CEMLA
CENTER FOR LATIN AMERICAN MONETARY STUDIES

III MEETING OF HEADS OF FINANCIAL RISK
Management in Central Banks

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Central banks financial risk management: challenges in a new inflationary landscape

Welcome and acknowledgements

Good morning. It is a great pleasure to give these introductory remarks at the III Meeting of Heads of Financial Risk Management in Central Banks. This meeting is taking place for the first time since the beginning of the COVID-19 pandemic in hybrid format, hosted by the Banco Central de Costa Rica and co-organized by Banco de España, Banco de México, Banco Central de Chile, and CEMLA.

Tackling current and emerging challenges for central banks' risk management is of greatest importance, especially during these uncertain times whence central banks face the need to unwind policy measures taken during the pandemic in a context of mounting global inflationary pressures. Moreover, the extension of central banks' policy actions during the pandemic, for instance, by changing collateral eligibility criteria or by entering into outright asset purchase programs, has highlighted the tight interrelation between mandates of price and financial stability and central banks' financial risks management tools.

Spanning over the next two days, this meeting aims at providing a platform for central banks' risk managers to discuss global best practices and recent trends to inform policy decisions in each of your jurisdictions. To accomplish this objective, the meeting features a distinguished group of international policymakers and academics from Latin America, the U.S., and Europe, who will share and discuss their experience in central banks´ financial risk management.

Before highlighting a few remarks to introduce todays' discussions, I wanted to thank the co-organizers for setting up this excellent agenda. Particularly, Francisco Chamú from Banco de México, Luis González Mosquera from Banco de España, Pablo Villa Michel from Banco Central de Costa Rica, and Christian Ferrada Krause from Banco Central de Chile provided key inputs to define and prioritize the topics in the agenda. I also wanted to sincerely thank Pablo Villa Michel and his staff for hosting the meeting in Costa Rica.

We are honored to host Deputy Governor Timothy Lane from the Bank of Canada and Professor Ricardo Reis from the London School of Economics as our keynote speakers during the meeting. Tim and I coincided as Central Bank Deputies at the G20 for a few years and I consider him a top central banker and a friend. I am convinced that we will benefit extensively from both Tim´s and Ricardo´s knowledge and experience to enrich the exchange of ideas between the more than 120 representatives from 40 institutions who will be joining us digitally, and in person in San José de Costa Rica.

Last, but not least, let me thank our staff at CEMLA for the assistance in organizing the meeting. Particularly, Matías Ossandon Busch and Peter Karlström from CEMLA's Financial Stability Directorate and our IT team have done a great job to ensure the effective interaction among central banks representatives taking part in the meeting, either digitally or in person.

My remarks will focus on the subject matter that central banks face daunting challenges as we exit the pandemic. In the face of an uncertain landscape, monetary and financial stability policies will need to respond with flexibility, keeping in mind the adverse legacies of the pandemic in the form of high debt, rising prices, and markets that have become used to central banks with a higher risk tolerance, willing to provide vast liquidity support at favorable terms.

The quest for sustainable recovery calls for a thoughtful balance between the necessary unwinding of policy measures and the potential adverse effects of a hasty policy adjustment. As I will discuss, either a delay in adjusting the monetary stance to address the risks derived from the current complicated inflationary environment, or speeding up this process in a heedless manner can have material consequences for central banks' risk exposures and the way such risks can be managed.

Central banks risk management during stress times

Central banks, like any organization, cannot achieve their mandates without taking on risk. Particularly, in a context of larger and more complex monetary policy operations, risk management frameworks have become an integral part of central banks' decision making, enabling the achievement of policy objectives in a risk-efficient way (ECB, 2015).

Financial risks at central banks can take multiple forms. For instance, the use of open market operations to conduct monetary policy is often restricted to credit transactions involving collateral, exposing central banks to counterparty credit risk if borrowing institutions cannot redeem a loan at maturity. Furthermore, any asset pledged as collateral is also subjected to credit, market, and liquidity risks. In this regard, central banks' operations face similar risks to the ones faced by collateralized lending operations by commercial banks. There are, however, two important differences that cannot be overlooked.

First, both the type of financial assets accepted by central banks as collateral and the lending rate charged on these transactions are determined as a matter of policy. Thus, all counterparties face the same conditions to access central bank funding, a factor that can exacerbate central banks' risk exposure considering that borrower-specific considerations cannot be applied. This characteristic of central banks highlights the importance of incorporating a risk equivalence objective across collateralized assets.

A second difference is that central banks can affect the extent of market or liquidity risk by means of their own monetary operations, changing, for instance, the expected path of interest rates or liquidity conditions in bond markets (see, e.g., Caballero et al., 2020). Therefore, when a central bank decides to adjust the monetary stance, one can expect that risk exposures will be modified not only as a consequence of idiosyncratic counterparty risks, but also from the effects of monetary policy on market dynamics.

This distinct feature of central banks has a pivotal role to play when thinking about the relationship between financial stability, systemic risk, and central banks' own risk exposure. In normal times, when markets are well functioning and liquidity is widely available, policy parameters such as collateral eligibility criteria or haircuts are less binding, given an ample availability of safe liquid assets and sound collateral. Similarly, other risk-mitigating measures based on the assessment of counterparties' financial soundness become less informative to discriminate across market agents in a context of soaring asset prices and high liquidity.

The picture naturally changes when we think about situations of high market stress (see, e.g., Ramos-Francia and García-Verdú, 2021). When facing the prospects of a systemic crisis, a central bank needs to respond in a timely way, rapidly and forcefully, that is, with a significant quantity of resources.

This is crucial for at least three reasons. First, a rapid and timely response is needed because liquidity in financial markets can "dry up" very quickly. In effect, it is well known from the experience in the last decades that, under conditions of intense systemic stress, financial markets can rapidly "freeze", as participants will have an incentive to act much more cautiously and, thus, to hoard liquidity, given the dramatic rise in counterparty risk. This can lead to very adverse equilibria. These equilibria are akin to that of a prisoners' dilemma strategic game, where, in the absence of some coordination device to reach the social optimum, all individual's incentives are not to cooperate.

Second, the amount of support should generate the general perception that it is sufficient to face the looming crisis. Indeed, the amount of resources should send a sufficiently strong signal so that investors conclude that the prospects of maintaining their asset and liability positions in the economy are better than those of exiting them.

Third, the transmission of financial stress can be particularly acute, given the nature of liquidity and credit markets, their interactions, and the plausible presence of significant negative feedback loop mechanisms. In effect, as is by now well known, there are mechanisms that amplify the effects of adverse shocks that can lead to very disruptive and costly equilibria.

Under these conditions, the capacity of a central bank to act not only as lender, but also as market maker of last resort becomes crucial, **with the direct consequence of increases in central banks' risk tolerance**. In practice, fulfilling these roles implies that, during crises, what constitutes acceptable collateral is usually modified in several ways, including its valuation, the universe of eligible assets that can be used as such, the set of institutions that can celebrate a contract entailing collaterals with the central bank, the maturity of the repos for which the central bank is the provider of liquidity, and the amount of resources that the central bank is willing to channel to support a given liquidity facility[1]. Indeed, relaxing collateral standards, for example, is what is precisely needed in most cases where there is systemic stress in markets. However, as in most cases, the key question is by how much to relax them, that is, in calibrating the policy action, since over doing it can also be costly.

From a financial risk management perspective, this type of scenario implies that risk control frameworks should put greater emphasis in achieving risk equivalence and efficiency in a context in which haircuts or collateral eligibility become less binding as a first line of defense to distinguish the chaff from the wheat. Moreover, risk frameworks should be adaptable to put their focus on idiosyncratic and market residual risks that may remain substantial even after collateralized assets have passed the sieve of risk-mitigating instruments.

Taking the heterogeneity of risk profiles across assets into account also matters to minimize possible distortive effects of central banks' decisions on relative asset prices, a dynamic that can trigger a vicious circle of moral hazard, adverse selection, and further increases in central banks' risk exposure.

Financial risk and pandexit challenges

After their heavy lifting in the last two years, central banks presently face the challenge of unwinding the widespread monetary support measures, while simultaneously managing emerging risks in the wake of global inflationary pressures derived from disruptions in global supply chains, as well as excessive aggregate demand (both fiscal and/or monetary) stimulus in some cases, and the uncertainty fueled by the war in the Ukraine.

I wanted to use this opportunity to highlight two factors that, in my view, are key to achieve a balance between the need to withdraw or even revert the extensive monetary support, while mitigating the risk of fueling further market stress by affecting firms and industries that came out of the pandemic with high debt levels and weaker balance sheets.

A first aspect to take into consideration is the cross-industry heterogeneity in financial vulnerabilities built up during the pandemic. For instance, industries that were more exposed to prolonged lockdowns or that were largely affected by global supply-chain disruptions, are likely to be more vulnerable to tightening financial conditions as interest rates

[1] This consideration is important for Latin American countries such as Brazil and Chile in which collateral frameworks expanded during the pandemic. For example, the Central Bank of Brazil introduced new repo transactions with dollar-denominated Brazilian sovereign bonds as collateral (Nechio and Serra Fernandes, 2021). In Chile, the central bank included high quality commercial loans as well as commercial portfolios with a government guarantee as collateral-eligible assets (Garcia, 2021).

increase, with the corresponding increase in refinancing cost for highly indebted firms, households, and sovereigns.

For central banks, this scenario could call for the definition of well-diversified benchmarks and concentration limits to avoid high exposures to sectors that may represent a higher risk. At the same time, central banks can consider unwinding policies with a gradual approach, for instance, by accompanying increases in interest rates with some prolonged flexibility in terms of eligible collateral and haircuts, allowing the economy to surf the wave of high inflation, while mitigating stagnation risks.

A second complementary aspect to consider is that financial risk units should also aim to arm central banks for the next crisis when adjusting risk-monitoring frameworks to the new scenario. Sustained financial losses due to an excessively lenient behavior may impose high reputational risks, potentially impairing central banks' independence. Moreover, remaining undaunted in the face of higher inflation and interest rate volatility can fuel financial losses in central banks' largely expanded balance sheets. These factors can limit central banks firepower and institutional independence when pursuing their mandates in the crises to come.

As a final note, the fiscal angle in this discussion should not be overlooked. Central banks accumulated vast volumes of sovereign debt during the crisis, both in advanced and emerging economies. This trend will likely create further political economy challenges for the interaction between monetary and fiscal policies, as the two have become more interrelated in the last years. Thus, the challenge in the near term is not only to rebuild safety margins and moderate risk exposures, but also to promote putting public finances on a sustainable path to help preserving central bank independence in the future

Final remarks

I would like to welcome you again and emphasize that this meeting is key to foster the dialogue between central banks on common challenges in their financial risk units. At CEMLA we are grateful to co-organize this year's meeting and we are looking forward to encourage further collaboration and research initiatives among central banks that can improve our common understanding of relevant challenges, especially in these uncertain times.

I wish you a fruitful discussion during the meeting. Thank you for your attention.

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