Tiff Macklem: Mitigating systemic risk and the role of central banks

Remarks by Mr Tiff Macklem, Senior Deputy Governor of the Bank of Canada, to "Conférence de Montréal", Montreal, Quebec, 6 June 2011.

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Introduction

It's a pleasure to be here today and to be part of this panel. My assignment is to talk about the role of central banks with respect to systemic risk–in ten minutes. Needless to say, this is a tall order, made all the more challenging by the fact that systemic risk requires looking across the entire financial system and considering the full sweep of policy instruments and how they interact.

But I will do my best to break it down into the essential points and look forward to the panel discussion and questions afterwards.

There are three points that I want to make.

First, we have made considerable progress in reforming the core of the global financial system. Basel III represents a very significant strengthening of the global rules. The reform agenda is now turning to the important issue of shadow banking–or market-based financing, as it is more aptly called–and the appropriate perimeter of supervision and regulation. Completing this reform agenda is critical to strengthening the resilience of the financial system.

Second, central banks have a pivotal role to play in mitigating systemic risk by:

- identifying system-wide vulnerabilities and using their panoramic view of the financial system to connect the dots;
- supporting financial stability by providing emergency liquidity assistance to solvent, but illiquid institutions; and
- protecting the global financial system from the failure of one institution by promoting robust core financial infrastructure and overseeing systemically important clearing and settlement systems, including central counterparties for over-the-counter (OTC) derivatives.

And third, while a better-regulated financial system should make inflation control easier, in the post-crisis world, monetary policy-makers have some new things to think about.

Let me add some colour on each of these points.

G-20 financial regulatory reform

The logical place to start the reform agenda was at the core of the system, and there has been a great deal of progress.

The financial crisis revealed all too starkly that the global banking system was dangerously undercapitalized and over-leveraged, and liquidity buffers were glaringly inadequate. The new global standards in the Basel III Capital Adequacy Accord redress this core vulnerability.

The crisis also taught us that regulating on an institution-by-institution basis is important, but it is not enough. The risk to the financial system is greater than the average risk to individual firms. Managing this risk requires new system-wide tools, and here, too, there has been considerable progress. The counter-cyclical capital buffer included in Basel III is a giant step forward. The Bank of Canada played a leading role in the development of the buffer, which provides for additional capital to be built up during periods of excessive credit growth in anticipation of a future economic downturn.

The reform agenda is now moving beyond the core.

This means taking into account the considerable importance of shadow banking or market-based financing. The credit intermediation activities of banks are closely regulated and supervised, and are backstopped with deposit insurance and central bank liquidity. In contrast, market-based financing is less regulated and does not have access to public liquidity support.

But it is big, and the crisis highlighted the systemic vulnerabilities market-based financing can pose.

For both these reasons the international agenda is now turning to the perimeter of regulation and market-based financing. It will be essential that reforms strike an effective balance between the benefits of market-based financing in terms of competition, diversification and innovation, and the risks related to regulatory arbitrage and systemic vulnerabilities.

The role of central banks

This leads to the role of central banks in mitigating systemic risks. As I said at the outset, a key role for central banks is to use their panoramic view of the financial system to identify system-wide vulnerabilities.

Central banks are well placed to recognize risks and prioritize them within a framework that maps potential weaknesses and traces the chain of cause and effect throughout the system.

But to do this effectively, we need to raise our game. We need a deeper understanding of the links between financial intermediation, money and credit flows, the balance sheets of households and businesses, and the range of available policy instruments. And this understanding needs to be combined with better detection of emerging financial imbalances.

This requires engagement with the private sector and building multidisciplinary teams that bring together economists, financial experts, accountants and lawyers, among others.

And it is not enough to simply draw up long lists of vulnerabilities. Risks need to be assessed and ranked, providing a clear sense of priority.

Since the outset of the crisis, the Bank of Canada has intensified its efforts to take account of credit flows in its policy analysis. Recent research has made important strides in incorporating financial intermediation into macro-economic models. This will allow us to assess new developments in the financial system and how alternative policy interventions will affect financial stability and economic activity.

We have also sharpened our analysis of systemic vulnerabilities in our *Financial System Review*, where we provide both an assessment and a ranking of the top-tier risks.

In addition to identifying system-wide risk, central banks have a historic role to play in providing liquidity to avert banking panics and crises. This role of lender of last resort is as old as central banking itself.

The central bank acting as lender of last resort does not prevent shocks, but it can neutralize their secondary repercussions. We inject liquidity where the system had generated it before by exchanging less-liquid assets for more-liquid ones.

Our actions to support liquidity in markets are guided by principles:

- lending to support liquidity should reduce moral hazard;
- interventions should be graduated, targeted, well-designed and created to prevent further market distortions.

The financial crisis demanded new types of liquidity facilities, including longer terms, broader pools of eligible collateral and a wider range of counterparties. This was necessary in Canada as domestic banks found it more difficult to fund themselves when global credit markets seized up during the financial crisis. The Bank is now assessing the effectiveness of the various extraordinary facilities used in the crisis with a view to strengthening contingency plans in the event of new shocks.

Finally, central banks play an important role in mitigating the harmful knock-on effects of failure through robust oversight of systemically important clearing and settlement systems.

One of the few parts of the global financial system that worked well through the crisis was clearing and settlement systems. They handled enormous volumes against a backdrop of extraordinarily volatile financial conditions and successfully closed out the positions of failed counterparties, reducing harmful spillover effects.

But the crisis also highlighted the systemic importance of over-the-counter derivatives markets and the need to clear standardized OTC derivatives through risk-proofed central counterparties. Globally, the derivatives market is huge. The amount of notional outstanding in OTC derivatives last year was $618 trillion. Here in Canada, the Canadian-dollar-denominated OTC derivatives market was about $9 trillion, of which a little over $6 trillion was in interest rate swaps.

Central counterparties (CCPs) for OTC derivatives will provide greater certainty of payment, mitigating the harmful spillovers resulting from the failure of a counterparty, and reducing contagion in times of stress. But CCPs also have the potential to create new single points of vulnerability. This calls for the careful design of CCPs, as well as robust regulation and supervision. It will also be important to ensure sufficient access to CCPs to avoid limiting competition. This is of particular concern in countries, like Canada, that are not host to a large global CCP.

Two paths to addressing these design issues are being actively considered. The first is to promote fair and open access to global CCPs, combined with shared oversight arrangements, so that strong, large and mid-tier derivatives market participants can have efficient access to central clearing. The second is to build local CCPs that are better aligned to local risks and local market conditions. A number of jurisdictions are committed to building their own onshore CCPs, including, Japan, Korea, China, Hong Kong, Singapore and Brazil.

Here in Canada we need to give serious consideration to the onshore option. This isn't to say that we should take the global option off the table. However, there are good reasons to consider onshore CCPs. Going local would give regulatory authorities a high degree of oversight and supervision over systemically important financial market infrastructure. Canadian authorities would also have much more control over the design and implementation of emergency measures, including the provision of emergency liquidity.

The Bank of Canada is co-operating with our peers in the public sector and the Canadian financial sector to determine the best path for the central clearing of OTC derivatives. The Bank of Canada has also supported the development of a domestic CCP for Canadian-dollar repos, which is scheduled to be launched later this year.

Implications for monetary policy

I'd like to conclude with a few thoughts on what all this means for monetary policy. The first and most obvious point is that life should be better.

Putting Basel III into effect, combined with expanding the perimeter and reducing contagion, will reduce the frequency and ease the severity of financial crises. Counter-cyclical capital buffers should help to lean against the build-up of excessive credit, moderating the financial accelerator and dampening economic fluctuations. All this should make the implementation of monetary policy easier.

However, there will also be some new things for monetary policy-makers to think about. The very fact that new macroprudential tools are being employed will have an impact on the transmission of monetary policy. Using these tools will change the behaviour of both the economy and the financial sector. Monetary policy-makers will have to understand these effects.

Moreover, new trade-offs may arise. Consider a situation where excess credit growth requires the counter-cyclical capital buffer to be activated at a time when inflation is already well contained. Since the tightening of such a broad-based macroprudential tool could be expected to put downward pressure on inflation, monetary policy can either accommodate this restraint and let inflation return to target over a longer horizon, or it could lower the policy interest rate and risk undermining the effectiveness of the counter-cyclical capital buffer.

Finally, even the best-designed regulatory and supervisory framework will have limitations. And there could be circumstances in which monetary policy should play a complementary role in support of financial stability. This is more likely to occur in situations where an imbalance is broad-based or is being fuelled by a low interest rate environment.

We know that monetary policy has a far-reaching influence on financial markets and on the leverage of financial institutions. This wide-scale impact makes it inappropriate for dealing with sector-specific imbalances, but potentially valuable in addressing imbalances that have spread to multiple sectors of the economy.

Needless to say, clarifying the role that monetary policy should play in supporting financial stability is an important issue to be considered in the renewal of the inflation-targeting framework.

Thank you for your attention. I look forward to the discussion and your questions.