BANK OF CANADA
BANQUE DU CANADA
CELEBRATING 75 YEARS
CÉLÉBRONS 75 ANS

Financial System Review

Highlights—December 2010

Risk Assessment*

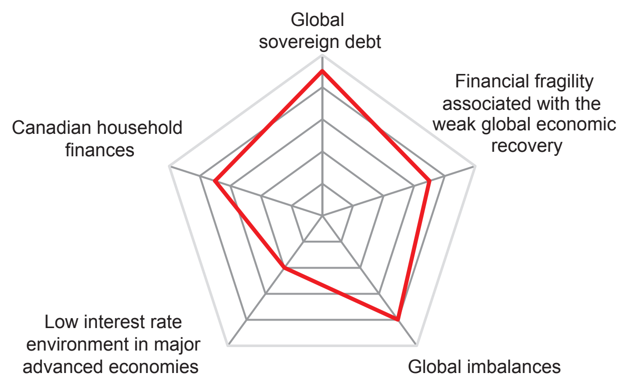
Although the global financial system continues to recover gradually from the unprecedented dislocations experienced in recent years, significant downside risks remain. The economic recovery in advanced economies is projected to be more modest than previously expected, and global current account imbalances, which narrowed during the recession, are widening again with the recovery. In light of these fragilities, there remains an elevated risk that global financial stability could be undermined by an adverse feedback loop between weak economic activity, fiscal strains and the financial system.

In Canada, the financial system remains relatively strong, and the aggregate financial position of the non-financial corporate sector is excellent. However, the vulnerability of the household sector has deepened, with the rate of growth of household debt continuing to exceed that of income.

The Governing Council judges that the risks to Canada's financial system are elevated and have increased over the past six months. Four major interconnected sources of risk emanate from the external macrofinancial environment: (i) sovereign debt concerns in several countries; (ii) financial fragility associated with the weak global economic recovery; (iii) global imbalances; and (iv) the potential for excessive risk-taking behaviour arising from a prolonged period of exceptionally low interest rates in major advanced economies. The main domestic source of risk arises from the increasingly stretched financial position of Canadian households, which leaves them more vulnerable to adverse events **(Figure 1)**.

* This section of the *Review* presents the collective judgment of the Bank of Canada's Governing Council on the main risks and vulnerabilities bearing on the stability of the Canadian financial system.

Figure 1: Risk assessment: December 2010



Note: Each rung indicates a perceived risk level: the farther away from the centre, the more elevated the perceived risk.

Key Risks

Global sovereign debt

A key concern is that the acute fiscal strains in peripheral Europe and weaknesses in the European financial system could reinforce each other and have adverse effects on other countries, including Canada, through several interconnected channels. First, debt problems in peripheral countries could have important cross-border spillover effects, which would be propagated to other countries with important economic and financial links to Europe. Second, concerns over the quality of sovereign debt in countries with severe fiscal strains could lead to heightened perceptions of counterparty risk and severe disruptions in global bank funding markets. Third, these problems could escalate into a generalized retrenchment from risk in the global financial system which, from Canada's perspective, would likely be the most important channel of financial transmission.

Market concerns over sovereign debt could also force countries to implement fiscal consolidation more rapidly, resulting in slower global growth.

While public debt challenges are the most acute in peripheral Europe, many advanced economies have fiscal positions that are not sustainable in the long run. Thus far, the effects of fiscal strains have been felt mainly by weaker financial institutions and by those governments that are the most vulnerable, but there is a material risk that fiscal strains could be transmitted to others through a generalized loss of confidence.

Canada's fiscal position is stronger than that of most other advanced economies, and its domestic financial sector has limited direct exposures to the sovereign debt of peripheral euro-area countries. Nevertheless, as noted above, there are a number of potential channels through which the Canadian financial system could be adversely affected by sovereign debt problems elsewhere. Overall, the Bank judges that the risk to the Canadian financial system from global sovereign debt is high and has risen since June.

Financial fragility associated with the weak global economic recovery

The global economic recovery is entering a new phase, and the pace of the economic recovery in Canada and other advanced countries is projected to be more subdued than was expected last June. While the ability of the Canadian financial sector to withstand a shock is likely greater than that of most other jurisdictions, the potential risk for domestic markets and institutions to be adversely affected by international conditions is elevated.

Overall, the Bank judges that risks arising from the financial fragility associated with a protracted global economic recovery have increased since June and are elevated. A more modest global economic recovery could further delay the improvement in the international financial sector and the pace of structural adjustments.

Global imbalances

Resolving global imbalances requires that the United States and other deficit countries boost domestic saving in a timely and sustained manner. At the same time, surplus economies—particularly the emerging economies of Asia—need to undertake structural reforms to bolster internal sources of growth. A transition towards more flexibility in exchange rates is an essential part of the solution, since it would facilitate a durable and orderly narrowing of current external disequilibria and provide greater resilience to future shocks.

While leaders of the G-20 countries have agreed to policies consistent with these objectives, the necessary structural adjustments have not yet been implemented. Since June, there have been significant geopolitical tensions over external imbalances, focused to a large extent on possible spillover effects from exchange rate and monetary policies. The risk of real and financial protectionism has increased. Thwarting adjustment will only exacerbate the buildup of imbalances, ultimately requiring a larger adjustment and increasing the risk of a disorderly resolution.

Overall, the Bank judges that the risk of market turmoil resulting from global imbalances is high and has risen since June. Heightened tensions in currency markets and related risks associated with global imbalances could result in a more protracted and difficult global recovery, causing further stress in the financial system.

Low interest rate environment in major advanced economies

Interest rates are at extraordinarily low levels in the major advanced economies, and markets are pricing in the likelihood that this will continue for an extended period. A long period of very low interest rates may be associated with excessive credit creation and undue risk-taking as investors seek higher returns, leading to the underpricing of risk and unsustainable increases in asset prices. Expectations of a sustained period of very low interest rates may also reduce incentives for financial institutions to repair their balance sheets in a timely manner. The Bank judges that the risk of this environment jeopardizing financial stability in Canada in the near term is moderate; however, careful monitoring of risk-taking is essential so that any buildup of financial imbalances can be identified early.

Canadian household finances

In Canada, with the growth rate of debt outpacing that of disposable income in recent years, the proportion of households with stretched financial positions that leave them vulnerable to an adverse shock has grown significantly. The risk is that a shock to economic conditions could be transmitted to the broader financial system through a deterioration in the credit quality of loans to households, which would prompt a tightening of credit conditions that could trigger a mutually reinforcing deterioration of real activity and financial stability. Developments since the June FSR suggest that the vulnerability of the Canadian household sector has increased. The probability of an adverse labour market shock materializing is judged to have edged higher in recent months, owing to the downward revision in the October *Monetary Policy Report* to the outlook for the global and Canadian economies.

The Bank judges that, overall, the risk of a system-wide disturbance arising from financial stress in the household sector is elevated and has edged higher since June. This vulnerability is unlikely to decline quickly, given projections of subdued growth in income.

Policy Actions

It is essential that all governments continue to take steps to stabilize and ultimately reduce public debt ratios. Most governments have already announced plans for consolidation. To reinforce credibility they need to take concrete measures consistent with these pre-announced plans.

Firm implementation of the G-20 commitments to co-operate in promoting an orderly, timely and sustained resolution of global imbalances that is supported by greater flexibility in exchange rates is essential. Market-oriented exchange rates that reflect underlying economic fundamentals are needed to facilitate this adjustment and to strengthen the resilience of economies to shocks. Surplus economies also need to undertake reforms to bolster self-sustaining domestic sources of growth, while deficit countries need to boost national savings.

To safeguard financial stability over the medium term, the regulatory reform agenda established by G-20 leaders must be implemented within an appropriate time frame. The recent agreements reached by the Group of Governors and Heads of Supervision to strengthen international capital requirements for banks and to introduce new global standards for bank liquidity are a significant development in this regard. The enhanced standards will be phased in over time so that banks can support the economic recovery while moving towards the higher requirements. The benefits will therefore build over time.

In Canada, the deteriorating financial position of the household sector requires vigilance. When taking on debt, households bear ultimate responsibility for ensuring that they will be able to service it in the future. It is also essential that financial institutions actively evaluate the risk surrounding households' ability to service their debt over time. Authorities are co-operating closely and will continue to monitor the financial situation of the household sector.

Reports

Reducing the likelihood and consequences of future periods of turmoil also requires a policy response that gives appropriate emphasis to managing systemic risks over the cycle and across institutions, complemented by structural measures to contain the propagation of risk across the system. Actions to establish a more-resilient financial market infrastructure are particularly important in this regard.

The lessons of the crisis are being applied in the far-reaching and multi-faceted reform agenda endorsed by leaders of the G-20 countries. These reforms aim to increase the resilience of the global financial system, making financial crises both less frequent and less severe.

In **The Countercyclical Bank Capital Buffer: Insights for Canada**, authors David Xiao Chen and Ian Christensen outline the key features of this new instrument and discuss the type of information that could be used by authorities to inform the operation of the countercyclical buffer. To illustrate, the authors consider what a small set of indicators might have signalled about the presence of excessive credit growth in Canada and the United States in the period surrounding the recent crisis.

The report, **Strengthening the Infrastructure of Over-the-Counter Derivatives Markets**, by Carolyn Wilkins and Elizabeth Woodman, discusses the importance of the OTC derivatives markets and the reforms under way to improve their resilience. In particular, the authors explore issues associated with the wider use of central counterparties.

In **Central Counterparties and Systemic Risk**, Nikil Chande, Nicholas Labelle and Eric Tuer argue that the current review of standards for such infrastructures must focus not just on ways to decrease the likelihood of CCPs failing, but (similar to the discussion around other financial institutions) also on containing the risks to which they are exposed and preventing their behaviour from exacerbating stresses in the financial system more widely. Three such system-wide issues are discussed: the procyclicality of margins, the default process and resolution mechanisms for failed central counterparties.

The report, **Contingent Capital and Bail-in Debt: Tools for Bank Resolution**, by Chris D'Souza, Toni Gravelle, Walter Engert and Liane Orsi, describes two other tools that have the potential to reinforce the ability of policy-makers to deal with the resolution of a systemically important financial institution. By ensuring that shareholders and creditors bear losses before others, bail-ins and contingent capital provide a strong incentive for such institutions to monitor risk-taking behaviour ex ante. The tools, which can be deployed quickly, increase the likelihood that the firm will continue operations, thereby decreasing the impact on the rest of the financial system. As well, they reduce the cost of the default for survivors—including taxpayers—by ensuring that losses are first borne by shareholders and creditors.