Carlos da Silva Costa: Risk management for central banks

Opening remarks by Mr Carlos da Silva Costa, Governor of the Bank of Portugal, at the Joint Bank of Portugal and European Central Bank Conference on "Risk Management for Central Banks", Lisbon, 25 September 2017.

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Thank you very much for your presence, I welcome you all and I hope that this conference and your stay will be very pleasant as summer turns to autumn here in Lisbon.

The first point I would like to make is that Carlos Bernardel, Helena Adegas and I first planned to organise this conference two years ago. We are now able to say that it was the right decision, and I think that by the end you will be the first to witness that.

When we took the decision to go ahead with this conference, risk management was an important matter. But now it is even more important. There is a lot of thinking available on this matter, but aside from the available thinking, we have a lot of problems to solve. And this means that we need new thinking on ways to solve the problems linked to risk management.

My opening remarks will take a different approach to my closing remarks at the end of the conference. I would like to speak initially about central banks and the way they face, or are faced by, risks. Central banks are 'complex entities' with broad mandates. Firstly, central banks are policy-makers and regulators. Secondly, they are also corporations and service providers. And they are asked to be accountable in both these capacities that are very important for the economy and society.

As policy-makers and regulators, central banks pursue a public interest mission of delivering price stability and safeguarding financial sustainability. As corporations and service providers they have to be well managed, they need to be efficient and they need to care about sustainability.

The risk management framework within central banks needs to take into account these two different – and sometimes conflicting – realities. As policy-makers, we need to understand that the financial crisis, and the context in which the crisis emerged and developed, provide ample food for thought about the role of central banks, including the issue of risk management.

Indeed, policy-making involves different types of risks and uncertainties.

When we speak about risk management, it is not only about asset management, but also about risk associated with our own decisions, to act or to defer action, because we are creating uncertainties for third parties and for the economy. For instance, the central bank may base the definition of its policies on a faulty representation of reality, either because the models used are conceptually wrong or incomplete, or because the coefficients are no longer right. And if you recall our past history of this crisis you see that these two risks were very present: the quality of the models and the quality, or the accuracy, of the coefficients.

Under certain circumstances, the central bank may also lack the necessary tools to achieve its policy objectives; or it may have to cope with deficiencies in the institutional setting – and I have plenty to say about the institutional setting and the difficulties created for the central bank by a lack of the right institutional setting – or it may have to cope with failures in coordination with the other relevant policy-making authorities.

And when we speak about coordination and risks for central banks, we also have plenty to say.

Materialisation of these risks may lead to a late recognition of accumulating imbalances. This, in turn, results in a failure to prevent imbalances from reaching a point when disruptive adjustment becomes inevitable and a crisis emerges.

This means that our main risk as a central bank in terms of policy-making is to act at the right moment in order to avoid making later action harder, ultimately leading to a crisis.

Once a crisis erupts, the nature of the risks changes, calling for more action by the policy-making authorities.

Initially, the priority must be to manage the crisis and mitigate its immediate impact. I am reminded of the popular Portuguese saying: 'In times of war there is no time to clean weapons'. And that is how it was during the crisis. When we are facing problems we need to act, despite the presence of some risks. That is why initially the priority must be to manage the crisis and to mitigate its immediate impact.

Unconventional, and often untested, measures are put in place, and the question arises as to, first: What are the right doses of the medicine and the right duration of the intervention?

Then one has to worry about the adjustment process towards a new 'steady state', and second, about reducing the probability of similar crises occurring in the future. This means that we are simultaneously in a situation where we need to ensure that the patient will survive, but the risks associated with the medicine will also be under control. The dilemma here is again on the appropriate doses:

- How to facilitate and speed up the adjustment while minimising the risk of 'curing the disease and killing the patient'?
- And how can we smooth the adjustment without sowing the seeds of the next crisis?
- In other words, how can policy avoid tail risks? And at what cost?

Also, policies designed to avoid tail risks often carry significant risks for central banks' balance sheets. This is something that has been studied by Professor Ricardo Reis, who is with us today. Such policies, and their reversal in the future, may jeopardise central banks' independence and their ability to deliver on their objectives over the medium run. This means we need to understand that central banks need to act when facing difficulty, but at the same time acting could be a big threat to the bank itself.

So, when deciding on their policies, central banks need to consider not only the overall economic impact of those policies, but also the possible implications for their own sustainability.

These and other difficult questions and trade-offs have been very much present in central banks' deliberations over the past ten years; and they will not go away in the future because they will be present in managing the balance sheet.

The second topic that we need to understand is that central banks are corporations and service providers. And related to that are the risks associated with formulating monetary policy and ensuring financial stability, as these activities will impact on their capacity to manage the balance sheet. Central banks also face a variety of other risks emerging from their operational activity, extending but not limited to those affecting:

- Asset management;
- Cash issuance;
- Payment systems;
- Information and communication systems, including cyber risks.

Materialisation of any of these risks may have a severe impact on the central bank's financial position and reputation. Their prevention needs to be part of the central bank's daily activities.

On top of that, as banks with a balance sheet, with responsibility for the assets on the balance sheet and with the needs of a central bank, and also as entities that have supervisory powers, central banks need to set an example for the banking community and the financial system. This means that we need to be the first to introduce new approaches, we need to be the first to think about risks and we need to be the first to spread best practice among the financial community.

In a nutshell I believe that to be effective, central banks need to be trusted; and in order to be trusted, they need:

- To have the ability to explain their policies and deliver on their mission;
- To be accountable for their use of taxpayers' resources;
- And finally to lead by example.

The road is very narrow and failure to deliver can cause serious and long-lasting reputational damage. Risk is so important because we are facing this risk always as front-runners when the risk emerges.

A 'risk-free' organisation does not exist. This is something that we should emblazon on the front of the central bank and also of the commercial banks: a risk-free organisation doesn't exist. And it is important for the central bank – within the constraints of the institutional and regulatory environment that embraces its operations – to define the appropriate level of risk appetite and tolerance, and to monitor this risk in an effective and suitable way.

A properly designed risk management framework in the central bank is a pillar of confidence and trust in the financial system and in the wider economy.

This is why conferences such as this are so important. By bringing together academics, policy-makers, practitioners and market analysts to exchange views – from very different, but complementary, angles – we are contributing to more robust policy frameworks and to more robust institutions.

And I think this is the main takeaway that we need to have at the end of this conference: the idea that we can do better, but we cannot avoid risk; and the art of the central bank is to deal with the risk without losing sight of the two main goals, financial stability and monetary stability. To do that, we may need to accept that some collateral effects are part of the process and are just the price we pay in order to achieve the two main objectives.

Thank you very much.

And thank you very much to those who are making presentations, those who agreed to take part in the discussions, and those who agreed to participate in this conference.

It is my honour now to present to you Yves Mersch, member of the Executive Board of the ECB. It is a pleasure for me because I've known Yves Mersch for more than 30 years. We have been together in different roles, together in the same room, discussing the Maastricht Treaty.

Yves Mersch was the chairman of the committee that discussed the Maastricht Treaty during the critical period of time before its approval. He was instrumental and made a key contribution to the development of these negotiations. Afterwards we met in different roles, including an important one that I would like to mention – that of being the first Governor of the Central Bank of Luxembourg. And this means a lot! This means creating a bank from scratch. And creating a central bank from scratch is not an easy task in terms of the relationship with the political power, in operational terms, in terms of creating credibility, in terms of bringing together a team. And I think that this point needs to be emphasised because it is a very important achievement by Yves Mersch.

After that, Yves Mersch joined the Board of the ECB, and he is one of the individuals we count on heavily at the ECB, for three reasons. First, because he is very important for ensuring the smooth running of the infrastructure that is critical for the working of the economy, for everything concerning currency issuance, everything concerning payments, and the major advances that have been achieved. Second, he is very important because he is in charge of the legal department, a critical department for ensuring central banks' independence – in fact more than just independence – central banks' obeyance to their ultimate objective.

And third, as head of the legal department he is an important ally for us in the national central banks in order to preserve our independence where there are temptations to reduce this independence. To be clear, the temptation to reduce the independence of the central banks is not only a characteristic of, I would say, the Southern countries. There are Nordic countries that have the same temptation. This means that wherever the treasury is, there is also the temptation to take it. And it is not only a question for the Portuguese people or others: put the money somewhere and the temptation will arise, it may be sooner, it may be later, but it will arise.

Yves Mersch is a key man for us, for our activity, because he is in charge of the department that gives us the sponsorship that is needed to continue with our activity without any risks, i.e. institutional risks. And institutional risk is a big risk that central banks are now facing: if you look to the United States or to Europe, you'll see that the political and monetary centres have different perspectives. To have someone in the legal department who knows very well which way is best is very comforting and reassuring.

So I give the floor to Yves Mersch, thanking him very much for the role that he plays in ensuring the independence of the Eurosystem and ensuring that central banks at national level are in line with the commitment that we undertook in the Maastricht Treaty.

Thank you very much.