BANK OF CANADA
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Financial System Review

Highlights—December 2008

Risk Assessment[1]

The turmoil in global financial markets entered a new phase in September, moving to a more acute and broad-based loss of confidence in the context of a series of failures and near-failures of large financial institutions in the United States and Europe.

Wholesale funding markets came to a standstill in many countries. Corporate bond spreads widened to new all-time highs in October, equity markets experienced sharp declines, and foreign exchange volatility increased sharply.

Following the announcement of the G-7 Plan of Action on 10 October and associated policy initiatives, the strains in short-term funding markets have started to ease, but it will take time for confidence to be fully restored.

The Canadian financial system has proved relatively resilient throughout the crisis, owing to lower leverage and more conservative lending practices, but it has not been immune to spillover effects. In particular, strains in Canadian wholesale funding markets have been significant in recent months, and this has impeded the normal functioning of the financial system.

The most likely outcome is for a gradual improvement in global financial markets and credit conditions in Canada as the various extraordinary measures aimed at resolving the crisis take hold. But uncertainties remain around the timing of the likely return to more normal financing conditions.

Against this background, five key sources of risk to the strength and stability of the Canadian financial system are explored in this issue of the *Financial System Review*.

Potential Risks

Funding and liquidity

The continued reluctance of lenders to enter the market, owing to uncertainty over their future funding needs and existing risk exposure, risks delaying the return of confidence and more normal financing conditions, which could aggravate the adverse feedback loop between the financial system and the real economy.

Capital adequacy

A deep, or prolonged, downturn in the economy could entail new challenges for Canadian banks in the form of higher credit losses, with potentially significant negative impacts on their capital ratios. The risk is that market forces could compel banks to restore their capital ratios, leading them to curb balance sheet growth more aggressively. This could result in a significant tightening of lending conditions for both households and businesses that would exacerbate weakness in the economy and increase difficulties for financial institutions.

Household balance sheets

With household balance sheets under pressure from weak equity markets, softening house prices, slowing income growth, and a record-high debt-to-income ratio, a severe economic downturn could result in a substantial increase in default rates on household debt.

Household indebtedness could act as a channel of contagion spreading losses through the Canadian financial system and causing a further tightening of credit conditions. The impact on the balance sheets of financial institutions would, however, be substantially mitigated by mortgage insurance and the associated government guarantee.

Global economic downturn

Given the strong economic and financial linkages between Canada and the United States, a deeper, or more persistent, recession than currently expected south of the border would have a substantial impact on Canadian businesses, households, and financial institutions.

While the level of capital at the major Canadian banks is sufficient to absorb the large losses associated with such an outcome, actions taken by the banks to continue to meet regulatory requirements could exacerbate pressures on the Canadian economy and the financial system.

1. This section represents the collective judgment of the Bank of Canada's Governing Council on the key risks and vulnerabilities bearing on the stability of the financial system.

Global imbalances and currency volatility

International financial and trade imbalances cannot persist indefinitely. The appreciation of the U.S. dollar since July 2008 could impede the gradual adjustment process of the past few years, increasing the risk of a disorderly resolution of these imbalances at some point in the future.

An abrupt and sizable decline in the value of the U.S. dollar would give rise to sharp movements in asset prices, additional volatility in financial markets, and a renewed rise in risk premiums.

Policy Actions and Assessment

In response to the severity of global financial developments and the risks that these developments pose to the Canadian financial system, the Bank of Canada has developed and implemented a range of extraordinary facilities within its sphere of responsibilities.

Immediate actions have focused on restoring confidence and re-establishing the normal functioning of the financial system.

Canada remains committed to the G-7 Plan of Action, which entails a number of initiatives to restore the flow of credit. The Bank of Canada has responded aggressively by expanding its provision of liquidity through an increase in term purchase and resale agreements, by widening eligible collateral, by extending the range of counterparties, and by introducing new lending facilities.

The Government of Canada created the Canadian Lenders Assurance Facility (CLAF) to provide insurance on the wholesale term borrowing of federally regulated (and some provincially regulated) deposit-taking institutions, thereby ensuring that they are not put at a competitive disadvantage from similar facilities offered by other countries. It also implemented a program to purchase up to $75 billion of insured mortgages to increase access to longer-term financing.

With the policy actions that have been taken to provide liquidity and funding support, financial institutions are increasingly expected to have the capacity to re-enter markets.

Reports

Credit, Asset Prices, and Financial Stress in Canada

This report describes work done at the Bank of Canada on measuring financial stress and assessing the performance of various measures of credit and asset prices as early-warning indicators of financial system vulnerability.

The preferred model, which includes business credit and the ratio of the average house price to income as explanatory variables, does not fully capture the sharp increase in stress observed since August 2007. This is not surprising, given the external origin of the shock. The fact that the key explanatory variables in the model failed to signal domestic vulnerability may simply reflect the fact that the Canadian financial system is relatively resilient.

Fair Value Accounting and Financial Stability

The authors examine the role that fair value accounting and the difficulties of its application in inactive markets play in amplifying cyclical fluctuations in the economy. They conclude that the unintended consequences of fair value accounting could be mitigated by not using fair value estimates in a mechanistic fashion. Good disclosure practices can provide users of financial statements with an understanding of the assumptions underlying estimates, as well as the uncertainty surrounding them.

Policy and Infrastructure Developments

Liquidity Risk at Banks: Trends and Lessons Learned from the Recent Turmoil

The market turmoil that began in late 2007 prompted banks and their supervisors to carry out an in-depth review of bank liquidity-management practices to ensure that they adequately reflect the realities of today's complex banking organizations and markets. Central banks are reassessing their role as provider of liquidity in difficult times and ensuring that they have all the tools they might need in such circumstances. ■

This document summarizes key points and information from the December 2008 issue of the *Financial System Review*. It is available only on the Bank of Canada's website. For further information, contact Public Information, Communications Department, Bank of Canada: 613 782-8111; 1 800 303-1282; email: info@bankofcanada.ca.