Bankers searching for elusive elixir

By KEN MARK

"We are not bereft of tools or knowledge. But we need a sense of mission and the political will to address these basic issues."

Daniel Schwanen, Centre for International Governance Innovation

SCHWANEN

Feeling intense pressure to prevent future asset bubbles, global central bankers and other regulators are seeking to fix underlying problems before they can ravage the world economy again.

"The G20 group of finance ministers is constantly recommending new regulations related to capital conditions and lending rates," says Daniel Schwanen deputy executive director, programs, Centre for International Governance Innovation (GIGI) in Waterloo. "Their goal is to increase co-ordination and transparency while not getting rid of experimentation or stifling appropriate risk taking that would restrict future opportunities.

"We are not bereft of tools or knowledge. But we need a sense of mission and the political will to address these basic issues. I believe that the next year or so is a window of opportunity to get it all done."

Proposed reforms include reducing banking misadventures by boosting market discipline through macro-prudential measures to tighten lending practices, deal with too-big-to-fail institutions and reduce moral hazard.

The severity of the current financial crisis has also stirred up private-sector support for major changes. "The market does not always get it right," says William White, a Canadian and the recently-retired chief economist of the Bank for International Settlements (BIS).

"Recent events indicate that markets do not operate efficiently."

He points out that from 2003 to 2007, as risk spreads dropped, asset prices rose steeply. As a result, collateral on bank balance sheets based on mark-to-market accounting increased as did their capital ratios enabling them to lend more aggressively which only further fueled the rise of asset prices.

Accountants play a crucial role in evaluating such assets. In White's view, the issue is using fair value or mark-to-market accounting to place a value on assets banks hold but do not trade or for which there is no active market. Fair value accounting compares such assets to like or similar assets that do trade and which reflect market changes and result in fluctuations on financial statements.

"Often when prices are rising quickly, the market can overvalue certain assets making balance sheets look better than they should," he says. "And in bad times, they may undervalue other assets that could lead to insolvency.

"There is no right answer."

In early 2009, various regulators leaned on accounting standard-setting bodies such as the International Accounting Standards Board (IASB) to change some of the rules related to impairment of financial assets, particularly loans. "They wanted new measurements to deal with possible future expected losses," says Ian Hague, a principal with the Accounting Standards Board in Toronto. "Accountants and regulators use different forms of accounting. That's because they have different uses for different information.

According to Hague, the new approach is expected to go beyond current practice and take into account expectations of possible future losses. And similar to other aspects of accounting, there is judgment and estimates involved. The IASB has recently issued a discussion paper seeking comments from practitioners.

The world's central bankers have started discussing the merits of an emerging regulatory policy dubbed 'leaning against the wind.' Its goal is to require banks to increase their capital levels countercyclical to market lending trends, especially when stock and housing markets are hot and loan demand is high.

Reducing bank lending capacity at such times provides regulators with a new tool to stop asset bubbles from forming just as buyers and investors are borrowing aggressively to pile into the rally and boost their returns through leverage.

In a recent speech, Bank of England Governor Mervyn King described the new approach as being "parallel to the long-established role which monetary policy plays in taking away the punch bowl just as the party gets going, so there is a role for the central bank to use macro-prudential policy instruments for financial stability purposes by turning down the music just as the dancing gets a little too wild."

According to White, a longtime countercyclical advocate, when credit levels rise, so do asset prices. More specifically, Schwanen targets easy money as the key offender by concluding, "Every bust is preceded by excessive lending."

Booms also create their own buying frenzy. In his research, White noticed that in the past few years in many developed economies, annual per capita savings rates dropped sharply from earlier levels of eight per cent to 10 per cent. For example, in New Zealand they fell to minus 10 per cent.

"When people's spending habits go weird, such changes can lead to economic catastrophe," he says.

Leaning against the wind is also expected to deliver a stability dividend as the global economy stumbles. In a recent speech, Julie Dickson, superintendent of the Office of the Superintendent of Financial Institutions (OSFI) stated that "capital cushions have to be available for unexpected losses in difficult periods, and the capital cushion should be robust going into a downturn."

WHITE

To keep the record straight, in Canada, OSFI sets national banking capital ratios based on international standards while the Bank of Canada decides interest rate levels. In many other countries, the national central bank does both.

The Bank of Canada is onside with this issue. In a late October speech in Montreal, Bank of Canada Governor Mark Carney stated that the bank is working closely with OSFI and the bank's international counterparts on proposed elements of the framework for countercyclical capital buffers above the minimum requirement.

As a result in tough economic times, lenders can use their freed-up credit capacity to drive the recovery by loaning money to businesses to buy equipment and hire employees as well as to consumers to purchase goods and services.

White insists that exuberant lending was the ultimate economic culprit. Traditionally, the economic dragon central bankers all sought to slay was inflation.

"But," says White, "in the U.S. Panic of 1873, the early '90s collapse of the Japanese economy and the late '90s Southeast Asian currency crisis which all resulted in economic meltdowns, there was no inflation. Rather, excessive lending was the cause."

To ensure that public guardians develop suitable policies, there are proposals that central bank economists should analyze new and more varied types of data. These include overall leverage ratios as well as the estimated contribution of individual banks to overall systemic risk based on their size, complexity and connectivity. Based on such findings, regulators might need to gross-up capital levels required of larger players.

To operate properly, such stabilizers must kick in automatically. Says Schwanen, "After regulators develop an acceptable formula for invoking a brake on lending, it is essential that everything has to be agreed upon in advance."

Still, White concedes that implementing the system internationally will be a huge problem. It will involve co-ordinating the different policies of various nations. At one level, there is concern over competitiveness. Countries do not want to set the regulatory bar too high, lest it put domestic banks at a disadvantage compared to those in other countries.

Other worries relate to very large banks that have global operations. White is concerned with jurisdiction shopping in which banks can, with a computer keystroke, shift huge amounts of capital from a country with tight capital rules to one with looser ones. "That brings us back to the too-big-to-fail problems since banks capable of doing this fit into the category," he says.

To prevent lenders from maintaining such preferential treatment,

See Critics on page 18

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Technology trends to watch in 2010

COMPUTER MONITOR

By Richard Morochove

Predicting the future is always fraught with uncertainty, particularly in the fast-moving field of business technology. A heads-up on future directions can save you money by showing you less expensive options or warn you about investing in a tech dead end. Here is my take on important technology trends to watch this year.

Wireless savings

Canadians will at long last get a real choice in wireless telephony this year. WIND Mobile launched late last year in Calgary and the Greater Toronto Area. Coverage will extend to Vancouver, Ottawa and Edmonton this year. DAVE Wireless plans to launch in the same five major cities early this year. Videotron plans to launch wireless service in Quebec sometime this summer. Outside their home service areas, the new wireless operators intend to offer services by means of roaming agreements.

Public Mobile plans to launch in Toronto and Montreal in the first half of this year and expand later in the Quebec City to Windsor corridor. Unlike the other new carriers, it plans to use CDMA rather than GSM technology, so you may expect it to offer a more limited range of phones.

In November, Bell and Telus launched their 3G HSDPA (high-speed downlink packet access) network, to compete more directly against Rogers. The new network allows Bell and Telus to offer some of the latest 3G smartphones from Research in Motion and Apple.

Already, the three major national carriers (Bell, Telus and Rogers) have dropped the notorious system access fee (about $6-7 per month) for new accounts. However, they've hiked base rates for voice plans by a few bucks to eat some, but not all, of the cost savings.

On the heels of the new competition, you can expect even lower wireless charges, particularly in Toronto, Montreal, Ottawa, Calgary, Edmonton and Vancouver. If your wireless contract is coming up for renewal soon, I recommend going month-to-month and holding off on a long-term contract renewal until mid-year, to see how the new competition affects the pricing of the incumbents.

Nextgen Tablet computers

Secretive Apple is planning to launch a tablet computer, tentatively called iSlate, which will probably ship in March. While details on the Apple device are scant, tablet computers are generally smaller than a notebook PC and feature a touch-sensitive display which can be operated by a pen-like stylus or fingertip. The Apple device will also offer wireless connectivity.

Microsoft is also readying a new tablet PC, dubbed Courier, for shipment about the same time. From what I've seen of the leaked device, Courier will appeal more to business users since it appears to be a beefed-up day planner with added multimedia capabilities. The Apple tablet appears to be aimed more at consumers who want to watch movies, play games and read e-books.

Tablet or pen-based computers have been around for more than a decade, without making a big impact on computer users. So I'm skeptical whether this latest generation will achieve greater success. They're bigger and heavier than a smartphone, yet won't offer the wider choice of applications available on a notebook computer.

If business applications need to be re-written for the tablet's touch screen interface, then the small selection of business software at launch will limit the utility of these tablets to businesses. Based upon that limitation, I'd hold off on buying a tablet, for now.

A cloud over Cloud Computing

Software as a service (commonly referred to as SAAS), also called cloud computing, has a lot of fans. You access services and data over the Internet, so there's no software to maintain on your PC and no data you need to back up.

However, there's a cloud over cloud computing. How reliable is the online service? What do you do when it fails?

Google's Gmail e-mail service is free, but several service outages last year have shown its limitations for business use. Microsoft's Danger unit experienced a major data outage which affected users of the U.S.-based T-Mobile Sidekick device. How does that affect the confidence of users in Microsoft's new Azure cloud computing initiative, which shifts processing from a company's PCs to a Microsoft data centre?

To be fair, Azure uses a different architecture than Danger, which Microsoft acquired a couple of years ago. But Microsoft's failure must be a concern to every business which considers Azure.

I predict that businesses which migrate to cloud computing this year will be more concerned about the reliability of the service and its backup, if something goes wrong.

Most of the popular cloud computing applications relate to e-mail, data backups, remote meetings and business portals. But as more specialized business applications come to the cloud, integration among cloud services will become more important to weave these disparate services into a single business solution.

And integration in the cloud will be only as strong as its weakest link.

Richard Morochove, FCA, is president of the Toronto-based computer consulting firm, Morochove & Associates Inc., serving accountants and their clients. E-mail comments to: *bottomline@morochove.com.*

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LexisNexis® Canada Welcomes

LINC ROGERS

New National Editor
Commercial Insolvency Reporter

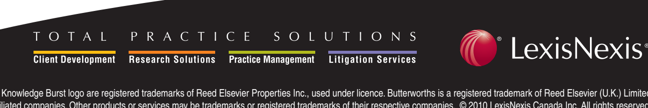
LexisNexis Canada Inc. is pleased to announce that **Linc Rogers**, a partner in the Restructuring & Insolvency Group with Blake, Cassels & Graydon LLP in Toronto, is the new National Editor for the *Commercial Insolvency Reporter*.

Mr. Rogers is an experienced insolvency lawyer whose practice focuses on all aspects of commercial reorganizations, distressed acquisitions, debtor-in-possession (DIP) financing and security enforcement. As a key member of the Blakes U.S. initiative team, he helped establish the firm's Chicago office; while there he focused on Canada/U.S. cross-border transactions and gained familiarity with U.S. bankruptcy law. He was also primarily responsible for cultivating and maintaining business relationships with restructuring and insolvency professionals throughout the Midwest United States. Since returning to Toronto in 2007, Mr. Rogers has been involved in a number of high-profile engagements in a variety of industry sectors.

Mr. Rogers is a member of the Education Oversight Committee of the Turnaround Management Association and was appointed as program co-ordinator and executive member of the Insolvency Law Section of the Ontario Bar Association. He has published extensively in Canadian, U.S. and international periodicals and is a frequent invited speaker at conferences and seminars throughout Canada and the United States.

LexisNexis Canada Inc. wishes to thank **Virginie Gauthier**, of Ogilvy Renault LLP, for her editorial leadership and contributions during her past two years as National Editor of the *Commercial Insolvency Reporter*. She will continue her involvement with the Reporter as a member of the Editorial Board.

For further details of *Commercial Insolvency Reporter*, go to **www.lexisnexis.ca/bookstore**



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Critics fear surfeit of regulation

Continued from page 4

regulators are considering new ways to limit the size, scope and complexity of very large banks. Currently, European regulators appear to be leaning more in that direction than other regulators as reflected in a recent statement from Neelie Kroes, the European Union competition policy commissioner. "It is our view that, while some banks may have been too big to fail, none are too big to restructure," she says.

> **"When people's spending habits go weird, such changes can lead to economic catastrophe."**
>
> *William White, retired chief economist*

Another issue is removing the implicit government bailouts for wayward banks when things go wrong. This is also known as moral hazard or subsidizing risk. In his speech, King referred to the UK proposal to limit government guarantees to so-called utility or deposit-taking banking.

The American version of the policy comes from former U.S. Federal Reserve chairman Paul Volcker, who proposes the return of the *Glass-Steagall Act* that separates Main Street deposit-taking banks from Wall Street investment banks and prohibits each from crossing over into the others' line of business.

There is plenty of support for the banking sector. According to King, in the UK alone, government direct or guaranteed loans and equity investment total close to one trillion pounds, or about two-thirds of the annual output of the entire economy.

For its part, the Bank of Canada is examining policies that will see that losses arising in future crises will be assumed by the institutions themselves. Some of the proposed changes include staged intervention regimes for detecting problems early and having individual banks prepare living wills or plans to unwind in an orderly fashion in case they should fail.

So far, most large institutions are opposed to such measures because of implementation costs and lower revenues. As well, other critics claim such calls for more widespread, macro-prudential monitoring will lead to regulatory overload.

In response, Dickson has stated, "Will the new emphasis on macro-prudential monitoring mean that these reports simply get thicker, with no real impact?

"I think the additional monitoring, combined with financial stability being added to mandates of regulators and central bankers, as recommended by the G20, will help. It will cause everyone to spend more time assessing such risks."