Sharon Donnery: Central bank risk management in a changing institutional and regulatory environment

Speech by Ms Sharon Donnery, Deputy Governor (Central Banking) of the Central Bank of Ireland, at the Joint Bank of Portugal and European Central Bank Conference on "Risk Management for Central Banks", Lisbon, 26 September 2017.

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Introduction

Robert F. Kennedy once said “like it or not we live in interesting times”.[1] As central bankers, supervisors, or market participants alike, those working in financial markets have certainly come through some extraordinarily interesting times in recent years.

For central banks, risk management is at the intersection of both central banking and supervisory structures, and the financial market. It is, therefore, a pleasure to speak to some of the issues which are emerging in this space, particularly in the context of the changing European institutional architecture and regulatory environment.

During recent years, fragile, and indeed unstable, economic and market conditions have required central banks to assume potentially substantial financial risks. These were taken with the objective of maintaining the appropriate functioning of the monetary policy transmission mechanism and restoring price stability. This fundamental shift in the risk profile of central banks’ response is an integral part to performing our role and to fulfilling our mandate of bringing inflation below but close to 2 per cent over the medium term.

In parallel, following the financial crisis, regulatory reform has focussed on better safeguarding the stability and efficiency of an increasingly globalised financial system and, importantly, mitigating the impact of future market failures. These changes have brought a whole array of new regulatory policies.

While most of the policy reforms are directed at commercial financial institutions, all financial market participants, including central banks are affected – not least by the important structural changes with the advent of Banking Union.

For the purposes of today’s discussion, the focus of my remarks is on the implications for central bank risk management. The implications, however, differ, depending on which part of a central bank’s mandate one focusses. It is possible to discern different implications of the recent developments in regulatory frameworks for risk management policies and practices, depending on whether we focus on monetary policy, financial stability, supervision, reserves management, or payments and settlements. Moreover, some of the implications of regulatory developments are not yet fully understood given many are still at an early stage of implementation.

Today, I would like to briefly discuss three aspects of recent developments in regulatory frameworks for risk management in central banks:

1. The impact of regulation on central bank counterparties, and hence collateral for central banks;
2. The prudent management of central bank balance sheets; and
3. Risk management and the co-ordination of supervisory and monetary policy mandates.

Impact of regulatory developments on central bank counterparties

The central bank sits at the heart of the financial system by providing liquidity to (and absorbing

liquidity from) eligible counterparties.

Like market participants, central bank's risk management practices must evolve if they are to continue to contribute to providing an effective policy response. This includes evolving in response to how changes in financial regulations affect counterparties.[2]

By design, the intention of such regulations is to alter the incentives and behaviours of credit institutions and market participants.

For central banks, however, our role is to ensure that the consequences of these changes do not unduly interfere with the Eurosystem's implementation of monetary policy, and our price stability objective. To achieve this objective it is important that we respond appropriately to changing counterparty behaviour, changing collateral composition and availability, and ensure the central bank balance sheet is sufficiently protected.

While difficult to predict with certainty, some characteristics of the Basel III Liquidity Coverage Ratio (LCR) or the introduction of collateral requirements under the European Market Infrastructure Regulation (EMIR), for example, may have consequences for monetary policy operations and therefore, for central bank risk control frameworks.[3] For example, because central bank funding is treated as High Quality Liquid Assets (HQLA) with a 100 per cent roll over rate, under the new regulatory framework, banks may be incentivised to pledge non-HQLA collateral (such as credit claims or some Asset Backed Securities) for funding, while keeping their HQLA unencumbered and available for other purposes.[4]

It should be noted that our counterparties, for the most part, hold excess liquidity and can access as much funding as required from the Eurosystem, subject to holding sufficient eligible collateral. Therefore, the intended, or unintended impact of financial regulation on central bank operational frameworks may only become fully apparent once there is a change in the monetary policy stance. The real incentives created by regulatory developments will then no longer be hidden by the excess liquidity.

Protection is key and it must be emphasised that accepting a different set of collateral does not necessarily imply that a central bank accepts more risk. Nonetheless, central banks need to be conscious of and need to plan for what these types of developments may mean for existing risk control frameworks. This may include enhancing risk measurement capabilities, such as frameworks to carry out internal assessments of collateral credit quality, and determining satisfactory haircut methodologies.

Central bank balance sheet risk management

Turning more directly to the prudent management of central bank balance sheets, in addition to the examples of Basel III and EMIR, regulatory developments have ushered in a considerable increase in financial reporting and financial risk assessment requirements, following the financial crisis.

These regulatory reporting developments necessitate that central banks hold a mirror up to themselves on aspects of their own practices, such as implementing broadly equivalent enhancements for effective risk management of our balance sheets. These include more sophisticated stress-testing or reflecting changes in accounting standards, such as IFRS 9 for example, to incorporate more forward looking elements in the measurement of risk exposures.

Notwithstanding that our mandate is different and implies that some risks and scenarios are an unavoidable consequence of the policy stance, central banks should aim for the highest standards of both governance and risk management. And central banks are indeed increasingly performing more forward-looking risk assessments in response to the increased risk profile, since the financial crisis.

At the Central Bank of Ireland for example, our 2016 year-end risk assessment identified an additional material risk, which relates to the potential for future interest rate mismatches on the Central Bank's balance sheet. This forward-looking assessment necessitated an additional risk provision, in this regard, arising from the actions taken by the Central Bank as part of the Eurosystem's ongoing non-standard monetary policy measures.[5] Incorporating such a provision was also enabled by a move to follow all aspects of the relevant ECB Accounting Guideline, including those categorised as non-mandatory.[6]

The impact of regulatory developments on central bank risk management is not confined to financial risks. A notable feature of recent regulatory reforms is far greater emphasis on rigorous standards of corporate governance within firms. Many of these standards are equally applicable to central banks. It is imperative that in the context of expanding central bank mandates, and in some cases large organisational change, we endeavour to meet and sometimes exceed these standards in certain areas.

Implications of changed supervisory approach and structures

Turning to more structural changes, Banking Union and particularly the establishment of the Single Supervisory Mechanism (SSM) has implications for how central banks share information and manage risks.

Deeper institutional integration has led to a changed landscape that may have implications for central banks performing their risk management mandate. Risk managers in the Eurosystem now engage with supervisors who perform their mandate as part of ECB Banking Supervision.

One potential challenge for national central banks may arise given risk management decisions relating to counterparties are taken independently. Supervisors may at the same time be taking similar decisions but with different priorities. If those assessments differ, for example in the case of counterparty solvency for Emergency Liquidity Assistance (ELA), potential communication challenges will have to be overcome, given the new institutional structure.

The Central Bank of Ireland learned during the crisis about the difficulties with a separate approach to supervision and central banking. Supervisory functions had been divested to the Irish Financial Services Regulatory Authority (IFSRA). However, they remained housed with the Central Bank, under the umbrella of the Central Bank and Financial Services Authority of Ireland (CBFSAI).

Subsequent reviews of the performance of the structure in the lead up to, and during, the financial crisis identified inadequate channels of communication between the two entities as part of the underlying factors behind the development of the risks that manifested in the Irish banking sector.[7]

The central banking and supervisory entities have since re-merged into the Central Bank of Ireland. To avoid such problems of the past, the Central Bank actively promotes a 'One Bank' philosophy to foster communication and collaboration across the different functions.

Other important elements of Banking Union also have implications for risk management in central banks. Resolvability assessments and resolution plans are key parts of the new regulatory framework of the Bank Recovery and Resolution Directive (BRRD). Furthermore, the Single Resolution Board (SRB) provides a similar overarching institutional structure with potential similar challenges as outlined earlier for the SSM.

We must continually focus on the efficient and effective cooperation of respective functions across our new multi-layered institutional structure, not least for periods of stress.

Conclusion

To conclude, the effects of accommodative monetary policy and the legacy of the financial crisis still weigh on banks' balance sheets and the full effects and incentives of regulatory measures are perhaps not yet observable. For central banks, in particular, the achievement of our price stability mandate has necessitated the expansion of our balance sheets with the resulting change in our risk profile.

Risk managers must always ask themselves whether they are adequately prepared for sudden changes in current circumstances. Risk managers must also look ahead in consideration of the impact of future longer-term developments and how they will affect the risk profile of central bank exposures and of the operation of central banks themselves.

In this regard, in my remarks today I have tried to address three aspects: counterparties and collateral; the management of balance sheets; as well as some institutional considerations to shine a light on potential emerging issues. To some extent, these issues only touch the surface.

All in all, I think it's fair to say whilst the crisis may have abated, we still live in interesting times.

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

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[1] I would like to thank Rosanna Lynch, David Doran, Glenn Calverley and Micheál O'Keeffe for their contribution to my remarks. See Robert F. Kennedy, Day of Affirmation Address, University of Capetown, Capetown, South Africa, June 6, 1966.

[2] See for example Poloz, Stephen S., 'Models and the Art and Science of Making Monetary Policy' Remarks by Governor of the Bank of Canada, 31 January 2017.

[3] See "Some Implications of New Regulatory Measures for Euro Area Money Markets", Doran, D., et al, Central Bank of Ireland Quarterly Bulletin, 1, 2014.

[4] EMIR is expected to result in increased high quality asset encumbrance for market participants due to certain stricter collateral requirements. In a similar manner to the potential effect of the introduction of the LCR, this may also lead to a decrease in the overall quality of collateral that is available to be pledged by banks with the Eurosystem, as market participants may hoard highly liquid collateral for repo postings.

[5] See "Non-standard monetary policy measures and the balance sheets of Eurosystem central banks", Donnery, Doran, Gleeson, and Carroll (2017), Central Bank of Ireland Quarterly Bulletin, 3, July.

[6] Guideline (EU) 2016/2249 of the ECB of 3 November 2016 on the legal framework for accounting and financial reporting in the European System of Central Banks (ECB/2016/34).

[7] See Honohan Patrick (2010), "The Irish Banking Crisis Regulatory and Financial Stability Policy 2003–2008: A Report to the Minister for Finance by the Governor of the Central Bank".