning. When I look through the agenda, I cannot help but be impressed by the range of subjects you will be covering today. I will take my lead from that and cover a few subjects in modest detail. I am sure Theo will then follow up on any subjects he may want to pursue with me in more depth.

The Global Economy is a Concern

Let me start at the broadest possible level – the global economy. The IMF talks about a three-speed global economy: countries doing well (these tend to be emerging market economies and developing economies such as Asia, which account for about three-quarters of global economic growth); countries on the mend (that is, the U.S.); and countries that continue to have major problems; Europe, the U.K., Japan are examples.[1] While the IMF didn't reference Canada in its three-speed global economy survey, the Bank of Canada continues to project slow economic growth in the coming years.[2]

There have been, and continue to be, significant downward revisions to economic growth forecasts. There is global debate about whether austerity is the right or wrong medicine for current ills.

The European situation continues to be challenging. Progress on a banking union has been slow. At this time, the European Community intends to move forward in June with proposals for a bank resolution fund, but German officials have reportedly said that such action would require a treaty change. So, there is still much to be done.

Accommodative monetary policies around the world are designed to aid economic growth, but concern has shifted to their less desirable by-products, such as promoting a search for yield, possibly fueling asset bubbles, and creating dependence on low interest rates and a buildup in interest rate risk. Commentators note that we are in uncharted territory, and managing the exit from loose monetary policies could be very challenging.

[1] Move From 'Three-speed' To 'Full-speed' Global Recovery, Urges Lagarde. April 18, 2013. Link to survey report : http://www.imf.org/external/pubs/ft/survey/so/2013/NEW041813A.htm
[2] Monetary Policy Report, Bank of Canada, April, 2013. The report can be found at the following link: http://www.bankofcanada.ca/wp-content/uploads/2013/01/mpr-summary-april2013.pdf

Negative Impacts of Low Interest Rates

The aggressive response by central banks to the global financial crisis, as well as the weak global economy, has manifested itself in very low interest rates. As noted by the outgoing Governor of the Bank of Canada, it is important that regulation and supervision be a strong line of defence to some of the consequences of low interest rates. Sustained low interest rates are a major area of focus for OSFI.

When low interest rates first appeared, OSFI saw that the impact was most noticeable on pension plans and insurance companies. But a sustained low interest rate environment, especially combined with a flat yield curve, affects the banking sector as well, largely through squeezing net interest margins, which negatively affects revenues.

This environment can provide incentives for banks to grow their earnings asset base by trying to gain market share (a zero sum game), increase fee income activities, reduce expenses, enter new markets, and by increasing the proportion of higher-yielding assets (both in the lending and investment portfolios). Of more concern, products and businesses that are over-reliant on low financing costs tend to grow and borrowers are strongly incented to increase leverage.

For all these reasons, OSFI is very focused on how banks are reacting to current conditions. We are also cognizant that the longer the low interest rate environment persists, the more interest rate risk can be built up. No one can predict when, or how fast, rates will start to climb (or indeed, whether they will fall further). Yet dependence on low interest rates can become significant, meaning that transition to higher rates could be very painful**.**

OSFI Activities Related to the Real Estate Market

The impact of low interest rates can clearly be seen in the Canadian real estate market. Consequently, the real estate lending market has been a significant area of focus for OSFI, because of the significant incentives for consumers to borrow and for banks to maintain revenues, the size of mortgage lending portfolios, the concerns about some markets being overvalued, and the possibility that customers' debt serviceability could be masked by low interest rates.

Thus, for some time, OSFI has been conducting major reviews of bank mortgage lending portfolios. We have issued a guideline[3] that includes a set of best practices for prudent residential mortgage lending. Further, we have been reviewing the models used by banks to calculate capital charges for the part of the mortgage portfolio that is not insured, and generally believe that the models are producing reasonable results.[4] The Minister of Finance has taken steps to place restrictions on mortgage insurance. All of these measures have led to some welcome changes in the market, slower growth in household credit, and a more balanced picture overall. In July 2012, OSFI was also given responsibility for overseeing the commercial activities of Canada Mortgage and Housing Corporation, which complements the range of other measures that have been taken.

As reported last week, we continue to monitor the mortgage market and watch the effects of the changes that have been made in this area. We also look ahead at other issues that may develop.

Weak Banking Systems Wreak Havoc

Since the global financial crisis began, there has been tremendous focus on prudential regulation of banks, as we have seen that failing banking systems wreak havoc on economies and governments. A financial crisis leaves citizens facing years of austerity. Low growth affects employment rates and the standard of living.

The crisis demonstrated the importance of the safety and soundness of banks, especially those that are systemically important.

That is one reason why OSFI implemented Basel III six years ahead of schedule and why we imposed a surcharge on the largest six banks in Canada. For those of you not familiar with Basel III – and you will be forgiven for not knowing about it! – Basel III is the global, regulatory standard on bank capital and liquidity. It was developed in response to the deficiencies in financial regulation revealed by the financial crisis.

[3] OSFI Guideline B-20, Residential Mortgage Underwriting Practices and Procedures. Link to guideline: http://www.osfi-bsif.gc.ca/osfi/index_e.aspx?ArticleID=4831

[4] Zelmer, M. *Let there be light: How more transparency can promote a safer financial system,* BMO Global Reserve Management Conference, May 7, 2013 (Toronto, ON). Link to remarks: http://www.osfi-bsif.gc.ca/osfi/index_e.aspx?ArticleID=5498

The Importance of Implementing Basel III

As you know, Canada's banking system fared reasonably well through the financial crisis. Because of this, I am often asked why OSFI is in such a rush to implement Basel III. Don't other countries require implementation more urgently than we do? These questions have been asked with even more enthusiasm as it becomes clear that some countries will not meet the timelines that had been agreed upon for implementation.

So, I would like to take this opportunity to highlight a few of the reasons why OSFI required immediate implementation of Basel III beginning in 2013 (and did not allow a gradual phase-in until 2019, which is what some other jurisdictions have allowed).[5] It is also why the surcharge on the big six banks will apply as of 2016, and will not be phased in.

First, as noted earlier, the current global economic environment is not comforting. When in unchartered waters, you do not want to test whether the boat is sound enough. We need to be prepared in the event of serious downside risks materializing.

Second, while the European Union and the U.S. have not yet adopted Basel III, other countries such as Australia, Singapore, Switzerland and China, have – in some cases with higher requirements than Basel III dictates. Even the U.S., which has not yet officially released its final Basel III rules, has required its banks to consider Basel III capital levels as part of supervisory control of dividends and share buy-backs. Consequently, there has been a doubling in the last four years of the capital in the largest U.S. banks. In addition, U.S. supervisors are openly discussing whether Basel III should be revised in the future to make the capital and liquidity requirements even more onerous on large banks.[6]

As for Europe, I will say that the G-20 communique issued on April 19, 2013, affirmed that countries that have not yet passed final rules to implement Basel III agreed to do so as soon as possible.[7] Our best information at this point is that the U.S. and the European Union will implement Basel III – although, as usual, the devil will be in the details.

5 With one temporary exception. Although a new CVA capital charge was included in OSFI's Capital Adequacy Requirement (CAR) Guideline published in December 2012, implementation of the charge was delayed, to allow time for the equivalent European and US rules to be finalized. This delay is meant to avoid potentially disrupting the OTC derivatives market. Canadian deposit-taking institutions will continue to be subject to counterparty credit risk requirements and, for those institutions approved to use the Internal Ratings Based approach, the requirements include the increased asset value correlation factor."

6 Tarullo, Daniel K. *Evaluating progress in regulatory reforms to promote financial stability,* May 3, 2013 (Washington D.C.). Link to speech: http://www.bis.org/review/r130506b.pdf

7 Communiqué G20 Meeting of Finance Ministers and Central Bank Governors. April 19, 2013 (Washington D.C.). Link to Communiqué: http://www.g20.utoronto.ca/2013/2013-0419-finance.html

Third, Canada's banks have been rated the strongest in the world, in part due to our strong standards. The International Monetary Fund has noted that, "Canada's banking system is well capitalized, has posted another year of strong profits, and continues to show low non-performing loans, also owing to high prudential standards and rigorous supervision."[8] Standard and Poor's, in a special report in December of last year, noted that "regulatory standards and supervision are generally strong, and the regulatory track record has been highly effective." More recently Bloomberg included four Canadian Banks in its list of the top ten strongest banks in the world.[9]

These references to high prudential standards do not come free of charge. They require that supervisors be vigilant, and that financial institutions implement internationally agreed upon standards. Strong regulation and supervision can be reflected in better ratings, and better ratings can allow for cheaper funding. From this perspective, strong supervision impacts the bottom line of a financial institution in a positive way. It does not limit opportunities; it expands them.

But we cannot rest on our laurels, as those of you working in the financial services sector will have heard me say many times before. Many point to the acceleration of household debt to record levels and increased vulnerability of households to sudden shocks in incomes, employment or a spike in interest rates. These warnings need to be heeded and, as noted earlier, a great deal has been done to heed them, such as OSFI's heavy focus on real estate lending. Canadian banks meet Basel III now (their ratios are actually stronger than many other global banks are reporting, once you consider that OSFI allowed no phase-in period). We, at OSFI, need to continue to assess vulnerabilities and our responses to them. As some have noted, "OSFI is a dark place" because of our focus on all the things that can go wrong. But it is a focus that has proven to be valuable. And this gives me comfort that Canada will continue to enjoy a safe and sound financial system.

[8] Canada: 2012 Article IV Consultation, February, 14, 2013. (IMF. Washington, D.C) Link to consultation: http://www.imf.org/external/pubs/cat/longres.aspx?sk=40320.0
[9] *The World's Strongest Banks*. Bloomberg, May 1, 2013. Link to story: http://www.bloomberg.com/slideshow/2013-05-01/the-world-s-strongest-banks.html#slide21