

Patrick Leblond

Canada, the European Union, and transatlantic financial governance

The focus of economic relations between Canada and Europe—and more specifically, the European Union—is usually on trade and investment, not finance. This has been true since at least the 1970s when Canada’s “third option” was in vogue, the third option being the idea that Canada should expand and deepen its trade relations with Europe so as to reduce its economic dependence on the United States.¹ More recently, the negotiation of a comprehensive economic and trade agreement has dominated the public

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¹ For more details on Canada’s third option, see Michael Hart, *A Trading Nation: Canadian Trade Policy from Colonialism to Globalization* (Vancouver: UBC Press, 2002), 291.

discussion of Canada's economic relationship with the EU.² In terms of international finance and its governance, Canada and the EU are normally not concerned with each other but rather with the United States. This is because in the post-World War II period, the US has dominated capital markets and the setting of international financial regulation.³ Cooperation between Canada and the EU in matters of financial governance has instead taken place in international organizations and forums such as the G7, the G20, the International Monetary Fund, the Bank for International Settlements and its Basel committee on banking supervision, and the Financial Stability Forum (now the Financial Stability Board), whose decision-making has traditionally been heavily influenced by the United States.⁴

Today, however, the United States no longer dominates international finance. After a rise in US financial power in the 1990s, the last decade has seen a number of events undermine America's influence. The first was the burst of the dot-com bubble in 2000. The exponential rise of the Nasdaq stock exchange and the massive entry of foreign capital that accompanied the US information technology boom in the second half of the 1990s reinforced the United States' position as the great leader of the globalization game. The dot-com bubble crash put a dent in US leadership, however, because the crash was blamed in part on inadequate regulation and supervision of the brokerage firms that promoted the shares of dot-com companies to the public. The second hit was the result of major accounting scandals at Enron and WorldCom in 2001 and 2002, which resulted in their bankruptcy, as well as that of Arthur Andersen—Enron's auditor and one of the world's

2 For more details on the comprehensive trade agreement under discussion, see Christian Deblock and Michèle Rioux, "From economic dialogue to CETA: Canada's trade relations with the European Union," in this issue of *IJ*; see also Patrick Leblond, "The Canada-EU comprehensive economic and trade agreement: More to it than meets the eye," *Policy Options* 31, no. 7 (July-August 2010): 74-78.

3 Beth A. Simmons, "The international politics of harmonization: The case of capital market regulation," *International Organization* 55, no. 3 (summer 2001): 589-620; Eric Helleiner, *States and the Reemergence of Global Finance: From Bretton Woods to the 1990s* (Ithaca, NY: Cornell University Press, 1994).

4 It should be noted that both the EU and some of its member-states (most often France, Germany, Italy, and the United Kingdom) generally sit on these bodies, with the EU's official status being limited to that of observer. In practice, however, the EU's representatives usually take full part in the discussions. For a good analysis of the EU's role in international forums, see Arne Niemann and Judith Huigens, "The European Union's role in the G8: A principal-agent perspective," *Journal of European Public Policy* 18, no. 3 (2011): forthcoming.

top-five accounting firms at the time. In this case, it was US accounting standards and corporate governance practices that were blamed for these failures. The third (and final?) nail in the coffin came with the burst of the US subprime mortgage bubble in 2007, resulting in a financial crisis that went global and in turn caused the world economy to suffer the so-called “great recession.”⁵ In this last case, blame was put on insufficient regulation and supervision of the US financial sector. As a result of these failures, the United States’ reputation as a beacon of financial stability has been severely dented, which has greatly undermined its ability to influence the governance of global financial markets.

Given the dominant role that the United States has played in the domain of international finance in the last 60 years, one should not be surprised that Canada and the EU have focused their international financial governance attention on the US rather than on each other. But now US financial hegemony appears to be waning, and at the same time, Canada’s financial profile has reached some kind of apex: its banks did not experience a crisis, while the EU is facing serious economic challenges of its own. What does this situation mean for the economic relationship between Canada and the EU and the challenges that they face in matters of global financial governance? More specifically, how have Canada and Europe responded to the rise and fall of American financial hegemony? Have their responses been similar or different? To what extent have their responses involved collaborating with each other?

To answer these questions, the remainder of this article is divided into three parts. First, it is argued that, based on theoretical considerations, Canada would have been expected to follow the US lead in matters of financial governance, while the EU would have been expected to oppose US hegemony. Accordingly, collaboration between Canada and the EU would be difficult. Second, this argument is put to the test by examining cases of securities and banking regulations in Canada and the EU as well as at the international level over the last 20 years. Finally, the article concludes that Canada is now well positioned to move beyond the role of honest broker between Europe and the United States in international financial governance matters. For its part, notwithstanding the global financial crisis’s severe effect on its economy, the EU has undertaken important institutional

5 The literature on the causes of the recent US financial crisis is by now vast. For a short and accessible explanation, see Martin N. Baily, Robert E. Litan, and Matthew S. Johnson, “The origins of the financial crisis,” *Fixing Finance* series no. 2008-03, initiative on business and public policy, Brookings Institution, Washington, 2008.

improvements in matters of financial regulation over the last 10 years that have given it more influence internationally.⁶ Hence, Canada and Europe are now in a position to compensate for the decline in US financial hegemony. This implies that global financial governance will most probably remain a mainly transatlantic affair for the coming decade, in spite of Asia's continued economic rise.

DIFFERENT PATHS TO REGULATING FINANCE?

As in matters relating to trade in goods and services, the globalization of capital should lead to mounting pressures by firms doing business internationally to harmonize standards and regulations and thereby reduce the costs of cross-border transactions. Harmonized financial regulatory standards should also be required to ensure the international financial system's stability, since the system is only as strong (or stable) as its weakest link in an era in which capital is mobile. The key issue of concern here is which standard or rule should prevail and which factors explain whether harmonization takes place or not. Theoretically, Canada should have followed the American lead in financial governance, while the EU should have challenged it.

In a materialist or realist perspective, great powers are leaders and the rest are followers. Moreover, great powers try to balance each other in order to prevent one from gaining relatively more power than the others. This does not prevent cooperation between great powers, but it usually occurs when the mutual net benefits are similar in size.⁷ As a result, given the

6 Elliot Posner, "Making rules for global finance: Transatlantic regulatory cooperation at the turn of the millennium," *International Organization* 63, no. 4 (fall 2009): 665-99; Elliot Posner, "Is a European approach to financial regulation emerging from the crisis?" in Eric Helleiner, Stefano Pagliari, and Hubert Zimmermann, eds., *Global Finance in Crisis: The Politics of International Regulatory Change* (New York: Routledge, 2010), 108-120.

7 Neoliberal institutionalists are not concerned with the relative gains problems identified by realists; they argue that international institutions will be created by states when there exists potential for mutual gains (even if they are asymmetrically distributed between participating states) arising out of international cooperation. On neoliberal institutionalism, see Robert O. Keohane, *After Hegemony* (Princeton, NJ: Princeton University Press, 1984). On the relative gains issue, see Joseph M. Grieco, "Anarchy and the limits of cooperation: A realist critique of the newest liberal institutionalism," *International Organization* 42, no. 3 (summer 1988): 485-507. In his study of global financial regulatory standard setting, David Singer criticizes neoliberal institutionalism (or what he calls functionalist approaches) on the ground that it cannot explain "cross-national variation in regulators' demands for international

respective sizes of their economies, we would expect Canada to bandwagon with the US and the EU to balance against the US. Similarly, in his analysis of international standards coordination, Daniel Drezner argues that great powers should be favoured in international regulatory negotiations.⁸ He points out that the country with the relatively smaller economy will benefit the most from coordination and, therefore, will be most willing to pay the cost of adjusting to the new regulatory standard. This means that “[t]he likelihood of a coordination equilibrium at one country’s standards is an increasing function of that country’s market size.”⁹ He also argues, however, that two similarly sized states are less likely to come to an agreement and that, as a result, the status quo should remain, with each state keeping its own regulatory standard (what the author calls “rival standards”), unless an agreement can be found in an international forum.

Hence, according to this materialistic logic, given its small, open economy and its high dependence on the United States for trade and investment, Canada should be expected to wish to align its standards and regulations as much as possible with American ones so as to make it as easy as possible for Canadian firms to do business in the US and US firms to do business in Canada. Given the EU’s large and relatively closed economy and its limited dependence on the US, we would expect it to oppose the adoption of US financial governance standards internationally and, instead, promote more acceptable (or neutral) international ones.¹⁰ Whether the EU would manage to convince other countries to follow its lead internationally is difficult to determine using a realist perspective. According to Drezner, in such a situation, the status quo should prevail.

According to the Joseph Nye’s idea of “soft power,” however, the EU’s success in promoting international standards that do not copy those of the US would depend not only on the relative size of its financial sector but

standards,” which is in part what the present article is interested in. See David Andrew Singer, *Regulating Capital: Setting Standards for the International Financial System* (Ithaca: Cornell University Press, 2007), 5.

⁸ Daniel W. Drezner, *All Politics Is Global: Explaining International Regulatory Regimes* (Princeton, NJ: Princeton University Press, 2007).

⁹ *Ibid.*, 55.

¹⁰ In his analysis of the governance of the international financial system in *ibid.*, chapter 5, Drezner argues that, following the east Asian financial crisis, the EU and the US were in agreement over the need to develop global financial regulation. This, however, does not mean that they were necessarily in agreement as to *what* new regulatory standards should be adopted.

also its performance. Nye defines soft power as a country's ability to attract others by the legitimacy of its policies and the values that underlie them.¹¹ Put differently, a country would have soft power if it can clearly demonstrate that its standards, regulations, and policies "work." In terms of finance, this means that rapid economic growth, low cost of capital, financial institutions' excellent performance, and the financial system's stability should all be factors that give legitimacy to a country's policies, standards, and regulations. In light of poor American financial sector performance in the last decade, we would expect that it would have become easier for the EU to prevent US standards from becoming de jure or de facto international, and instead to promote alternative financial regulatory standards developed within the confines of international forums. Of course, this is dependent on the EU maintaining, if not improving, its own financial sector performance.

In sum, according to the logic of economic size and legitimacy, Canada and the EU would be expected to have responded differently to the rise and fall in US financial hegemony over the last two decades or so, when pressures for harmonization and convergence of regulatory standards were most intense, given globalization's rapid expansion over the period. How does this theoretical argument stand against the reality of financial regulation in Canada and the EU in the 1990s and 2000s? To answer this question, we examine two areas of financial regulation: securities and banking. The intent here is not to provide a detailed and comprehensive description of financial regulatory measures in Canada and the EU and their evolution over the last couple of decades in comparison with the US. That would be beyond the scope of the present article. Rather, the article sketches out key elements of the systems in each jurisdiction.

SECURITIES REGULATION

Securities regulation involves setting rules for the buying and selling of equity shares, bonds, and their derivatives, which serve to finance corporations. Such rules are generally geared towards making sure that information is shared widely, so as to avoid investors with "inside" information using it to their advantage at the expense of other less-informed investors (the asymmetric information problem). Hence, a large portion of securities regulation is concerned with disclosure requirements, i.e., what information should be made publicly available by companies and when should it be made available.

11 Joseph S. Nye, Jr., "The decline of America's soft power," *Foreign Affairs* 83, no. 3 (May-June 2004): 16-20.

A key element of this regulatory process involves accounting and auditing. Accounting is the means by which companies report the financial state—assets and liabilities—and profitability—net income—of their activities so that investors (shareholders and creditors) can assess the value and performance of those activities. Moreover, investors want to be able to compare financial statements across many companies so as to make a better assessment of their value and performance. This requires that companies' financial reports be prepared according to the same accounting standards. Finally, these reports must be audited by an external firm so that investors may trust the numbers reported by a company's management, which is ultimately responsible for preparing financial statements. This prevents investors from having to do it themselves, which would be very costly and cumbersome. Obviously, it is crucial that external auditors be independent from a company's management so that they can perform their work objectively for the benefit of investors.

In terms of accounting standards, there are two basic approaches, which depend on the purpose that they are supposed to serve. In one approach, developed in Anglo-Saxon countries, standards are devised to satisfy the needs of financial investors, who have an arm's-length relationship with the companies in which they invest. In the other approach, traditionally found in continental European countries for instance, financial reporting standards have traditionally served governments' need to raise tax revenues. This is possible because there is a much closer relationship between investors and the firms in which they invest, especially since financing most often comes from banks rather than financial markets. Therefore, because of their close-knit relations with firms, investors do not need to rely so much on the financial information that companies make available to the public.

Given Canada's British roots and its close economic links with the Commonwealth until World War II, it should not be surprising that its accounting standards have been modelled after those found in the UK. However, as the Canadian economy became increasingly integrated with that of its southern neighbour, Canada's accounting standard-setter, the Accounting Standards Board, undertook to converge Canadian accounting standards with American ones. This convergence process was most visible in the 1990s, as US accounting standards (commonly known as "generally accepted accounting principles," or GAAP) were increasingly being adopted internationally by companies wanting to tap foreign capital markets and non-US stock exchanges wanting to attract foreign companies that would

list their shares with them.¹² Because Canadian firms were increasingly raising funds in the US and many of them had subsidiaries there that had to be consolidated in the Canadian parent company's accounts, it made sense to harmonize Canadian accounting standards with US ones. If, in addition, US GAAP were becoming the de facto market standards internationally, there was no reason why Canadian standards should not be aligned with their American counterparts. This situation changed in 2005 when, in its strategic plan, the Accounting Standards Board decided that it was shifting its focus away from US GAAP to international financial reporting standards—the IFRS, which are developed by the International Accounting Standards Board, a private international organization based in London. The official announcement was made in 2006, indicating that the changeover to the IFRS would take place on 1 January 2011. This decision was the result of the EU's adoption of the standards back in 2002, as well as active cooperation between the International Accounting Standards Board and the US Financial Accounting Standards Board in view of reducing, if not eliminating, the differences between the two sets of standards—which we will treat in more detail below.

In Europe, there was great fear in the mid-1990s that the continued fragmentation of EU financial markets would mean the increasing dominance of world capital markets by the US, as investors and companies would flock where capital is cheaper and easier to trade. The fact that an increasing number of European companies were raising financing in the US set alarms ringing in Brussels as well as in national capitals. It came, therefore, to seem important to integrate financial markets across the EU. For this to happen, accounting standards across the EU needed to be harmonized. In fact, for this purpose, EU stock exchanges had already started allowing companies to produce their financial reports using US GAAP. This prompted a second fear, namely that US GAAP would become the de facto common accounting standards in the EU and around the world. Hence, a competing set of financial reporting standards had to be promoted. The choice was really between “European” standards and the IFRS. Given the mitigated success that the EU had had in its previous attempts to harmonize standards across the Union, it seemed that creating a new set of common EU accounting

¹² The same logic that argues that accounting rules should be standardized nationally applies globally as capital becomes increasingly mobile.

standards would prove impossible.¹³ Since it was not politically acceptable to use UK standards for the whole EU, even if financial market participants considered them to be the best in Europe, adopting IFRS became the most sensible choice, economically and politically.¹⁴

In doing so, the EU also hoped to influence the harmonization of financial reporting standards internationally such that IFRS would become the standard set of principles and rules across the world, rather than US GAAP. By being the first jurisdiction to make these standards solely applicable for companies whose shares were publicly listed on a stock exchange, the EU could provide the necessary impetus for the harmonization of financial reporting rules across the globe. EU officials hoped that it would even be possible to convince the United States to harmonize its own accounting standards with IFRS.¹⁵ As a result of the close cooperation between the international and the US financial accounting standards boards, the US Securities and Exchange Commission has recently committed itself to allowing US companies to prepare their financial reports according to IFRS by 2014 (for now, only foreign companies whose shares are listed in the US can use IFRS).¹⁶ There are now more than 100 countries that require or permit the use of IFRS to prepare financial reports.

The EU has not had the same leadership internationally and vis-à-vis the US in other areas of corporate governance standards. For instance, the Sarbanes-Oxley Act of 2002, passed by the US congress in response to the Enron and WorldCom accounting scandals, imposed a series of new

13 For more details on the EU's attempt to harmonize its accounting standards before the 1990s, see Per Thorell and Geoffrey Whittington, "The harmonization of accounting standards within the EU: Problems, perspectives and strategies," *European Accounting Review* 3, no. 2 (1994): 215-39.

14 Geoffrey Whittington, "The adoption of international accounting standards in the European Union," *European Accounting Review* 14, no. 1 (2005): 127-53.

15 The Sarbanes-Oxley Act of 2002 required the US Securities and Exchange Commission and the Financial Accounting Standards Board to pursue the convergence of US GAAP with IFRS. For details on how the scandals cast a shadow on the quality of US GAAP, see Sarah B. Eaton, "Crisis and the consolidation of international accounting standards: Enron, the IASB, and America," *Business and Politics* 7, no. 3 (2005).

16 For details on EU-US relations with respect to the process of harmonizing international accounting standards through the International Accounting Standards Board, see Patrick Leblond, "EU, US and international accounting standards: A delicate balancing act in governing global finance," *Journal of European Public Policy* 18, no. 3 (2011): forthcoming.

regulations on US and foreign corporations that raise financing in the US. For example, executives, including chief executive officers and chief financial officers, have to personally certify the financial reports published by a company, which means that they are legally liable for them. In addition, in order to prevent conflicts of interests and enhance their independence, auditors can no longer offer ancillary consulting services, and companies' board of directors must now have audit committees—which oversee the financial statements' audit—that are strictly composed of independent board members who cannot be in any way involved with or related to the company's management. The act also created a public company accounting oversight board to regulate auditors of publicly listed companies, so as to ensure that auditors perform their work competently and objectively. These are just some of the important reforms the act put in place to restore investor confidence and increase transparency in US financial markets.

Canada was quick to follow in the US's footsteps. The Canadian Securities Administrators, a forum of provincial and territorial securities regulators (there is no national regulator in Canada) that serves to coordinate and harmonize regulations and actions across the country, adopted a series of measures between 2002 and 2004 that were very similar to those found in the Sarbanes-Oxley Act. For instance, in July 2002, even before the US act became legislation, the securities administrators announced the creation of the Canadian public accountability board, which is an independent public oversight body responsible for overseeing the work of auditors of public companies in Canada. As in the US, Canadian companies are required to hire registered auditors, who themselves must report to an independent audit committee of the board of directors. They must also adopt a code of ethics and make it public. Like their US counterparts, Canadian executives are also required to certify financial reports that are made public. There are some differences between American and Canadian rules, but they are small. For example, Canadian companies are not prohibited from making loans to executives. The main difference between the two sets of rules is that Canadian ones are not cast into law like American ones. Canadian rules, instead, are regulations issued by the provincial and territorial securities regulators under the Canadian Securities Administrators' aegis. They have, nevertheless, been as effective as the US legislation.

The EU's response to US accounting scandals, as well as to the ones that happened on European soil, such as Ahold and Parmalat, has been much more moderate. In the wake of the Enron scandal, the European Commission was quick to set up a high-level group of company law experts in

September 2001 to make recommendations for an EU regulatory framework for company law, which included corporate governance matters. Following the group's report, issued in November 2002, the European Commission adopted an action plan—"Modernizing company law and enhancing corporate governance in the European Union: A plan to move forward"—that it presented to the European Council and the European parliament. The main elements that have been implemented are: the requirement that public companies publish an annual report on their corporate governance practices, as per the national code of their home member-state (or the member-state where most of their shares are listed on a stock exchange); the creation of a European corporate governance forum, whose objective is to coordinate national corporate governance codes as well as the latter's monitoring and enforcement; national provisions ensuring a stronger role for independent directors; and the reinforcement of shareholders' rights vis-à-vis management, especially across EU borders. In sum, the minimum corporate governance requirements at the EU level fall considerably short of those found in Canada and the US. This does not mean that the rules and regulations found in individual EU member-states cannot be stronger, as in the UK, for instance.

When it comes to securities regulation, Canada has tended to follow US leadership, with respect to both accounting standards and corporate governance rules, as expected. The only exception is that Canada moved to adopt the International Accounting Standards Boards' standards more quickly than the US, though the international convergence movement towards IFRS was already well under way as a result of the EU's adoption of it. The accounting standards case makes it clear that the EU wished to challenge US financial hegemony. As for corporate governance rules, the EU was unable to implement common rules because of the various capitalist models found among its member-states.¹⁷ Moreover, because the US rules are considered very costly and restrictive and have led many foreign companies to raise capital in Europe and Asia instead, the EU did not feel much pressure to follow suit. Canada could not afford such a luxury, since Canadian companies are highly integrated into US goods, services, and capital markets.

17 For detailed discussions and analyses of the "varieties of capitalism" concept, see Peter A. Hall and David Soskice, eds., *Varieties of Capitalism: The Institutional Foundations of Comparative Advantage* (New York: Oxford University Press, 2001); and Bob Hancké, Martin Rhodes, and Mark Thatcher, eds., *Beyond Varieties of Capitalism: Conflict, Contradictions, and Complementarities in the European Economy* (New York: Oxford University Press, 2007).

BANKING REGULATION

The failure of a bank represents a risk to the financial system's stability. One bank's failure can threaten other banks in the system and create a domino effect, which is known as systemic risk. The typical way to reduce systemic risk is by regulating the amount of capital that banks have.¹⁸ Capital adequacy rules aim to prevent regulated financial institutions from taking excessive risks. They are necessary because the safety nets offered by deposit insurance and the guarantees of the central bank—in its role as lender of last resort—create a moral hazard for governments. Because of such guarantees, depositors and creditors tend to pay less attention to the soundness of the banks in which they put their money. This means that banks can take greater risks with depositors' and creditors' money without losing deposits or having to pay higher interest rates (to pay for the risk premium). As such, market discipline fails to function properly and the government and its agencies ultimately end up paying the costs of banks' excessive risk-taking without reaping any of the benefits.

Since the late 1980s, there has existed an internationally agreed framework for capital adequacy rules for banks. This framework is known as the Basel accord, which has been developed by the Basel committee on banking supervision under the aegis of the Bank for International Settlements.¹⁹ Before the global financial crisis, the Basel accord's minimal capital requirements as a percentage of risk-weighted assets were at least four percent for tier-one capital and eight percent for total (tiers one and two) capital. Now, as a result of a new revision to the Basel accord (known as the Basel III framework) adopted in November 2010, the minimum requirement for tier-one capital will be raised to six percent, while that for total capital will remain at eight percent. However, a "conservation buffer" of 2.5 percentage points will have to be added to these minimums, thereby making the effective rates 8.5 and 10.5 percent of risk-weighted assets, respectively. Furthermore, the definition of what counts as capital has been narrowed, thereby making the reserve requirements even more stringent. These new minimum capital

18 Capital regulation takes the form of minimal ratios for a bank's capital expressed as a percentage of its assets or its credit exposures, on a risk-weighted basis or not.

19 The first Basel accord, Basel I, came into being in 1988; its successor, Basel II, was agreed to in 2004 but not implemented until 2007. For details, see Howard Davies and David Green, *Global Financial Regulation: The Essential Guide* (Cambridge: Polity Press, 2008), 32-46.

requirements will be gradually phased in between 2013 and 2019, although many of them will already be in place by 2015.²⁰

Canada, the EU, and the US all subscribe to the Basel rules, whose content has been heavily influenced by the United States.²¹ In Canada's case, however, the minimum thresholds imposed by the Office of the Superintendent of Financial Institutions have been set higher than the current Basel rules, at seven and 10 percent, respectively. Furthermore, Canada's financial regulator imposes more stringent restrictions than the Basel accord on what can be included in the calculation of tier-one capital.²² For their part, the EU and the US have only required that their banks meet the minimum capital requirements set by the current Basel accord.

Canadian banks face an additional capital requirement: they cannot have an assets-to-capital multiple above 20. This means that banks' total (non-risk-weighted) assets cannot be more than 20 times their total capital, which corresponds to a minimum ratio of five percent.²³ Prior to the recent global financial crisis, Canada and the US were the only countries to impose such a limit on banking leverage. Unlike the US, however, Canada has required that all of a financial group's activities (on and off the balance sheet) be included in the calculation of the assets-to-capital multiple. In the US, only commercial banking activities have been included in the multiple's calculation. This is why US financial groups were able to pile on debt and use leverage to boost their profits, which they did through non-regulated investment banking, hedge fund, and private equity activities. These "shadow" activities nonetheless came to threaten the stability of systemically more important commercial banking operations when the real estate bubble burst.

Capital regulatory thresholds such as capital-adequacy ratios and assets-to-capital multiples (or leverage ratios) are meant to limit banks' leverage.

20 These new requirements were officially adopted at the G20 leaders' summit in Seoul, 11-12 November 2010. For details, see "The Basel committee's response to the financial crisis: Report to the G20," Bank for International Settlements, Basel, October 2010, www.bis.org.

21 See Ethan B. Kapstein, "Resolving the regulator's dilemma: International coordination of banking regulations," *International Organization* 43, no. 2 (spring 1989): 323-47; and Singer, *Regulating Capital*, chapter 4.

22 Lev Ratnovski and Rocco Huang, "Why are Canadian banks more resilient?" working paper WP/09/152, International Monetary Fund, Washington, 2009, 16.

23 For details, see Etienne Bordeleau, Allan Crawford, and Christopher Graham, "Regulatory constraints on bank leverage: Issues and lessons from the Canadian experience," discussion paper 2009-15, Bank of Canada, Ottawa, 2009.

They are considered crucial to ensure the financial system's stability. Excessive indebtedness, or leverage, combined with corresponding poor-quality assets, are the main cause of the recent global financial crisis that first afflicted the US and then the EU. In fact, as the amount of credit increased in the financial systems of Europe and the United States, the marginal quality of the assets purchased with each new dollar or euro of debt declined.²⁴ This is why capital regulation is one of the main issues on which the Financial Stability Board and the Basel committee on banking supervision have been focusing as part of the regulatory reform mandate handed to them by G20 leaders.

As already mentioned, the new Basel III capital rules were adopted in November 2010, after a two-year-long evaluation and negotiation process. In addition to higher capital requirement ratios and a stricter definition of capital, the Basel III regulatory framework includes a minimum leverage ratio that banks will have to satisfy.²⁵ As such, the reform package follows in Canada's footsteps. However, it proposes a minimum leverage ratio of three percent (instead of five in Canada's case) for tier-one capital divided by total adjusted assets. This leverage ratio takes as its starting point the US leverage ratio, whose minimum is also three percent of tier-one capital over total adjusted assets. Fortunately, unlike the US but like Canada, it includes deferred taxes and off-balance sheet exposures in the denominator's calculation. By including off-balance sheet items in its leverage ratio, the Basel committee recognizes the wisdom of Canada's more comprehensive definition of a financial group's total assets. Nevertheless, the Basel committee's minimum leverage ratio requirement is considered weaker than expected (Canada's five percent ratio was originally considered the likely standard to be adopted) and, according to the *Financial Times*, should therefore be "unchallenging" for banks.²⁶ As with the Basel committee's concessions on the definition of capital, European banks are again expected to be the main beneficiaries from

24 On the role of indebtedness and credit expansion in bringing about financial crises, see Charles P. Kindleberger, and Robert Aliber, *Manias, Panics, and Crashes: A History of Financial Crises*, 5th ed. (Hoboken, NJ: John Wiley & Sons, 2005), chapter 4; see also Carmen M. Reinhart and Kenneth S. Rogoff, *This Time Is Different: Eight Centuries of Financial Folly* (Princeton, NJ: Princeton University Press, 2009).

25 Apparently, the EU managed to water down the definition of capital from the Basel committee's original proposal in December 2009. See Megan Murphy and Patrick Jenkins, "Shares bounce as rules softened," *Financial Times*, 28 July 2010, 3.

26 Katia D'Hulster, "The leverage ratio: A new binding limit on banks," World Bank, Washington, December 2009, 3; Murphy and Jenkins, "Shares bounce."

this softened stance, because they still have on average the highest levels of leverage.

FINANCIAL REGULATION: STILL A TRANSATLANTIC AFFAIR

The United States dominated securities and banking regulations in the 1980s and 1990s. However, things have changed since 2001. Although the US remains an influential player in global financial governance matters, the EU has been able to challenge American financial hegemony and now finds itself in a strong position to exercise greater influence in global financial regulatory matters. As such, the EU's stance over the last two decades is in accordance with the argument presented earlier. With regard to Canada, the congruence between the evidence presented in preceding sections and the theoretical argument elaborated at the beginning may appear at first sight more mixed than in Europe's case. On closer inspection, however, it becomes clear that when Canada's standards deviate from their US counterparts, those deviations are either marginally weaker or significantly stricter. Canada certainly does not seek to challenge US standards. For instance, in the case of banking regulation, Canada went above and beyond the minimal standards set by the Basel committee on banking supervision and implemented by the United States. And it is likely to continue to do so, given that it did not manage to impose its own leverage ratio (or assets-to-capital multiple) requirement at the global level. One could reasonably argue, however, that having stricter capital requirements for financial institutions does not amount to a challenge to US financial hegemony, since it means higher regulatory costs for the Canadian financial system. As for securities regulation, Canada followed in the US's footsteps, except when it decided to shift the convergence of its accounting standards towards IFRS rather than US GAAP. Nevertheless, there were already strong indications that the US was serious about attempting to harmonize US GAAP with IFRS. So, again, Canada was not taking a big risk in announcing its intention to adopt IFRS before the US did so.

In the introduction, we mentioned that it was unusual to think of the economic relationship between Canada and Europe in terms of finance. The evidence presented herein with respect to securities and banking regulations underlines that Canada and Europe have tended to adopt different financial regulatory paths, usually on the basis of what the United States does. This is because Canada and the EU differ with regard to the size of their economies and degree of interdependence vis-à-vis the US economy. Canada and the EU only cooperate on financial governance matters when they meet in

international forums like the Basel committee on banking supervision, the Financial Stability Board, and the International Monetary Fund. Nevertheless, if an agreement is achieved at one of these forums, it is because the Americans and the Europeans have negotiated a compromise. In such instances, Canada's role is limited to making use of a certain amount of soft power to propose regulatory solutions to its partners. Canada's soft power, which increased following the global financial crisis, is, in turn, dependent on having a successful economy with a stable, high-performing financial system. With Asia's phenomenal growth and development and the decline of American financial hegemony, Canada and the EU must cooperate much more closely with each other than they have in the past if they wish to see global financial governance remain a mostly transatlantic affair.