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Governor Carney discusses key risks to financial system, advocates for macroprudential approach

TORONTO, ONTARIO – While measures taken to address the global financial crisis will be successful, policy-makers need to improve their ability to detect the next crisis before it occurs, Bank of Canada Governor Mark Carney said today. In a speech to the Women in Capital Markets group, Governor Carney said that taking a macroprudential approach to regulation, – an approach that "focuses on the forest, not the trees" – is essential to developing better early-warning systems for financial stability.

The Governor discussed ways in which the Bank of Canada promotes financial stability through the provision of liquidity and advocacy. The Bank has made financial stability a strategic priority, he noted, and is placing increased emphasis on identifying risks and vulnerabilities and leveraging its position in domestic and international organizations.

In terms of the crisis, the most likely outcome for the Canadian financial system is gradual improvement from the current levels of stress. However, Governor Carney identified five risks to financial stability from the Bank's perspective, with a particular focus on three: the state of household balance sheets; the liquidity and funding of financial institutions; and the procyclicality of bank capital.

With respect to household balance sheets, Governor Carney underlined that while its resilience will be tested during the recession, the Canadian household sector remains relatively healthy. He noted that the household debt-service ratio remains well below its historical average. "This gives a measure of assurance that most households can comfortably manage their debts," he said.

Governor Carney added that challenges to bank liquidity and bank funding could aggravate the adverse feedback loop between the financial system and the real economy. "The challenge for policy-makers is to provide transition support that effectively restarts rather than replaces markets."

Regarding the procyclicality of bank capital, Governor Carney outlined the risk that market forces could compel banks to maintain higher capital ratios than necessary to guard against the possibility of a worse economic outcome. To combat this, he suggested that banks could be required to build up capital buffers during times of rapid credit expansion, then draw down these buffers during a downturn. "In this way, capital requirements would moderate the ups and downs of the credit cycle – the reverse of what currently happens – reducing the risk of a future crisis."