
Canada's FSR Experience

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Presented by:
Christopher Reid
Assistant Chief, Financial Stability

Presentation Overview

- Motivation
- Evolution of the FSR
- FSR tool box
- Future directions

Why do we produce the FSR?

- The FSR brings together the Bank's assessment of conditions in the Canadian financial system.
- It contributes to financial stability by improving awareness of risks.
- It draws attention to collective action problems (the macroprudential perspective).

How is financial stability defined?

- There is no single, widely accepted definition of financial stability
- Nonetheless, a definition helps to motivate the development of an appropriate policy framework
- The FSR defines financial stability as:

“the resiliency of the financial system to adverse shocks, thereby enabling the continued smooth functioning of the financial intermediation process”

Historical Timeline

- Jan 2000** Governing Council endorse development of an FSR
- Sept 2000** First FSR produced as an internal working document
- Dec 2002** Public launch of the FSR
- Dec 2008** FSR re-launched with new approach to risk assessment

Lessons from the early days

The FSR was the first attempt at monitoring risks across the financial system as a whole:

- It required a shift from the traditional analytic focus on risks to the projection outcome towards risks to the underlying financial system
- Gaps in the Bank's knowledge were identified, helping to frame the research agenda
- Data requirements were highlighted

Structure of the FSR

IMF good practice advocates:

- Clarity: main stability issues should be clearly presented
- Consistency: report should be easy to follow for repeat users
- Coverage: the report should be sufficiently comprehensive

Structure of the FSR

The FSR is split into two main sections:

Current Analysis

- Risk Assessment
- Macro-Financial Developments

Research Articles

- Reports and Research Summaries

Internal Process

- Produced 2 public and 2 internal versions every year (2000-2005)
- Dry-runs were initially a useful developmental tool
- But are a strain on resources
- Timeliness restricted use of recycling material from internal versions to external ones

FSR production process

The FSR production process for the front section kicks off with a monitoring note:

- Sectoral breakdown highlights key developments since the last FSR
- Implications for the Key Risks are drawn out
- Potential emerging risks are identified
- General topics for internal discussion are highlighted

FSR production process

The review process commences 9 weeks prior to publication:

Stage 1 Workshop to discuss monitoring note

Stage 2 Governing Council (GC) agree storyboard

Stage 3 First and second drafts discussed by Working Group

Stage 4 Final review and sign-off by GC

What didn't work ...

- Research summaries – wrong venue
- Drawing from existing work – need firm workplan commitments
- Distinction between “Policy Infrastructure Developments” and “Reports”
- Working in silos
- Lack of clearly identified conceptual framework

Recent changes

In the context of a broader internal review of the Bank's financial stability function, the FSR has recently experienced some changes:

- The 'Risk Assessment' became a Governing Council policy document from Dec 2008
- A more structured approach to identifying financial system risks, with greater consistency across time
- Back section reports focus on a specific theme

Conceptual Framework

Three steps:

1. Identification
2. Evaluation
3. Communication

Risk Assessment

- The FSR focuses on a small number of key risks to the Canadian financial system...
- ... based on a probability and impact approach
- Financial system resiliency is assessed in light of developments in global markets and the economy
- Policy actions to mitigate these risks are highlighted

Risk Assessment

Five key risks to the Canadian financial system have been identified:

- Funding and liquidity
- Capital adequacy
- Household balance sheets
- Global economic downturn
- Global imbalances and currency volatility

It is recognised that these risks may interact

The FSR tool box - evaluation

- There is no widely accepted model or analytical framework for assessing financial stability...
- ... as the analysis of financial stability is still in its infancy, as compared to that of monetary stability
- The Bank of Canada is developing tools to enable a more systematic approach to assessing financial system vulnerabilities

Example 1: DSR simulations

- Household loans represent around 25% of the total assets of Canadian banks
- It is therefore important to assess the financial health of the household sector
- Aggregate data mask the underlying distribution of the household debt-service ratio (DSR)...
- ... so a tool was developed for performing stress-testing simulations on household micro-data

Example 1: DSR simulations

- For a given macroeconomic scenario, this tool allows us to assess:
 - the future path and distribution of the DSR
 - the proportion of debt at risk of default
- Results are regularly published in the FSR
- Ongoing research to refine this exercise is focused on:
 - dynamic macro scenarios
 - endogenous default rules

Example 2: banking system stress-tests

- Stress tests provide information on the behaviour of the financial system under ‘exceptional but plausible’ shocks
- The shock can be based on a macroeconomic scenario linked to default rates
- The exercise can help to inform FSR risk assessments

Example 2: banking system stress-tests

- Canada's financial system was the subject of an FSAP update in 2007
- Our experience is described in an FSR Report (June 2008)
- The process stimulated the Bank's stress-testing research agenda
- Regular updates of the top-down stress-testing exercise will eventually be presented in the FSR

Communication strategy

- Communicated and distributed to our FISC partners before publication (OSFI, Dept. Of Finance).
- Deputy Governors will present FSR to media and market participants
- FSR is often used as the backbone of Governing Council speeches.

Communication issues

- Explaining the purpose of the FSR to the media can be an initial challenge...
- ... as they may be accustomed to the central bank providing forecasts, as with the MPR.
- An explanation in the Preface can be helpful:
“The focus of this report... is on providing an assessment of the downside risks rather than on the most likely future path for the financial system”
- A briefing for journalists may also be useful

Where do we go from here?

Our medium-term vision for the FSR:

- Publish regular top-down stress-tests of Canadian banks
- Improve our range of quantitative models
- Develop summary indicators
- Survey financial market participants



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