X Meeting of Heads of Financial Stability
Digital Meeting

Opening Remarks
Financial Stability in extraordinary times

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- Good morning. It is a pleasure to welcome you to the X Meeting on Financial Stability. We have a distinguished group of experts and policy makers from the central banking community, who will generously share their perspectives on financial stability.

- For this meeting, we have 57 registered participants, from 23 central banks. I am convinced that the discussions will be thought-provoking and inspiring for all of us, particularly so, under the current circumstances. I encourage you to take advantage of this event and reflect on how this meeting could become even more relevant as means to share our experience on financial stability and its policies.

- Allow me to thank the participants, especially to our members from central banks, and our CEMLA staff for assembling a relevant and meaningful agenda for this event. Let me also thank our keynote speaker, Professor Dimitrios Tsomocos, our invited presenter, Ricardo Correa, and all of our panelists, for taking the time to share their expertise and knowledge.

Motivation

- Now, let me motivate our interest in financial stability in relation with the recent events and the associated policies to promote it. After the Global Financial Crises (GFC), some of us believed that the following most important threat to the financial system was climate change; however, the Covid-19 pandemic came to change many things and among them this perception. In fact, COVID-19 and its detrimental economic consequences has brought the first test of financial stability after the GFC.

- This crisis for sure has different roots than the GFC, but has the tremendous turnaround in policies helped in mitigating the negative shock that COVID posed to the economy and the financial system?

- Unfortunately, the COVID-19 crisis is far from being over yet. We still have to wait before we are able to make a final judgement. Important questions will be: was the financial system prepared? And were the emergency measures that were taken adequate? While the crisis
is still unfolding in the LAC countries, I consider it of the highest importance to exchange experiences about the threats to financial stability we are facing now as we are doing in this meeting.

- In the rest of my talk, I will first discuss the financial stability implications of the current Covid-19 crisis; second, I will discuss macroprudential stress testing and its usefulness; finally, I will comment on financial stability monitoring, which is of particular importance under the current circumstances.

COVID-19 and Financial Stability

- Most countries have taken different measures to mitigate the impact of the COVID-19 health crisis. According to the World Bank and International Monetary Fund (IMF) in their Position Note published in May, some of these recommendations consisted on prudential regulatory and supervisory measures to support banks facilitating credit to the real economy, measures related to supporting borrowers and loan restructuring, and to strengthen payment systems, among others, IMF-WB (2020).

- In the same vein, according to the FSB, policymakers have taken some actions such as: “(1) government guarantees and direct lending, loan restructuring; (2) central bank policy interventions to ease credit conditions and keep markets open; (3) prudential measures to facilitate the flow of credit to the real economy,” . For instance, some authorities have recommended that financial institutions use capital buffers to finance the real economy and absorb losses in this stressful period, FSB (2020).

- Central banks have accompanied fiscal authorities to avoid market freezes by providing unprecedented amounts of liquidity as it has been the cases of México, Brazil and the US, among many others. Additionally, monetary authorities have acted in order to avoid disruptions on the credit flows while facing higher risk levels.

- As a result of the reforms promoted by the G20 after the GFC, the global financial system is in better shape to cope with this tremendous global shock. Unfortunately, some financial institutions are still vulnerable in this stress period due to COVID-19. Learning from the previous crisis, it is important to assess the degree of interconnectedness and potential contagion effects through direct exposures and overlapping portfolios. Moreover, to identify those banks and financial institutions that can contribute to systemic risk contagion across the financial system is particularly important more than ever.

- Nowadays, it is well-known that during the GFC, there was not detailed enough information to assess in an adequate manner important vulnerabilities and emerging risks in some financial markets. The textbook example is the Over The Counter (OTC) derivatives market. As a consequence, the global financial system’s reform emphatically encouraged the use of Central Counterparties (CCPs) for the settlement of the vast majority of derivatives. Given the current situation, it was, apparently, an appropriate decision.

- Here at CEMLA, we are collaborating with the University College London (UCL) and some
central banks in the region on the development of tools to study interconnectedness, financial contagion and systemic risk. Now is the time to put these studies at work. It is important to mention that in addition to the academic papers produced as a result of such collaboration we have the knowledge, models and code available for other jurisdictions that would like to perform similar studies.

• Among the studies that we have performed with some central banks in the region we find: anomaly detection on payment systems, interconnectedness analysis in payments as well as on the interbank markets, identification of systemically important banks, firms and systemic risk measurement.

• However, despite the grim economic outlook, not everything is bad news. The coronavirus crisis resulted in a drop of carbon dioxide emissions, according to the ECB, the lockdown will allow a reduction around 4% to 7% than the estimates before the crisis. This is an opportunity to foster greener financial markets to get access to a low-carbon economy by adopting sustainable technologies and life styles. Climate change could pose significant risks to price and financial stability as it has been widely recognized. In particular, for markets, as asset prices might reflect properly the externalities associated with climate change in a not distant future.

• Certainly, the Great Lockdown has resulted in lower emissions of CO2 and other greenhouse gases and has also brought important changes and lessons which might stay after the health emergency has passed. For example, it has been proved emphatically that remote working is a reality and to a certain extent education and shopping can rely on its online versions more.

• Moreover, we hope that despite its huge impact on the world economy, the current COVID-19 health crisis is temporary, but the risks associated to extreme weather events, whose origin is rooted on climate change, will stay with us for some years to come.

• This health crisis opens a window of opportunity to start managing transition risks. Instead of going back to business as usual, the financial sector can finally reduce its exposures to the carbon intensive sectors of the economy. Creating the right incentives for the economic participants in such sectors to trigger the transition to more sustainable practices.

• Many of the short- and medium-term challenges for the stability of the financial system are related with the COVID-19 outbreak. Some of these challenges are related to interest rates, foreign exchange imbalances and vulnerabilities arising from increasing market-wide risks. Therefore, it is important to use effective tools for assess the impact of COVID-19, such as scenario analysis, adequate risk monitoring and stress tests.

• It is important that LAC countries continue with international cooperation and coordination on the COVID-19 response, including information sharing and exchanging experiences on the policies implemented. Here at CEMLA we are prepared to participate with you on any initiative and we will also facilitate the exchange of experiences and ideas like we will be doing in this meeting.
Since the GFC great progress had been made and the increased focus on financial stability has led to the development and introduction of important new policy tools to insure the future safety of the financial system. Among these tools the implementation of macroprudential stress tests and new sets of financial stability monitoring tools stick out to which I turn next.

**Macroprudential Stress Testing**

- Macroprudential stress tests are able to detect macro-financial vulnerabilities of the financial system. Stress tests assess the impact of stress scenarios in macroeconomic and financial variables on tested institutions. They inform policy makers about the resilience of the financial system to future shocks and are therefore a useful ingredient for macroprudential policy decisions.

- The methodology of macroprudential stress tests is both versatile and complex. This allows tailoring stress tests for different purposes while raising technical and resource-driven challenges. Let me emphasize the potential of employing stress tests for macroprudential purposes that might justify the effort:

  First, stress test methodologies have great potential to be used for the calibration of macroprudential policies. For example, the analytical framework behind stress test models could be used to calibrate macroprudential capital buffers, van Oordt (2018). Stress test results on the banking system are used in many jurisdictions to set forward-looking capital guidance. They are therefore an important complement to accounting-based capital ratios and underpin the macroprudential aspect of the new revised Basel capital framework.

  Second, stress testing frameworks are adaptable to different scenarios according to policy needs. They are therefore a helpful tool in assessing upcoming risks to financial stability. Most recently, central banks implemented Covid-stress tests to gauge the resilience of banking sectors to the recession caused by the pandemic. Stress tests are also applied to assess the impact of climate change on financial systems.

  Third, stress test methodologies can be extended to evaluate complex interconnections in financial systems. Especially extending stress tests beyond the banking sector by including non-bank financial institutions has great potential to evaluate the risks to financial stability that stem from the growing shadow banking sector and from the real economy.

- As much as we can enhance all the benefits that adequate stress testing frameworks can bring for central banks and supervisory authorities, there some important challenges that this tool must address in the short and medium term:

1 For example, Covid-stress tests have been executed at the ECB, the Fed in form of a sensitivity analysis to Covid during the 2020 DFAST, the Central Bank of Uruguay, and the Central Bank of New Zealand, among others.

2 Climate change scenarios have been developed, for example, at the Dutch Central Bank DNB, Banque de France, or Bank of England.
With all its potential, macroprudential stress testing is still a relatively new policy tool. Progress is needed to make full use of stress testing potential. A key challenge is therefore to develop and implement methodologies that reflect the complexity of macro-financial linkages and banks’ adaptive behavior to crisis situations. This includes incorporating feedback loops between macroeconomic variables and bank balance sheets, allowing dynamic balance sheets that include endogenous capital measures, and integrating interdependencies between financial institutions and contagion mechanisms in the modelling framework.

These modelling advances are still in early stages of development and require great investment in capacities until they are fit for setting policies. Exchanging experiences and discussing methodologies across jurisdictions will help facing these challenges.

Financial stability monitoring

- The financial strain triggered by the pandemic has highlighted the importance of building sound financial stability monitoring capabilities. Since the global financial crisis countries have been working on methodologies and infrastructures to measure, track, and evaluate financial stability risks. The aim of these initiatives has been to reduce systemic risk by identifying financial vulnerabilities that could amplify unexpected shocks and disrupt financial intermediation.

- Hereby the distinction between triggers and vulnerabilities is central (Adrian et al., 2014): while the former ones imply shocks that are usually difficult to predict, the latter ones refer to features of the financial system such as leverage, maturity transformation, or interconnectedness, that can amplify shocks through financial contagion or collapses in asset prices. A proper financial stability monitoring framework should therefore be able to measure and trace over time vulnerabilities that can harm households and businesses and that can be a target of preemptive policy actions.

- In the current context at least two aspects of monitoring have proven to be key to calibrate policy responses. First, the unique feature of the crisis has required a precise targeting and timing of policy measures, including liquidity provisions, the release of countercyclical capital buffers, and credit guarantees. Authorities have faced the challenge to identify key funding markets experiencing stress and to design in due course measures to sustain credit supply. Hereby, frameworks that provide a broad range of comparable real-time financial stability metrics are needed to identify and prioritize policy targets (see, i.e., FSB 2020).

- Second, the incipient but still uncertain path of recovery will highlight the trade-off between the price of financial risk and the build-up of systemic risk: while economic expansion comes along with a reduced cost of financial intermediation and more risk appetite, the potential for financial externalities and therefore for systemic risk will tend to increase. Here, we should note that financial externalities such as assets’ fire sales only manifest in “bad” states of the world, in opposite to the usual textbook production externality. Therefore, monitoring frameworks should be designed to anticipate the potential for financial
externalities especially during an expansionary recovery cycle.

- Beyond the current crisis, global discussions on the improvement of financial stability monitoring suggest three important lines of action. First, there is a need to introduce comparable and forward-looking financial stability indicators that can guide preemptive policy actions. The International Monetary Fund has been encouraging, for instance, the introduction of Growth-at-Risk (GaR) indicators, which provide a tractable estimation of the likelihood of economic downturns given current macro-financial conditions (see IMF 2019).

- GaR indicators have two key advantages: First, they can be based on a broad range of variables including, for instance, housing market imbalances or credit boom-bust cycles. Second, they can facilitate the global coordination of policy actions by providing a common methodology to gauge financial stability risks.

- A second line of action reflects the fact that monitoring frameworks need to capture the importance of non-bank and shadow-bank financing and their contribution to systemic risk (see FSB 2020). To the extent that non-banks get increasingly involved in maturity transformation and credit activities, they become important both because of their direct role in credit provision, and because of their interconnectedness with other financial institutions.

- A third aspect related to the above is the role of FinTech companies. The FinTech Issues Group of the Financial Stability Board (FSB) has drawn attention on how emerging FinTech innovations can both support financial stability and also engender systemic risk, in areas such as credit scoring, digital currencies, and machine learning. Up-to-date monitoring frameworks have been encouraged by the FSB to incorporate issues like the operational risk from third-party service providers used by banks, the role of cyber security, and the monitoring of macro-financial risks arising from FinTech activities being integrated to incumbent financial firms (see FSB 2017).

- These challenges are likely to remain in the international agenda in the coming years. The exchange of countries’ experiences in setting up monitoring frameworks will certainly facilitate the adoption of global standards in this important area.

Outlook of the Meeting

- In the following three days, we will have valuable interventions by international experts. Starting today, we will have as the keynote speaker Professor Dimitrios Tsomocos from the University of Oxford, a distinguished economist and researcher and a close collaborator of our center. Additionally, a COVID-19 and Financial Stability panel, where distinguished members from the Federal Reserve Board, Banco Central de Reserva del Perú and Banco Central do Brasil will share and discuss national policy actions to address financial stability risks and challenges related to the Covid-19 pandemic.

- Tomorrow, we will have a special talk about financial stability governance and central bank communications with Ricardo Correa from the Federal Reserve Board. Then, we will
have the opportunity to hear from international experiences on the implementation and the challenges of macroprudential stress testing.

- Surely few jurisdictions would have contemplated stressful scenarios like the one we are living in now on their supervisory exercises. Nevertheless, due to its worst-case approach and prospective construction, stress testing is as important as ever in the financial authorities’ toolkit. The panel will have the participation of Fabrizio López-Gallo Dey from Banco de México, Rodrigo Lluberas from Banco Central del Uruguay and Daniel Osorio from Banco de la República.

- On the third day, we will have a panel covering regional and international experience on financial stability monitoring. One of the most important lessons of the GFC was that to gather the right data for financial stability monitoring is crucial. This session will focus on discussing experiences in implementing frameworks to measure, track, and evaluate emerging financial stability risks and systemic risks, with a focus on central challenges ahead. In this session, we will have the participation of Grzegorz Halaj from the Bank of Canada, Ángel Estrada from Banco de España and Gilneu Francisco Astolfi from Banco Central do Brasil.

- Before concluding, I would like to welcome you again to the Meeting, let me emphasize that if you need anything from CEMLA, let us know. We will do our best regarding collaboration and research initiatives related to financial stability as we have been doing in the past year.

- I expect a productive exchange of ideas, methods and points of view in this field, which has proven to be quite an important contribution towards the understanding of financial stability analysis and monitoring. I wish you all fruitful discussions and once more, thank you for joining us in this virtual Meeting.
References

Adrian, Tobias, Dong He, Nellie Liang, and Fabio Natalucci (2019). A monitoring framework for global financial stability. IMF Staff Discussion Note, SDN/19/06, August 2019.


