Pierre Duguay: Fostering financial system stability

Remarks by Mr Pierre Duguay, Deputy Governor of the Bank of Canada, to the Pictou County Chamber of Commerce, Pictou, Nova Scotia, 27 November 2008.

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Good evening. It's a great pleasure to be here. When I last spoke in Nova Scotia three years ago – almost to the day – I discussed the Bank of Canada's role in strengthening the country's financial system to make it resilient to shocks so as to limit damage from inevitable economic and financial storms. It was a timely metaphor, given that I spoke shortly after Hurricane Katrina had breached the levees of New Orleans. We were concerned at that time about the buildup of global economic imbalances, and about the narrowing of risk spreads which suggested that risk was perhaps being underestimated and vulnerable to a sudden reversal. These factors have since proven to be key contributors to the current, worldwide turmoil in financial markets. A third contributing factor, which we didn't foresee, has been the extent to which financial markets had expanded without proper support structures, like a house built on sand. I'll have more to say on this point a bit later in my remarks.

So, I thought it would be worthwhile to review the risks we were aware of leading up to the current crisis, what took us by surprise, and what we have learned must be done to strengthen financial system resiliency for the future, both here and abroad.

The Canadian financial system has fared relatively well through this crisis, thanks to effective regulation and prudent practices that have worked like sandbags to protect our financial system from the storms in today's global economy. In this respect, we may be a model for much of the world. But, because our prudential regulation is focused on protecting institutions, rather than supporting core financial markets, we have learned that there is still much work to do in this area. So I will also discuss some reforms that may be necessary to mitigate the effects of future global financial crises. I will close with a few words on the current economic situation in Canada.

The global financial crisis

We have all heard a great deal about the tumultuous global events that began in the summer of 2007 as a result of rapidly rising delinquencies on subprime mortgages in the United States. The sudden realization that exposure to these defaults was both widespread and difficult to locate (because of a lack of transparency) led to a drying up of liquidity and an increase in bank funding costs. That turmoil accelerated dramatically this September, moving far beyond liquidity problems to a more acute and broad-based crisis of confidence, sparked by a series of failures and near-failures of financial institutions in the United States and Europe, and increased prospects of a world recession. As a result, wholesale funding markets came to a standstill in many countries, and commercial banks essentially stopped making unsecured loans to one another at terms longer than overnight. The crisis rippled through various markets as investors became very risk averse. Corporate bond spreads surged to new all-time highs, equity prices plunged, and foreign exchange rates became very volatile.

Investors' concerns about the impact of the turmoil on the global economy turned into a vicious circle. Financial institutions became increasingly reluctant to extend credit, given their own funding difficulties and their concerns about what an economic slowdown would imply for the credit quality of their loan portfolios. Tighter credit conditions and the increased difficulties that businesses faced in trying to raise funds have, in turn, contributed to the slowdown in the world economy. Another contributing factor was the drop in consumer confidence triggered by the wealth destruction that resulted from sharp falls in equity markets and housing prices. The combination of these factors has produced extremely volatile and difficult financial conditions, and what has become the deepest, broadest, and longest financial crisis since the 1930s.

In response, governments and central banks around the world – including the Bank of Canada – have undertaken a series of unprecedented actions aimed at stabilizing the financial system. These include making available significant overnight and term liquidity to a broad range of market participants; guarantees of bank deposits and borrowing; purchases of bad assets; and capital injections for financial institutions. The G-7 Plan of Action announced in early October has provided the foundation for urgent and unprecedented measures to stabilize financial markets and restore the flow of credit, essential to continued economic expansion. Importantly, it included a commitment from G-7 leaders to use all available tools to support systemically important financial institutions and prevent their failure.

Governments in industrialized countries and in some systemically important emerging-market economies have also pledged to take steps to encourage economic growth and to reduce the severity of the global recession.

Canada’s response

Consistent with the G-7 Plan of Action, the Bank of Canada has acted swiftly to ensure that adequate liquidity is available to institutions within our borders. Our actions have been significant. We have moved aggressively by expanding the Bank of Canada's provision of term purchase and resale agreements (PRAs) to a total of $34 billion. Term PRAs provide liquidity to key market participants for terms up to three months against a wide range of securities. Further, we have widened the range of assets we accept, and extended the range of counterparties with whom we will transact. We also introduced a new term-loan facility for those financial institutions that participate directly in the Large Value Transfer System, taking their non-mortgage loan portfolios as collateral.[1]

I should point out that none of these liquidity measures are inflationary because they involve sales of government debt either from the Bank's portfolio or from new issuance rather than an increase in the money supply.[2] The substitution of risk-free government securities for less liquid assets on the balance sheets of core financial institutions acts as a kind of lubricant to the machinery of banking. In return, these core institutions are expected to pass on the extra liquidity through other market participants and, ultimately, into the real economy.

The federal government has also been actively working to address the impact of the financial crisis. In recent weeks, it announced the Canadian Lenders Assurance Facility, a voluntary program of insurance for interbank lending to ensure that Canadian institutions are not put at a competitive disadvantage to their international peers when raising funds in wholesale markets. The government has also increased to $75 billion the amount of insured mortgage pools that it will buy from financial institutions, thus supporting the availability of credit to Canadian households and businesses.

How does the Bank of Canada deal with risks?

The Bank of Canada's role in fostering financial system stability is not always well understood. So let me explain our work in this area a bit more.

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[1] As well, as part of an unprecedented coordinated action by the world's major central banks, the Bank of Canada entered into a US$30 billion reciprocal currency-swap arrangement with the U.S. Federal Reserve. This facility would only be activated in the event of an acute shortage of U.S. dollars in Canada, but it does provide the Bank with additional flexibility to address rapidly evolving developments in financial markets.

[2] Proceeds from new issuance of government debt related to Bank operations are held on deposit at the Bank of Canada.

As part of its commitment to Canadians, the Bank fosters the safety and efficiency of the financial system, both in Canada and around the world. Our goal is to encourage a resilient system that can withstand shocks – even large shocks. The Bank's power to achieve this goal comes from our central position as Canada's monetary authority. This makes us the ultimate provider of liquidity to Canadian financial institutions and to the country's financial system more generally. It also gives us a prominent voice in international organizations as well as in such domestic bodies as the Financial Institutions Supervisory Committee (FISC) and the Senior Advisory Committee (SAC). FISC and SAC provide forums for the Federal Deputy Minister of Finance, the Superintendent of Financial Institutions (OSFI), the Governor of the Bank of Canada, the Chair of Canada Deposit Insurance Corporation (CDIC), and the Commissioner of the Financial Consumer Agency of Canada (FCAC) to share information, coordinate actions, and advise the federal government on financial sector policy.

At the international level, the Bank, the federal Department of Finance, and the Superintendent of Financial Institutions are represented on the Financial Stability Forum (FSF). The impetus for this global forum came from a summit of G-7 leaders in Halifax more than a dozen years ago, and the FSF truly came to life in the wake of the Asian crisis of the late 1990s. This entity brings together senior representatives of national financial authorities from selected countries to promote international financial stability, reduce the spread of shocks, and increase market resiliency. The importance of the FSF as a source of global coordination was recently underscored by the G-20 leaders, with their call for its expansion to include top emerging-market economies such as China and India.

As you can tell from that description, the Bank has essentially two key tools at its disposal. One is our power to supply liquidity; the other is our capacity to produce the solid research and analysis that underpins our advice and enables us to influence public sector decisions and private sector behaviour. We do not supervise financial institutions for depositor protection – that falls within the realm of OSFI and CDIC. Nor do we regulate financial markets for investor protection – a responsibility carried out by the provincial securities commissions.[3]

To carry out our responsibilities, we monitor trends in financial developments in Canada and abroad, assess their implications for financial system stability, and identify risks to the Canadian financial system so that we can act and convince others to act, to limit damage from economic and financial storms. We publish our assessments, based on this monitoring, in our semi-annual *Financial System Review*. The next issue will be published and posted on the Bank's website on 11 December.

Strengthening resiliency

At the beginning of my remarks, I spoke briefly about the need to strengthen the resilience of our financial system.

As I have already noted, in Canada we have taken many of the correct steps, some beginning 20 years ago, as we worked to strengthen the supervisory system for individual financial institutions. The coordination among domestic agencies with an interest in the financial services sector is based on a long history of effective collaboration and on a common understanding of where mandates interact. Yet there is still work to do so that we can be even better prepared the next time a crisis crashes onto our shores. History shows this is inevitable, given the difficulty investors have in going against the crowd and resisting the extremes of heady optimism in good times, and fear and even panic in bad times.

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[3] We also have statutory responsibility for the oversight of risk containment measures in systemically important clearing and settlement systems. This infrastructure has continued to function very well throughout the global turmoil.

Given that inevitability, it is imperative that we address the weaknesses in the global financial system and in the regulatory and supervisory architecture that were exposed by the current crisis, if we are to increase the resiliency of the financial system to shocks and better support economic stability. The Financial Stability Forum has examined lessons from the current crisis and made a number of recommendations earlier this year aimed at enhancing market and institutional resiliency. Work continues under the guiding principles of the FSF, to encourage a financial system that:

- operates with less leverage;
- is immune to the misaligned incentives that contributed to the current crisis; and
- has stronger oversight and greater transparency so that risks can be more readily identified and dealt with.

Collectively, we must find ways to improve the transparency of complex products traded in financial markets, so that investors are better able to assess the risks they take on. We must also examine how best to strengthen macroprudential regulation (as opposed to institution-centered microprudential regulation) by:

- bolstering controls on leverage;
- encouraging the buildup of adequate capital buffers in good times that can be drawn upon in bad times, thus dampening the credit cycle;
- developing mechanisms to provide liquidity to core financial markets so that they remain open; and
- expanding the amount of financial infrastructure that is properly risk-proofed, for example, custodial banks and clearing houses for credit default swaps (CDS).

Economic outlook

Let me close with a few words about the economic outlook. The intensification of the global financial crisis has led in Canada to an increase in credit spreads and a tightening in credit conditions generally. The global recession is deepening, and with it there have been further declines in the prices of many commodities and a deterioration in Canada's terms of trade, which reduces Canadian incomes. The nature of the slowdown in the United States, with the acute weakness in the housing and auto sectors, is particularly problematic for our exporters. These factors present serious challenges to Canadian industries, including key Nova Scotia industries in the primary resources, manufacturing, and tourism sectors. Thus, while domestic demand in Canada remains relatively healthy and the depreciation of the Canadian dollar will offset some of the declines in external demand, the risks to growth and inflation in Canada identified in the October *Monetary Policy Report* appear to have shifted to the downside. In the face of the crisis, we have already cut official interest rates by half, to 2 1/4 per cent over the past year and have stated that some further monetary stimulus will likely be required to achieve the inflation target over the medium term.

Conclusion

Let me conclude. We have avoided the worst effects of the global financial crisis, thanks to a resilient financial sector built on the conservative lending practices of Canadian banks, and to our effective regulation and prudent practices in the sector. Still, the crisis is being felt in our economy. But we have taken bold steps to re-open financial markets and I can assure you that the Bank of Canada will continue to provide as much liquidity as is needed to encourage the re-establishment of the normal functioning of Canadian financial markets. You can also count on the Bank to add its voice to calls for initiatives to strengthen the resiliency of both the domestic and international financial systems.