Central Banks must be debt watchdogs

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Just as financial systems act as both lubricant and engines of market economies, we can also now see that today's leveraged financial systems are inherently unstable. That is why the state needs to be involved in safeguarding systemic stability. The social costs of a systemic failure are otherwise too high. Yet clearly early warnings were not acted upon and measures that might have mitigated disaster were not taken.

Much is now being written about the need for new regulations but this largely misses the point. What has been lacking is a framework for systemic oversight that "hard-wires" mechanisms both for sounding early warnings and providing the necessary architecture and instruments to deliver a more effective response to the build-up of systemic pressures.

At the root of the crisis is the huge increase in leverage in recent years – at the level of banks, asset managers, consumers, embedded within products, and now, increasingly, by governments. We have long known that once leverage reaches certain levels, the system can be vulnerable to shocks that cause a catastrophic loss of confidence. Once this point is reached, the result is panic and a dash for cash, creating the self-feeding vortex of reduced asset prices we see today.

Historically most financial crises have during their course destroyed 15-25 per cent of one year's national income of affected states. We risk this happening today on a global level given the joined-up nature of the financial system in the liberalised and information technology-enabled world.

What should individual states do to prevent a recurrence? First, they should ensure the architecture exists both to help limit the build-up of leverage and minimise the damage if instability ensues; and second, create an effective range of policy tools to mitigate the build-up and its impact.

None of this is easy. The power of the vested interests ranged against appropriate policy action to contain leverage build-up is intense. In good times politicians want growth, even if it is debt-fuelled. Banks want profits. Bankers want bonuses. Borrowers and consumers – voters – want to go on borrowing and spending.

We simply cannot just put the issues into the "too difficult" box.

First, we need to define the architecture by empowering under statute an independent party, with an explicit mandate to oversee the build-up of leverage and deploy the necessary policy instruments to contain it. Its responsibilities, powers and accountability should be explicit and transparent under the law, giving it the independence to stand up to vested interests for which financial instability may seem remote.

Note that this systemic oversight role differs from day-to-day banking supervision. Both are important but the systemic oversight role has been under-emphasised in recent years. In my view the party best equipped to carry it out is the central bank. The ministry of finance or treasury is too remote from the intricacies of the market and too close to the political process. Only the central bank has the necessary closeness to the financial nervous system and operational capability because it alone creates risk-free central bank money – that essential ingredient in times of stress.

Experience also suggests that people respect central banks that are able and willing to stand up to politicians and governments, as much as the vested interests of bankers and their customers.

Apart from the architecture we also need the appropriate policy instruments. This too is a challenge but in essence they need to conform to a very simple principle. The creation of the credit that leads to extra leverage should be made more expensive as leverage builds, and priced at the margin accordingly.

We have learnt during this crisis that, whatever shadow banking system may have emerged, the ultimate sources of credit creation under central banks were the banks or investment banks. In future, as leverage mounts, capital requirements for these should come under the aegis of the central bank, as is de facto the case now in the US. A system that requires higher capital requirements as leverage builds would increase the cost of credit, affecting directly the banks and then their clients, including the shadow banking system, leveraged asset managers such as hedge funds, proprietary trading desks and insurance investors – even long-only asset managers who deploy products that contain embedded leverage. This would discourage the build-up that is the source of danger. While the central bank should be the main whistle-blower and make the policy recommendation, deployment of the policy instrument could be handled by the banking supervisor where that is a separate body as in the UK.

Would it work? Or is the proposal naïve? I believe not. The basic issues are understood. The policy instruments could be created. Improved understanding of relevant policy issues has enabled us to implement independent systems of monetary policy in recent decades. Implementing these without independence too on financial stability has to my mind been at the root of the problem.

Besides, a failure to grasp the nettles that have led us to today's situation would condemn us to another bout of instability of perhaps even greater intensity within a generation. Those future generations would owe us no thanks for our insouciance.

FT Editorial - Balance the Bank

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What next for financial regulation? Sir Andrew Large made a valuable contribution to the debate this week. As a former deputy governor of the Bank of England and a former chairman of a UK financial watchdog, he has deep knowledge of the inner workings of the system.

Sir Andrew, writing in the FT, argued that the state needs to create a more effective framework to prevent systemic instability. In particular he says that central banks must have a key role. He proposes giving them an explicit mandate to assess high-level systemic risk, issue warnings and establish rules, focusing particularly on leverage.

Applied to the UK, this proposal would make the Financial Services Authority, the bank regulator, subordinate to the Bank of England on financial stability issues. The Bank is certainly the natural institution to take the lead. It is the lender of last resort and, as the current crisis has shown, rate-setting must be dovetailed with financial policy.

This would create a delicate working relationship between the Bank and FSA and the changes could be politically sensitive to push through. But allowing the Bank to alter capital requirements, for example, would give it a powerful new tool for guarding the system from asset price bubbles and shocks. The current international bank accords – Basel II – permit dangerously cavalier leveraging-up in good times.

The crisis, however, has shown all too clearly that the financial stability wing of the Bank is under-resourced. Since the 1980s, monetary policy has, increasingly, been the Bank's flagship policy area; financial stability has been allowed to wither. There are too few staff and they are too poorly paid. When Paul Tucker takes up his post as the Bank's deputy governor for financial stability in March, his first priority must be to reverse this.

The FSA also needs more resources. The Bank must have a detailed overview of institutions, markets and systems; intelligence from the FSA is the only way to achieve this. And if the FSA is to do more it will need a commensurate increase in staff numbers. Raiding the FSA to staff the Bank would be robbing Peter to staff Paul.

Even if the Bank and FSA were well equipped, however, they could do little about global problems, which can be fought only with international co-operation. There need not be a single model for enforcement, but policies such as counter-cyclical capital ratios would work most effectively if introduced worldwide. Governments and regulators must work together to prevent more years like 2008.