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Seeking Financial Stability: The Best Role for the Bank of Canada

A former Governor of the Bank of Canada finds good public policy reasons why Bank involvement in financial stability endeavours should have clear limits.

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The Study In Brief

Since the 2008/09 upheaval and panic in financial institutions and beyond, each country has had a responsibility to re-examine its regulatory and supervisory processes and establish a clear and focussed policy framework for preventing threats to financial stability. Some countries have seen the establishment of new structures, such as the US Financial Stability Oversight Council, and the allocation of new responsibilities for macro-prudential oversight.

Perhaps reflecting ongoing satisfaction that the Canadian financial system was not an epicenter of this upheaval, perhaps also reflecting uncertainty about how to introduce changes, including where the ensuing roles and responsibilities for macro-prudential action would reside, Ottawa has not yet shared with the public any views regarding such a framework.

At the same time, the C.D. Howe Institute has provided a forum for a number of studies covering various aspects and points of view as to how matters might best be organized to provide such a framework, and this *Commentary* continues in that vein.

But unlike other studies, which have addressed in some detail the various options for the kind of formal structure that Ottawa might need to put in place, the central focus here is on the best role for the Bank of Canada in light of its monetary responsibilities. It emphasizes that through a record of consistent achievement over many years, the Bank has established a remarkable general understanding and acceptance of its monetary policy framework – one centered on sustained low, and therefore stable, inflation as a national financial anchor.

This *Commentary* concludes there is no particular virtue in adding to the Bank's responsibilities further, and quite distinct, policies that will stretch that credibility. Given the high value of what the Bank is already responsible for, it should be particularly hesitant about taking on new responsibilities on such a broad, and as yet extremely ill-defined, policy front. Financial stability is an area where the likely policy tools are markedly different from those normally involved in monetary policy. Also, given a longstanding continuing federal financial regulatory establishment, the channels of responsibility and authority for those tools promise to be somewhat diffuse. Nonetheless, in line with both history and good sense the Bank should always be there, supplying its particular expertise and judgement to help out, while at the same time maintaining its monetary policy independence of action.

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The 2008/09 upheaval and panic in financial institutions and beyond has led to a global effort to find ways of forestalling similar disasters. Much work has been done. Much still remains.

In one area however, the consensus is very clear: each country has a responsibility to re-examine its regulatory and supervisory processes and establish a clear and focussed public policy framework for detecting and preventing threats to financial stability.

Perhaps reflecting ongoing satisfaction that the Canadian financial system was not an epicenter of this upheaval, perhaps also reflecting uncertainty about how to introduce changes, including where the ensuing roles and responsibilities would reside, Ottawa has not yet shared with the public any views regarding such a framework. Nor has there yet been any comprehensive analysis as to the key elements in the Canadian financial system that allowed the system to come through the global financial crisis in decent shape, in particular the significance for financial stability of a structure dominated by a handful of systemically important banking institutions with substantial franchise values to protect.[1]

Such analysis would seem to be an essential basis for establishing a suitable financial stability policy framework going forward. However, the C.D. Howe Institute has in this indefinite interval provided a forum for a number of studies covering various aspects and points of view as to how matters might best be organized to provide such a framework.[2] This *Commentary* continues in that vein.

Unlike those earlier studies, my focus here is relatively narrow. In particular, rather than wrestling with the hierarchies, roles and combinations of the various Canadian regulatory and supervisory bodies that, judging by the record to date, may have to be involved in decisionmaking in the area of financial stability,[3] I focus above all on what the Bank of Canada should offer. In another sense, however, the scope is quite broad. That is to say, my purpose is to assess the costs and benefits for public policy of the way the Bank, as the institution pre-eminently responsible for monetary policy, should get involved.

I find there are good public policy reasons why Bank involvement in financial stability endeavours should have clear limits. That is, this involvement should be one where it is an informed, concerned and productive adviser, rather than being the institution in charge. Also of course, bearing particularly in mind the not necessarily transparent way the Ottawa system can work in situations where a ministerial decisionmaking role is involved, the Bank should be careful not to be cast as being

The author wishes to thank David Longworth, Angelo Melino, Finn Poschmann, Christopher Ragan, and Pierre Siklos for comments on an earlier draft. Any remaining errors are the responsibility of the author.

1 There are of course explanatory commentaries if not analysis as to the reasons for Canada's relative success, above all via the Bank of Canada (see Carney 2010, Murray 2010, and Northcott, Paulin and White 2009).

2 In 2009, studies by the author and then Nick LePan were published, and in 2012 two more papers, first by Christopher Ragan and then by Paul Jenkins and Gordon Thiessen, were also issued.

3 In its recent review of the Canadian financial scene, the G-20 Financial Stability Board made a point of noting "Canada's relatively complex regulatory structure."

in charge if in reality crucial decisions regarding financial stability actions are ultimately taken elsewhere.

Sustaining the Credibility of the Monetary Policy Framework

As is now very well recognized, the Bank of Canada, through a record of consistent achievement over many years, has established a remarkable general understanding and acceptance of its monetary policy framework – one centred on sustained low, and therefore stable, inflation as a national financial anchor. In this way, it has helped Canada mitigate the multiple distortions generated in the economy by various actors trying to live with inflation.

Alternatively put, this record has served to generate stable expectations in regard to a central element in Canada's financial outlook. Accordingly, it has provided a platform for well-informed decisionmaking by both producers and consumers, by both the real and financial sectors of the economy and, it may be added, by governments at various levels. Since the Bank's role in this regard is an undeniably valuable contribution to a well-functioning economy, anything that dilutes it or renders it less sure is a cost to be taken seriously.

In implementing this policy framework the Bank does, as it has made abundantly clear, pursue its 2 percent inflation target with a degree of flexibility.[4] It thereby aims to take into account shocks to the economy that occur from time to time, and in this way lessen fluctuations in output and employment. However, if the sustained price stability that it needs to deliver, and the multiple actions and expectations that depend on this continuity, are to be preserved, it has to use this flexibility sparingly.

Furthermore, given the high value of what the Bank is already responsible for, it should of course be particularly hesitant about taking on responsibilities on a second broad, and as yet extremely ill-defined, policy front – financial stability. This is an area where the likely policy tools (still work in progress) are markedly different from those normally involved in monetary policy, the channels of responsibility and authority for those tools promise to be somewhat diffuse, and the ultimate payoffs will be extremely difficult to measure.

What It Might Take to Deliver Financial Stability

The issues associated with financial stability have generated a substantial and still growing literature worldwide. However, this territory has been ably surveyed in a Canadian context through the recent studies of Ragan (2012), and Jenkins and Thiessen (2012) (both available at www.cdhowe.org), so the review here of issues and potential policy responses can be quite brief.

- The general concern is the evident risk that financial institutions of whatever stripe, because of their leverage, interconnectedness and tendencies to pro-cyclical behaviour, will again be both the source and propagator, as well as likely victims themselves, of shocks that damage the stability of the economy.
- The financial institutions that can be involved are varied in nature and their interconnections manifold. Furthermore, there is no guarantee that the damage that can occur will be readily anticipated. Accordingly, the range of potential policy concerns and approaches is wide.
- Those approaches have come to be grouped under the general heading of macro-prudential regulation – "macro" because they relate to the

4 As Governor Carney noted in 2009 (Carney 2009), since 1998 the Bank of Canada's policy horizon for achieving its inflation target had "varied from five to ten quarters" over its projection period. More recently, in a press interview (Carney 2012), he noted that the policy horizon "has extended as long as 10 quarters and as short as half a year."

performance of the financial system generally and its effects on the economy rather than to individual institutions,[5] and "prudential" because they are concerned with avoiding excessive risk in the system.

- Reflecting the main types of systemic risk that have been identified, regulatory policies in the macro-prudential field are customarily divided into two main categories – policies aimed at improving the underlying resilience of the financial system, and ones aimed more at combatting pro-cyclical financial behaviour (especially credit booms and busts) that can magnify economic upswings and downturns. One can also usefully include here asset-price bubbles as a subset of pro-cyclical phenomena.[6]
- As regards resilience, the policy focus has been mainly on the adequacy of institutions' underlying capital and liquidity cushions in relation to the risks they carry. In some countries, particular emphasis has also been given to the challenges posed by any failure of systemically important financial institutions (SIFIs), and the kinds of moral hazard risks that are run if such institutions are assumed to be too big, important or interconnected to fail.[7]
- For pro-cyclicality, most attention to date has been given to the possibility of adjustments over the cycle in banking institutions' required capital. This means applying from time to time what has come to be known as a "countercyclical capital buffer" to combat the above-noted over-exuberance among financial institutions in providing credit in the upswing and to provide a credit-easing counterweight as economic conditions deteriorate and such institutions move to the other side of the boat. However, as recent Canadian housing and mortgage market experience has shown, sector-specific regulatory tools may be available as well.
- As is to be expected, indeed demanded by the circumstances, any work done nationally on these matters has a comprehensive international counterpart. For banking system issues, the international effort is mainly channeled through the ongoing labours of Basel III, with broad direction for work on all types of institutions and issues in the financial universe coming from the G-20 Financial Stability Board.

Drawing Fine, but Clear, Distinctions

Nothing in the argument in this *Commentary* ought to be taken as suggesting that the Bank should exclude itself or even be excluded from the Ottawa macro-prudential policy process. By virtue of the array of information and insights deriving from its monetary policy responsibilities, it is bound to have a contribution to make in the macro-prudential area. Indeed, it also needs, for monetary policy's sake alone, to have a good understanding of the issues and the macro-prudential choices that are to be made, even if it does not in the end make those choices itself.

At the same time, because of the importance of getting clear thinking about monetary policy (and about macro-prudential policy as well), it is equally important to draw as clean a distinction as possible between macro-prudential actions and monetary policy initiatives. The rest of this section expands on this.

5 That would be "micro-prudential." At the same time, it should also be recognized that in the prudential area the distinction between "macro" and "micro" can become blurred, especially where financial institutions are relatively large.

6 Here, a recent striking Canadian example has been the low-interest-rate, credit-fuelled, upsurge in major parts of the housing market, the consequential impact on prices and, just as important for the future, the impact on household indebtedness.

7 Some initial, though still rather modest, steps to address the SIFI issue have been taken in Canada, inasmuch as the Office of the Superintendent of Financial Institutions has asked the big, clearly SIFI, Canadian banks to prepare recovery plans (Dickson 2012).

Different Instruments

As alluded to earlier, an important argument in favour of separate treatment, beyond the general desirability of being as clear as possible about the role and scope of monetary policy, is that the instruments of monetary policy, on the one hand, and macro-prudential policy, on the other, are qualitatively different.[8]

The fundamental immediate objective of Canadian monetary policy has been to generate a path of low, stable inflation. The Bank's key policy instrument to achieve this, deriving from its control over its balance sheet together with a commitment to transparency and consistent communication, has been its operational influence on Canadian short-term interest rates.[9]

Macro-prudential policy tools, while still evolving, are on a clearly different plane. This is seen in the area of financial system resilience, where the focus has been on getting an appropriate and durable alignment between institutions' balance-sheet risk and leverage – so that the more that is allowed of the former, the less there should be of the latter. The availability of liquidity on an institution's balance sheet in the event of market failure is a further dimension, as are any special preventive steps needed when a financial institution's possible failure presents a risk to the system and the economy as a whole.[10] One is hard pressed to see any connection between these kinds of structural, and relatively timeless, considerations and the appropriate path of short-term interest rates for an effective monetary policy.

As regards actions to manage pro-cyclical credit or bubble disturbances, some overlap with monetary policy decisions may sometimes have to be confronted. However, this is by no means automatic. In particular, it is now well recognized that because they will be directly related to the problem at issue, the first lines of policy defence for threats to financial stability[11] need to be macro-prudential in nature, and not driven by monetary policy.

As already noted, the tool that has been gathering most attention in this regard is the requirement for adjustments over the cycle in the leverage of credit-granting institutions. But such adjustments are far from exhaustive of the range of likely instruments available.[12] And if the apparent financial pressure is identified more closely with a particular sector of the economy, recourse might also be had to some particular regulatory instrument available to cool matters off – as has already been the case for Canada through cumulative changes in the terms and conditions for residential mortgage insurance offered through the auspices of the federal government's Canada Mortgage and Housing Corporation.

8 On this important, indeed analytically central, point as well as others, see Svensson (2010 and 2012).

9 Admittedly, as a result of the financial crisis and its aftermath, there have emerged around the world a range of relatively novel monetary policy instruments – in particular, initiatives such as quantitative and credit easing to promote economic recovery in an already low interest rate, still heavily levered, economic environment. However, these new, exceptional features do not change the basic story or the policy distinction that is being made here.

10 The Bank of Canada, like any normal central bank, is a lender of last resort to banking institutions under certain conditions and circumstances, and in fact became so to an extraordinary extent during the financial crisis. However, the objective in financial stability design is to minimize the need for such "last resort" measures.

11 After, of course, prudent management of the financial institutions themselves – especially, from a macro-prudential angle, if they are relatively large.

12 A good review of what is potentially available to policymakers is contained in the Financial Stability Board progress report, "Macroprudential Policy Tools and Frameworks" that was released in August 2011.

As for the Policy Overlap

However, in the absence of, or failure to apply, appropriate macro-prudential tools, the Bank of Canada may from time to time have some difficult decisions to make in the realm of second best. If everyone is lucky, the Bank may be able to kill two birds with one stone. It may, for example, find it reasonable to embark on a monetary policy tightening process aimed at heading off emerging inflation pressures, while at the same time recognizing that this action also acts in the direction of restraining a clearly over-exuberant credit expansion generally.[13]

But if it is unlucky, the Bank may be presented with a policy dilemma – namely, whether it should undertake these same tightening actions even though an overall inflation threat is not apparent, in the interests of cooling off credit. The argument here would be that the eventual collapse of an unsustainable credit, and debt, expansion would endanger economic performance down the road, and make the Bank's monetary policy path more difficult to maintain over time. This also means that it may consider it necessary to throw into the breach some of its store of inflation-targeting flexibility.

Still, even allowing for this possibility, it by no means follows that the Bank should play a formal leadership role for macro-prudential policy in the cycle, any more than it should do so in the case of work on financial sector resilience. To amplify, there are all sorts of situations and policy toolkits that exist apart from the objectives and tools of monetary policy. And macro-prudential policies, like, for example, the fiscal stabilization policies of various levels of Canadian governments, are but one of those toolkits. Accordingly, financial stability – and what macro-prudential actions are or are not being undertaken – is legitimately to be seen as simply one further element in the economic and financial environment that monetary policy must allow for in decisionmaking. In short, having to allow for, or recognize, such an element is not the same as having to control it.

Further Considerations

Beyond the general argument for the importance of securing clear distinctions across policies with different decisionmaking regimes, there are other considerations that militate in favour of the kind of role for the Bank that is being outlined here.

The Embedded Distribution of Regulatory Power

Except for a specialized role in regard to payment, clearing and settlement systems, the Bank is not, and has never been, a supervisor or regulator of any part of Canada's financial system. The reasons for this are longstanding and well-entrenched (Crow 2002). They relate not so much, if at all, to any perception that the Bank would be incapable of dealing with such matters, as they do to how Ottawa has consistently thought such regulatory authority should be allocated for political accountability.

At the federal level, this power resides essentially with the Office of the Superintendent of Financial Institutions (OSFI) and with the Department of Finance. That is to say, with the existing, longstanding assignments of this authority in Canada, the ultimate responsibility for the development of macro-prudential tools and their

13 However, it is by no means assured that what the Bank might need to do on the interest-rate front to encourage an appropriate outcome for inflation will prove to be the right amount to combat excessive credit exuberance, for example.

implementation[14] is in effect assigned to these two bodies, as well as always, through them, to the Minister of Finance.[15]

Therefore, for the Bank to take on clear-cut decisionmaking authority implies some fundamental redistribution of that regulatory authority. But in the absence of any major disaster on the financial stability front, the current Ottawa view as to an appropriate regulatory world is hardly likely to change. In such circumstances, a whole loaf for the Bank is surely out of the question. And the contention here is that no loaf must be better than half of one, such as chairing a governmental committee, given all the ambiguities, in particular regarding the responsibility for actions taken or not taken, that such a half-and-half arrangement would bring in its train.

Various possible regulatory alternatives, and the issues each raises, are carefully and comprehensively discussed in the studies of Ragan, and Jenkins and Thiessen, that were referred to earlier in this paper. However, the considerations I emphasize suggest that the best approach in Canadian circumstances would be to develop a financial stability mandate for Ottawa's Senior Advisory Committee (SAC) on the basis of the existing structure. This committee, chaired as now by the Deputy Minister of Finance with regular membership of OSFI and the Bank of Canada, would naturally need to be endowed with the authority required for macro-prudential interventions, as well as with any reporting arrangements to the Minister of Finance. But it would then also be clear that the Bank was there in an advisory capacity – part of a deliberative committee but not running the show. Thus, the institution would then also be in a clear position to address the complete situation facing monetary policy, financial stability factors included among others, on the basis of the terms established by its monetary policy mandate and the degree of flexibility that it considers prudent.

Furthermore, just to be clear, in the very unlikely circumstance that the Bank were to be offered the whole loaf, managing these two sets of policies in any kind of straightforward way would seem to call for some kind of double-breasted and complicated, if not also unconvincing, formal policy division within the institution. Such a contrivance would have the further challenge of arriving at an agreement as to how the Bank's careful statutory arrangements for independent decisionmaking, as currently exist for monetary policy, might be extended to cover actions aimed at financial stability.

And Can They Do It?

One concern in regard to the possibilities for macro-prudential decisionmaking, voiced both in Canada and internationally, is whether those in charge have the capability and/or proper authority actually to take action in a technically effective and timely way. And there, the focus is not so much on what a central bank with the proper authority could or could not do, as it is upon the capabilities of other relevant agencies. For example, in a 2011 Financial Stability Board report on macro-prudential policy tools, it is noted that "[a] possible risk associated with a central involvement of finance ministries in the operation of macroprudential frameworks is a reduced degree of insulation from pressures linked to the political cycle." In similar vein, Jenkins and Thiessen (2012) refer to "[t]

14 With the notable, and admittedly awkward to say the least, exception of action in the area of securities markets and their prudential regulation, which is divided up among the provinces.

15 In fact, the Minister of Finance by statute "presides over" and "is responsible for" OSFI, while the Superintendent is the deputy head of the office – thereby underlining the seemingly inevitable political dimension in financial sector supervision and regulation.

he difficulty…in getting the political process to be forward looking and to submit to criticism for actions taken now that have benefits well into the future."

Jenkins and Thiessen go on to observe that "[a] nother shortcoming is that the Department of Finance is largely a policy agency with limited capacity for implementation." However, this is a deficiency that could clearly be rectified, and in any event OSFI is inevitably there to bear some of the implementation load. Accordingly, the principal worry has to be the potential danger from political influence.

However, given the existing clear and longstanding responsibility of the Minister for both his own department and for OSFI, it seems more than likely that he would retain some kind of ongoing ultimate deciding role. This, of course, is especially the case when (as in recent months) it comes to decisions regarding CMHC mortgage insurance terms and conditions. This is where Canada has in fact made its first essay at macro-prudential actions of a countercyclical nature, and is also an endeavour that appears to have been broadly constructive. It is hard to conceive of the Bank of Canada giving instructions to CMHC – though the Bank could well provide timely advice – even directly, to the Minister of Finance on the subject.[16]

In any event, whether the Minister did or did not get involved, it would still be appropriate, given the monetary policy role that the Bank shoulders, for decisions of a macro-prudential nature to be made without the Bank being in charge of them, but rather participating in an advisory capacity. Then, to repeat, the Bank would make its independent, separate decision on what to do for monetary policy – while at the same time taking into account the macro-prudential environment – and therefore be able to give a clear account of the basis, all other things considered, for its policy decisions.

Conclusion

The Bank of Canada has a monetary policy framework that recognizes the need in an uncertain world for a degree of flexibility in the timing for achieving its inflation control target. To date, it has managed this flexibility without undermining the credibility in inflation performance that, indeed, this capacity for flexibility itself requires.

However, there is no particular virtue in adding to the Bank's responsibilities further, and quite distinct, policies that will stretch that credibility when appropriate alternatives are available. As for those alternatives, there is an enormous amount to be said for setting the decisive responsibility for macro-prudential policies squarely on the acknowledged federal regulators. Thereby, both statutory authority and responsibility for policy inputs are properly combined.

To reiterate, in line with both history and good sense the Bank should always be there, supplying its particular expertise and judgement to help out – and providing it to recipients who, one is surely entitled to assume, are more than glad to have this available.

16 Here, it is worth bearing in mind that the Minister and the Governor are in any event required under the *Bank of Canada Act* "to consult regularly on monetary policy and its relation to general economic policy," above and beyond what might make its way through a committee.

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