Lawrence Schembri: Stress prevention – central banks and financial stability

Remarks by Mr Lawrence Schembri, Deputy Governor of the Bank of Canada, at a joint Bank of Canada, International Monetary Fund, Centre for International Governance Innovation and Peterson Institute for International Economics workshop, Ottawa, Ontario, 6 May 2016.

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For the better part of the past two centuries, central banks have played an important role in the maintenance of financial stability, but primarily one of "stress or crisis management." In particular, central banks have served as lender of last resort, providing liquidity to prevent stress from sparking contagion in solvent, but illiquid, financial institutions.

But that role is starting to change.

While central banks responded boldly to the global financial crisis with liquidity provision and monetary policy actions to avoid a repeat of the Great Depression, the severity of the economic fallout obliges us to ask whether they could have done more to prevent it, rather than just trying to manage and mitigate its economic impact.

This query goes well beyond considering whether monetary policy aggravated the financial vulnerabilities that contributed to the crisis and raises broader questions concerning the responsibilities of central banks.

It's time, then, for central banks to rethink their role in financial stability:

- first, by recognizing that while the best contribution monetary policy can make to financial stability is price and macroeconomic stability, this is a necessary, but not sufficient, condition for financial stability;
- second, by focusing on crisis prevention through means other than monetary policy, while at the same time modernizing their role as liquidity provider or lender of last resort; and
- third, by enhancing their contribution to financial stability by exploiting two of their key strengths – their financial-system-wide perspective and their analytical capacity.

Going beyond monetary policy as a crisis prevention tool

In thinking about enhancing the role of central banks, we should reconsider two notions that have helped to advance our analysis.

The first is the "lean versus clean" debate. As Lars Svensson has compellingly argued, monetary policy is too blunt an instrument to be used to mitigate financial vulnerabilities. Other tools are better suited for this purpose.

The second notion is the "lines of defence" analogy, with monetary policy serving as the last defensive barrier when other measures to reduce financial vulnerabilities and mitigate systemic risks are either absent or inadequate. This view suggests that actions be taken *sequentially*. Consider, instead, how we promote road safety and prevent car accidents, which require the *simultaneous* application of standards for

- driver education and competence;
- automobile operations and safety; and
- road quality and appropriate signage.

A similar tri-fold approach for financial stability would entail clear objectives accompanied by the necessary powers and instruments for

- financial education and information for consumers, lenders and investors;
- microprudential regulation and supervision; and
- macroprudential monitoring and regulation.

A broader contribution for central banks

So how can central banks broaden their contribution to financial stability?

By promoting financial stability through the following measures:

First, by encouraging prudence on the part of borrowers and lenders.

Most central banks publish or contribute to financial system reviews or financial stability reports. Such reviews or reports monitor and assess financial vulnerabilities and risks and serve as an early warning mechanism. In addition, the underlying analysis in them provides a basis for recommendations for pre-emptive policy actions. These publications are thus an important means for central banks to contribute to financial stability.

For example, the Bank of Canada has used its *Financial System Review* to inform households and lending institutions of our assessment of the vulnerability associated with elevated household debt in an effort to encourage all parties to exercise appropriate caution.

Second, by enhancing market discipline through increased transparency.

By making their analyses and assessments public, central banks can increase awareness of financial system vulnerabilities, risks and their potential triggers so that investors and other market participants can appropriately price and manage risk.

Third, by strengthening regulation and supervision of the financial sector.

Since the crisis, the regulatory and supervisory framework for financial systems has been strengthened, and more rigorous global standards have been implemented in many jurisdictions. Central banks contributed to the development of these standards through their involvement in international forums such as the Financial Stability Board and other standard-setting bodies. An important example is the Basel III regulatory reforms, which require banks to hold more and higher-quality capital and meet new liquidity and leverage requirements and have thus made the banking system more resilient.

While some central banks, including the Bank of Canada, are not directly involved in overseeing the implementation of these new standards, they can help evaluate their effectiveness. By working with regulators to implement coherent macro stress tests on the banking system they can jointly assess the ability of the banking system to withstand severe macroeconomic shocks. These tests would incorporate existing vulnerabilities. Their main goal is to encourage the institutions themselves, as well as the supervisory bodies, to take remedial measures to increase resilience, as necessary.

In addition, given their system-wide perspective, central banks can monitor and evaluate unintended consequences of regulatory standards on the financial system and real economy, especially with respect to market functioning and the availability of credit.

Fourth, by contributing to the monitoring of systemic risk and the development of macroprudential measures.

As noted, most central banks do in-depth analyses of financial vulnerabilities. They also often investigate possible remedial measures to mitigate the vulnerabilities and they share their work with other agencies responsible for macroprudential oversight. The mechanisms for doing this differ according to the macropudential policy framework in each jurisdiction.

Valuable aspects of the analyses by central banks include monitoring for the impacts of financial innovation and possible instances of risky regulatory arbitrage, as well as the identification of data gaps.

Again, because of a central bank's system-wide perspective and analytical capacity these contributions are essential for the formulation of appropriate macroprudential policy.

Such policy initiatives come in all sizes, but let me give you an example of what we did here in Canada. In the immediate aftermath of the crisis, household debt and house prices resumed growing faster than disposable income in response to lower interest rates and the recovering economy. The Department of Finance and a number of agencies, including the Bank of Canada, worked together to mitigate this growing systemic vulnerability.

The Bank's analysis of household debt and house prices helped inform the regulatory changes that were adopted. The federal government tightened rules for government-supported mortgage insurance, including increasing minimum down payments. For its part, Canada's bank regulator, the Office of the Superintendent of Financial Institutions, released new guidance on mortgage underwriting and mortgage insurance that implemented enhanced global standards.

These measures were successful in slowing household credit growth and they complemented the Bank of Canada's accommodative monetary policy by better targeting the stimulus to the most creditworthy households.

To further enhance our contribution to macroprudential oversight in Canada, we have two aspirations:

1. To develop a framework for system-wide macro-level stress tests that integrates different sectors of the financial system – banking, insurance and investment funds – as well as financial markets and financial infrastructures.

2. To improve our models to better understand the interactions between monetary and macroprudential policy.

Conclusion

Let me summarize and conclude.

The public often sees central banks as responsible for financial stability, but, in practice, this is a mandate the banks rightly share with the government and other financial regulators and supervisors. So although central banks don't themselves have a broad set of instruments to mitigate financial vulnerabilities, they *do* have that system-wide view, which they can and do use to promote financial stability by making public their analyses of financial vulnerabilities and risks and making recommendations for preventive policy actions.

In the end, how central banks contribute to financial stability, in conjunction with other public authorities, will depend on the macroprudential framework in place. What we have learned from the participants at this conference is that the framework varies across jurisdictions, typically reflecting differences in institutional settings, and that the different structures seem to be working well. Thus, the important take-away from this evidence is that the framework's form matters less than its function and that the measure of success should be macroprudential outcomes, namely lower systemic risk and fewer instances of severe financial stress.

At the same time that central banks are enhancing their efforts to promote financial stability, they must maintain their focus on monetary policy to achieve price and macroeconomic stability. These are necessary conditions for financial stability.

On behalf of my colleagues here at the Bank of Canada, thank you for joining us and for sharing your views on this important issue.