BANK OF CANADA
BANQUE DU CANADA

Financial System Review

Highlights—June 2008

Developments and Trends

Key Points

Although there has been some improvement in conditions over the past several weeks, strains in global credit markets have broadened since December.

The forced selling of fixed-income assets by leveraged investors into illiquid markets appears to have led to wider spreads on these assets than would be justified by underlying credit risk.

Enhanced disclosure of potential losses by several large global banks and efforts to strengthen their balance sheets are beginning to reduce counterparty concerns.

Tensions in Canadian credit markets have been somewhat less severe than those in the United States.

The strong balance sheet positions of the Canadian financial, non-financial, and household sectors have helped them to weather the turbulence.

Weaknesses in the global financial system are now better understood, and improvements are being developed.

The key risk to the financial system is that the downturn in the U.S. economy may be deeper than currently anticipated. Associated losses would further erode bank capital and exacerbate the liquidity problems in financial markets.

Box 3 – Exposure of Canadian Banks to the United States: An Aggregate View

The direct exposure of Canadian banks to the United States represents about 16 per cent of total bank assets, more than the combined exposure to any other group of foreign countries.

Although exposure to the United States as a proportion of total claims has remained roughly stable since the early 1990s, its composition has shifted as the activity of Canadian banks in capital markets has increased.

In the mid-1990s, exposure to U.S. securities and loans represented roughly 3 per cent and 10 per cent of total Canadian bank assets, respectively. By 2007, these figures had converged, each representing just under 8 per cent of total Canadian bank assets. This shift towards increased holdings of U.S. securities, all else being equal, implies that the return on U.S. exposures has become more dependent on the performance of financial markets.

Given their direct exposure to U.S. assets, and given the expected future weakness in the U.S. real economy and potential further volatility in financial markets, Canadian banks' balance sheets may experience further pressure.

Highlighted Issue: The impact of the recent market turbulence on credit growth in Canada

Since the start of the financial market turbulence, there has been a major loss of confidence in structured finance instruments, which has seriously impeded the financing technique of securitization, both globally and in Canada.

In Canada, securitization has been highest in the residential mortgage market (particularly NHA-insured mortgages) but has also been fairly significant for consumer credit. It still accounts for a relatively minor portion of business credit.

Although the financial market turmoil has reduced securitization activity, it has not yet had a noticeable adverse impact on the overall growth of credit in Canada.

This outcome has been helped by the banks' willingness to assume more consumer and business credit on their balance sheets, while being able to sell significant amounts of residential mortgages through the Canada Mortgage Bond Program.

Mortgage Market and the Household Sector

In contrast to those in the United States, conditions in Canada's housing markets remain relatively favourable. Income growth, low unemployment rates, and relatively good financing conditions have continued to support rising house prices, albeit at a slowing pace.

A sharp housing market correction, similar to that in the United States (i.e., driven by subprime-mortgage innovation), is unlikely in Canada. The subprime-mortgage market remains small in Canada, it has not experienced the excesses of its U.S. counterpart, and the quality of the mortgages within it remains good.

Aggregate indicators of household financial stress continue to suggest that the Canadian household sector is in good financial health. However, the recent popularity of product innovations in the mortgage market, such as low down payments and longer amortization periods, suggests that a certain proportion of homeowners have little home equity and would be more vulnerable to adverse economic shocks.

With possible further decreases in financial asset prices and continued slowing in house price increases, the financial position of the Canadian household sector is likely to deteriorate going forward. This deterioration would be more significant in the event of a sharp reversal in commodity prices, which could lead to a reduction in house prices in some local markets.

At present, however, the financial situation of households does not pose a threat to the stability of the Canadian financial system.

Reports

Bank of Canada Oversight Activities during 2007 under the Payment Clearing and Settlement Act

This report presents an account of the Bank of Canada's activities in the oversight of key clearing and settlement systems during 2007.

Under the Payment Clearing and Settlement Act (PCSA), the Bank oversees clearing and settlement systems that could be operated in a manner that could pose systemic risk, i.e., the risk that the failure of a participant precipitates other failures. Three such systems have been designated by the Bank of Canada (as approved by the Minister of Finance): the Large Value Transfer System (LVTS); CDSX, which clears and settles securities transactions; and CLS Bank, a global system for the simultaneous settlement of foreign-currency transactions.

The turbulence in financial markets that began in August 2007 led to increased volumes and activity for each of the designated systems.

The core payment, clearing, and settlement infrastructure functioned well during the period of market turbulence in 2007, and supported the stability and efficiency of the financial system.

The IMF's Financial Sector Asssement Program (FSAP) review of CDSX confirmed its soundness, efficiency, and reliability.

Policy and Infrastructure Developments

Financial Market Turmoil and Central Bank Intervention

Recent disruptions in financial markets have led central banks around the world to re-examine their roles in providing "liquidity" to the financial system.

This article sets out a policy framework for why, when, and how a central bank might intervene, and it identifies appropriate central bank instruments, consistent with central bank policy goals and functions. It concludes that:

- Central banks should provide liquidity to financial markets in extraordinary circumstances because: markets require liquidity for efficient pricing, illiquidity can contribute to financial system instability with real economic consequences, and a central bank's unique characteristics make it well suited to be the ultimate provider of liquidity to the financial system.
- A central bank should intervene to address financial market turbulence only when there is a significant market failure and significant financial instability with macroeconomic consequences could be avoided or mitigated.
- A central bank should price the provision of liquidity to financial markets competitively through auctions.
- A central bank should have a range of facilities with which to provide liquidity to the financial system, to better focus the provision of liquidity as needed. These include term repos, term securities lending, and term loan facilities.
- The provision of liquidity to financial markets should be guided by the following principles.
  - Targeted intervention
  - Graduated intervention
  - Well-designed intervention
  - Efficient, non-distortionary intervention
  - Mitigation of moral hazard

This document summarizes key points and information from the June 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.