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CHECK AGAINST DELIVERY

The Changing Face of Risk in the Global Financial System

Introduction

Good afternoon.

I would like to talk to you today about risk.

I know that risk is ever-present in your work, as you fulfill your commitments to the beneficiaries and sponsors of your pension plans. Important risks surround the investment performance of those plans, as well as the value of pension liabilities. All of you are, no doubt, acutely aware of these risks, which have become much more pronounced over the past few years.

At the Bank of Canada, we also focus on risk as part of our commitment to Canadians. Our mandate demands that we take an economy-wide perspective on risk. In setting monetary policy to achieve our 2 per cent target for inflation, we assess the risks to the real economy and inflation. In our work promoting a stable financial system, we assess the various risks to financial stability, both in Canada and globally. It is on these risks to financial stability that I would like to focus my remarks today.

The global financial crisis was a watershed. During the crisis, many financial system risks materialized and new risks emerged. I will talk briefly about the pre-crisis setting—the Great Moderation—when risks were perceived to be diminishing. I will then discuss how this complacency was shattered, the risks that materialized and the actions being taken to address those risks. Finally, I will talk about new risks that have emerged in the global financial environment, which stem from the “two-speed” recovery of the global economy.

I would like to use this discussion today to illustrate two main points. First, the sources of risk are evolving, and continuous effort is needed to identify and track risks as they evolve. Second, risk can come from unexpected sources. That means we must strive to ensure that the Canadian and the global financial systems are resilient enough to withstand the impact of unexpected events. At the Bank of Canada, we are working on both of these fronts.

The Great Moderation

Let me begin by talking about the “Great Moderation.” For much of the past quarter-century, conventional wisdom held that the global economy was becoming increasingly stable. In the advanced countries, inflation had been tamed, recessions were milder than

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in the past and financial stability seemed assured. Ironically, that view was reinforced by the bursting of the dot-com bubble in 2001, which may have shaken the financial markets and given a number of you some sleepless nights but was seen as a test of the resilience of the global financial system. The Great Moderation was believed to be, at least in part, the product of sound economic policies and a sophisticated financial system that could transform and reallocate risks efficiently.

Emerging-market economies had quite a different experience during that period. Mexico, Korea, Indonesia, Thailand, Russia, Brazil and Argentina all suffered devastating crises that arose from a combination of financial system weaknesses, unsustainable public debt and external imbalances.

Then, during the last decade, the emerging-market economies, too, became progressively more stable. In most cases, they persevered in setting their public finances in order, in cleaning up their financial systems and in undertaking bold reforms to unfetter their dynamic economies. They made use of a benign global environment to reduce their external debts and build up international reserves.

There were still concerns about vulnerabilities—notably the global current account imbalances—but the risks were widely underestimated.

The 2008 Crisis

When the global crisis did occur, it started in an unexpected place: not on the periphery, but at the very core of the global economy, in the world's most sophisticated financial system. As stresses began to appear in the U.S. subprime-mortgage market, many knowledgeable people thought that those stresses would be easily contained, since the problem loans were relatively small and securitized so that the risk could be borne by well-informed, diversified and adequately financed investors. In the autumn of 2008, however, as we all know, this turned into a global cataclysm, which spread through the world economy and financial system. Liquidity dried up as institutions became afraid to lend to one another. Their balance sheets deteriorated as they held fire sales of assets, and investors worldwide fled from risky assets.

With the resulting credit crunches and massive loss of wealth, the financial stresses triggered the "Great Recession"—the most severe since the Second World War. In this recession, no country escaped unscathed. However, the emerging-market economies were slower to be drawn into recession and quicker to recover than the advanced economies.

The global economy is now in a two-speed recovery. Emerging-market countries have resumed robust growth. But in many of the advanced economies, notably the United States and Europe, economic growth has been sluggish, as households, firms and financial institutions continue to repair the damage to their balance sheets. As I will discuss later, this two-speed recovery creates a new configuration of risk in the global financial system.

Here in Canada, the financial system proved more robust than in other advanced economies, although problems with asset-backed commercial paper could have had very serious ramifications had it not been for timely official intervention. The Bank of Canada had to inject substantial amounts of liquidity into the system to keep core funding markets functioning. Nonetheless, Canada suffered a severe recession, mainly because of the collapse in our exports.

The recovery is now well under way, both in Canada and globally. Indeed, in Canada, we are already in an expansion, as we have surpassed pre-crisis levels of economic activity and employment. But we must still ask how the crisis happened, and what must be done to avoid a recurrence.

What happened in the crisis?

Perhaps the biggest surprise of the crisis was the fact that defaults of subprime mortgages in the United States—a small segment of that country's housing market—could cause the global financial system to unravel. As events unfolded in the autumn of 2008, we were reminded that the global financial system is bound together by an extensive web of interconnections. These interconnections among financial institutions and markets can spread trouble to unexpected places and cause small shocks to have outsized effects.

The financial crisis highlighted three main weaknesses in the way that the system handled risk.

- First, many financial institutions were excessively leveraged, had inadequate cushions of capital to absorb losses and insufficient liquidity to function in stressed market conditions.
- Second, the complex and opaque web of securitized lending and derivatives markets, which were believed to help the economy better manage and distribute risk, instead turned out to transmit and amplify that risk.
- Third, financial institutions that were "too big to fail" had diminished incentives to manage risk and, ultimately, shifted those risks to taxpayers.

These vulnerabilities were permitted to build up—or were even fostered—by the perception of diminishing risks in the Great Moderation. Financing patterns that appeared well-constructed in the context of ever-diminishing risk turned out to be imprudent once the system came under stress. Regulation fell well behind financial innovation.

The global response

The global financial reforms launched by G-20 leaders are designed to address the three weaknesses I have just discussed. First, to reduce the incidence and severity of financial crises, financial institutions will be required to have more ample cushions of capital and liquidity. Second, steps will be taken to reduce the risk that financial markets become channels of contagion. And third, mechanisms to deal with the too-big-to-fail problem will be made more robust. I will briefly discuss each of these elements.

The centrepiece of the agenda for global financial reform is the new Basel III rules on capital and liquidity. These rules substantially increase the loss-bearing capital that financial institutions must hold, combined with required liquidity ratios and a limit on leverage. In addition, a countercyclical buffer will be established so that capital is built up in good times, which can subsequently be available to absorb losses.[1]

On financial markets, a key step is to strengthen market infrastructure to reduce systemic risk. The G-20 leaders agreed to require clearing and settlement of over-the-counter derivatives through central counterparties, and to increase transparency in those

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[1] The Bank of Canada's research report on the costs and benefits of the new rules can be found at <http://www.bankofcanada.ca/2010/08/secondary-page/strengthening-international-capital-and-liquidity-standards-a-macroeconomic-impact-assessment-for-canada-2/>.

markets—which proved to be a channel of financial contagion during the crisis. A central counterparty is also being established in Canada for clearing repurchase agreements (repos), a key form of short-term financing.

A related issue is market-based financing, including securitized lending. Work has begun under the auspices of the Financial Stability Board to define the sector, to develop the data and methodology to systematically monitor it, and to develop policy options.[2]

To address the too-big-to-fail problem of systemically important financial institutions, work is under way to ensure that they are appropriately supervised and adequately capitalized to absorb losses, and to establish a framework for resolution in the event that they do fail.

So this, in a nutshell, is what is being done to address the weaknesses underlying the 2008 crisis, with a view to creating a more resilient global financial system. I will now go on to discuss a new pattern of risks that has emerged since the recession.

Risks in a Two-Speed Global Recovery

As I have already mentioned, the current global recovery is operating at two speeds, with robust growth in emerging-market economies and anaemic growth in the advanced economies. This two-speed recovery, accompanied by a widening of global economic imbalances, is at the centre of a new configuration of risks to global financial stability. These risks comprise sovereign risks, financial fragility, the search for yield, and related stresses in emerging-market economies and foreign exchange markets.

Twice a year, the Bank of Canada publishes its *Financial System Review* (FSR), which examines developments in the financial system with a view to identifying potential risks to its overall soundness. This publication also highlights the efforts of the Bank, and other domestic and international regulatory authorities, to mitigate those risks. The pattern of risks I am going to discuss was examined in our December 2010 issue. We are continuing to track them and will provide an updated assessment in June.

Sovereign risks have become increasingly prominent in a number of advanced economies. Many countries entered the crisis with weak fiscal positions and then were further weakened by the effect of low growth on tax revenues and the costs of economic stimulus and the bailouts of financial institutions. These problems are most acute in the peripheral countries of Europe—notably Greece, Ireland and Portugal. But many advanced economies still have precarious public finances and will need to persevere to address these problems.

Canada's fiscal position, in contrast, is stronger than that of most other advanced economies. Moreover, the domestic financial sector has limited direct exposure to the sovereign debt of peripheral euro-area countries. Nevertheless, there are a number of potential channels through which the Canadian financial system could be adversely affected by sovereign debt problems elsewhere, such as higher funding costs and a decline in asset-price valuations.

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[2] See "Shadow Banking: Scoping the Issues–A Background Note of the Financial Stability Board," Financial Stability Board, 12 April 2011 <http://www.financialstabilityboard.org/publications/r_110412a.pdf>.

The low growth of many advanced economies has led to lingering **financial fragility**. The outlook for banks in Europe—and, to a lesser extent, the United States—continues to be clouded. Although many banks around the world made substantial progress in repairing their balance sheets, some remain unusually strained. They are also exposed to vulnerable economic sectors, notably residential and commercial property markets. In some cases, their funding positions are fragile, subject to fragile investor confidence.

With the weak growth of the major advanced economies, interest rates in a number of those economies are at extraordinarily low levels and are expected to remain so for an extended period. While stimulative monetary policy is needed to support the global economic recovery, this "**low-for-long**" scenario creates risk for the global financial system, and for the pension industry in particular.

As you know, institutional investors such as insurance companies and pension funds are often expected—or in some cases even required by contract or mandate—to deliver a target rate of return. In many cases, these targets are now unrealistic and can be met only by taking on more risk than is prudent. Changes in accounting rules, which use low, risk-free interest rates to discount liabilities while valuing assets at current market prices, increase the pressure to achieve these high returns on a continuous basis.

This is a particular instance of the "search for yield" that often accompanies a long period of very low interest rates. It 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. A number of other developments—the record issuance of high-yield debt securities in the United States, the rebound of capital flows into emerging-market economies and the popularity of commodity exchange-traded funds in recent quarters—are consistent with this pattern.

The influence of sustained low interest rates in major advanced economies on risk-taking behaviour is a powerful dynamic that bears watching.

Global imbalances are linked to the three risks I have just described and also pose some additional risks to the global financial system. The counterpart of these imbalances is that surplus countries in many cases are resisting upward pressure on their currencies and this is resulting in domestic inflationary pressures. As the authorities try to bottle up these inflationary pressures, that puts further stress on their financial systems. There is also the risk that the needed exchange rate adjustment, when it does come, will be disorderly.

Resolving global imbalances requires that the United States and other deficit countries boost domestic savings 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 in order to reduce their reliance on external demand. Greater exchange rate flexibility is also an essential part of the solution.[3]

These are some of the main risks to financial stability that we see emerging in the two-speed global recovery. Let me now talk briefly about how the Bank of Canada is working to sharpen its analysis of risks.

[3] All are key goals of the G-20 Framework for Strong, Sustainable and Balanced Growth. Canada co-chairs the committee monitoring the implementation of policies under this framework.

Strengthening Risk Assessment

At the Bank of Canada, we are developing new risk-assessment tools and models that capture the diverse sources of risk and help us understand how they propagate through the financial system. While the Bank is making important progress in this area, we are not alone. The International Monetary Fund and the Financial Stability Board, as well as central banks and academics, are also making significant efforts in this area.

Improvements in risk-assessment frameworks will focus on detecting vulnerabilities in the financial system. The Bank of Canada is thus developing a more rigorous empirical analytic framework to complement our current analysis and market intelligence. It may be that a single model of the financial system is neither practical nor realistic. Given the complexity of the financial system, a suite of models combining a number of analytical tools, approaches and indicators could provide the best avenue for success.

While we are working to identify key risks, recent events have reminded us that we have to expect the unexpected. The earthquake and tsunami in Japan are examples of the kind of shocks that nobody had foreseen. Another example is the—no less seismic—political unrest of the Middle East.

Clearly we can't anticipate every shock. That's why it so important to ensure that the financial system is more robust, so that it can withstand the shocks that will occur. Resilience, therefore, is the main goal of the G-20 reform agenda.

Conclusion

Allow me to conclude. Risk is ever-present, but its nature and sources change over time.

Complacency is itself a source of risk—and indeed, the Great Moderation sowed the seeds of its own destruction as vulnerabilities were allowed to build up.

This calls for vigilance in assessing the shifting nature of risk. The Bank of Canada continues to evaluate risks, sharing its assessment with other public institutions, international counterparts and the private sector.

But we must also expect the unexpected. The only defence against the unexpected is the development of a more resilient financial system—and the current set of financial reforms will do just that.

Thank you.