Intelligence MEMOS

From: Janet Cosier

To: Bank of Canada Watchers

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Re: **CENTRAL BANK RISK MANAGEMENT IN TIMES OF TURBULENCE**

Over the last year, the world's central banks have started to report negative equity positions, a product of sharply increasing interest rates that have created mismatches on their balance sheets.

In many instances, these mismatches have arisen because central banks are now paying higher interest rates on financial institutions' deposit liabilities (settlement balances held at the banks) than they are earning on their bond portfolios. As a result, they are reporting large net interest losses, which are expected to continue over the next few years – thereby stopping remittances of profits to governments in the foreseeable future.

Given these circumstances, questions have arisen about the ability of central banks to carry out their monetary policy mandates. Reputation and independence issues have come to the forefront.

And concerns exist regarding the financial independence of central banks and the implications for public finances of the cessation of profit remittances to governments.

My new C.D. Howe Institute E-Brief explores a number of risk governance topics for the Bank of Canada including:

- the significant expansion of its balance sheet under quantitative easing;
- the ensuing financial losses and the design options to manage these losses;
- the adequacy of capital provisions to cover financial losses;
- improvements to enterprise risk management frameworks; and
- the issues of reputation, confidence and trust.

I conclude that, in order for the Bank of Canada to be financially and functionally independent from government, it needs an earning capacity large enough to cover its annual operating costs in the future as well as sufficient buffers to absorb losses from actions undertaken during periods of financial stress.

Given this requirement, one of my main recommendations is that the government should make an additional capital investment in the Bank of Canada so it can effectively manage its current situation. The paper also provides guidance throughout to enhance the Bank of Canada's financial risk management framework to make it more robust and transparent in a world of elevated balance-sheet risk.

Central banks are considering different approaches to fund and report these losses in consultation with their respective governments. Given the drawbacks of accounting for the financial losses as negative equity – the current ad hoc approach implemented by the government in 2023 – or as a deferred asset, recapitalization of capital reserves is a more transparent structured approach for the Bank of Canada to manage its balance-sheet financial risks currently and in the future.

Taking this decisive step will strengthen the Bank's financial health, independence, and accountability and transparency.

Looking out further, the Bank of Canada and other central banks may not always have sufficient financial independence. A central bank's financial position will need to be strengthened over time to take into account changes in the external environment as well as in the scope of the Bank's operations.

From a risk governance perspective, central banks around the globe, including the Bank of Canada, are strengthening their enterprise risk management frameworks to encompass the identification of emerging risks, including emerging balance-sheet financial risks. Building the Bank of Canada's capacity and knowledge of these financial risks is critical input into the periodic assessment of the adequacy of the Bank's capital reserves and buffers.

Specifically, I have the following recommendations:

1. Review of quantitative easing program – provide estimates about the costs and benefits of this policy tool on the Canadian economy, given the large impact of this policy on government finances and other key stakeholders including the public.
2. Identify, monitor and take emerging risks into account for each of the Bank's core functions in order to assess the total financial risk exposure of the Bank's balance sheet and the adequacy of its capital reserves.
3. Enhance the focus on the emerging risks by discussing them with the finance and audit committee and the board of directors, as the need arises. To enhance accountability and transparency, on an annual basis, disclose any significant emerging risks in the Bank's audited financial statements, and discuss them in the annual report.
4. Rapidly undertake an independent review of the Bank's monetary policy forecasting tools and decision-making processes related to the quantitative easing program by external monetary policy and public communications experts.
5. Enhance communications for the public with clear, simple, concise and consistent messages deploying different tools to promote the transparency and accountability of the Bank in these turbulent interest-rate times.

Janet Cosier was an advisor to the Governor on Strategic Planning and Chief Risk Officer at the Bank of Canada, where she also served as Chief Financial Officer and as Chief Internal Auditor during her 30 year career.

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