July 2016

SPP Roundtable Bulletin

FINANCIAL STABILITY GOVERNANCE: SOME PRESENT ISSUES

In our discussions with Governors of central banks over recent weeks the following issues are uppermost in many minds.

1. Brexit referendum

For many, the issue is not so much the event itself, but the implications for policymakers generally. These include the need for all jurisdictions to use the event as an opportunity to review the strength of their arrangements and framework for financial stability given the unpredictability of political shocks such as this.

Two aspects are relevant.

First, the example of the UK's financial authorities. The Bank of England had announced a series of measures the previous day, ie within 2 weeks of the referendum itself. These showed the benefit of the preparatory work, both in the lead up to the referendum itself, but also over the last few years in terms of securing higher levels of resilience. The fact that the PRA had required a faster build up capital over a five-year period and had conducted extensive and severe stress tests that permitted it to determine that it would be possible to use part of this as a counter cyclical buffer was highly significant.

Second, the significance of the main factors responsible for the Brexit vote and their relevance to financial stability. The issue of Europe in that context was secondary.

We now live in a world that has changed enormously. There has been significant social and political polarisation and concern about growing differences in income and wealth. Indeed the real issues in relation to a Brexit event centre on the 'rage' felt by those left behind in the last 20 years or so in both mature and emerging economies. So financial authorities need to recognise areas where the financial system itself played a role, not only in creating this rage but in particular what it could do to address it looking ahead. Brexit is in that respect a wakeup call.

The centrality of maintaining financial stability is axiomatic. This focuses attention on several factors. Firstly, even if it is stronger, the banking sector no longer has the same capacity to intermediate finance as it did before the 2007. This is partly because of increased competition from non-bank financial intermediaries and fintech. It is also partly the result of regulations rooted in the need to prevent a recurrence of the 2007 crisis. The traditional banking model is broken. There is a degree of hollowing out of banking. Meanwhile development of capital markets in Europe and the emerging markets which is so important will take many years.

Secondly the potential volatility of markets has been heightened as a result of QE and unintended consequences of the response to the zero bound. We think in terms of shocks of two or three standard deviations, but we need to prepare for the shocks to be larger: and we can no longer rely on risk models alone and must learn to live in a world of heightened uncertainty.

Thirdly the rage itself and unpredictability of populist response has been reinforced by distortions in asset prices with low investment returns arising from the QE process.

2. *How safe should the system be and who decides? What is the relevance for central bank independence?*

A general conundrum faced by all central banks and their governments is just how safe should the system be and who decides? And what does it mean for independence?

Our discussions suggest that before we answer that question we need to consider pragmatically how the financial system itself has changed, and how the priorities of the Authorities need to change as well.

On the one hand, response to the 'broken banking model' both in terms of respite for the banks, and encouragement of the alternatives needs added emphasis.

On the other, attitudes to the legitimacy of actions taken by the financial authorities need to be reconsidered. Several decades ago the problem was inflation that created a serious economic, political and social threat. Now the problem is the prospect of deflation and interest rates that are abnormally low or even negative. Furthermore, in the lead up to 2007 when monetary policy reigned supreme, the independence of central banks was regarded as desirable and legitimate to ensure price, and implicitly financial, stability. The politicians felt comfortable leaving this to the CB's.

In the new world not only is monetary policy itself inevitably intertwined with the fiscal and hence political dimension, but also the balance of policy priority has shifted towards financial stability. This shift was a response to the 2007 crisis, but now is further encouraged by the combination of QE's unintended consequences and combined populist rage [initially at the fat cats after the crisis, but after QE much more widely].

Central banks cannot avoid playing a major role in that area of policy. This has implications for the doctrine of central bank independence. As central banks have become more involved in financial stability policy, there are now calls for greater accountability Governments have a number of ways of exercising influence over central banks: by setting the financial stability remit; through the appointment process and through select committee hearings. In the financial stability area it is not possible/acceptable to operate with the degree of independence that was politically acceptable during steady state monetary policy. How in the new world is the balance to be struck?

So in deciding who should have a voice in terms of 'who decides how safe the system should be' there needs to be a pragmatic acceptance of the need to forge a consensus. Governments need to be involved of course. But central banks and other Authorities do too and with an eye on the voices of populism in the background. Our thinking about the role of the central banks – what they are capable of and what they are asked to do – needs to be revaluated.

Equally, in deciding on how safe the system may be at any given time, we need to improve our understanding of the implications of the currents around us in this new world. The systemic risk comes from a combination of QE distortions, economic unfairness, and rage. Herein lies the huge challenge facing the policymakers: the fact is that there is so much we do not understand. Our present models are inadequate.

So the relationship of the Central Bank and the State will have pragmatically to adjust. One day perhaps we will get through this and be back in calmer waters where Central Banks can both be more independent again and be seen as having a less central role.

3. Background: some further reflections

On the changing landscape

Regulatory arrangements have become too complex It better to be pragmatic than dogmatic.
Low interest rates mean that in current value terms banks should be thinking far into the future. However, they are very myopic.

On the determinants of financial stability

The current level of interest rates makes traditional banking difficult in both developed and emerging markets. In the latter the larger interest margins makes life difficult for the vital SME sector as the engine of growth. Capital and liquidity there to support lending to the sector but there is “Water, water everywhere and not a drop to drink”.
The process of QE and the growth of the central bank balance sheets have altered the financial landscape. There is ample capital to support credit liquidity but little demand for it.
Serious questions remain about the capacity of both cash and futures markets to cope with any potentially massive exit of funds from markets in response to shocks. Vulnerabilities may lie within CCPs, which have become super-systemic and yet compete strongly with one another so that clearing margins are thin.
There is an imbalance in the attention given to risk and uncertainty, with relatively more attention to risk, which can be monitored, measured, modelled and managed. Uncertainty is more difficult to manage in this way; technocrats spend too much time on the boiler room and not enough time in deck looking for icebergs.

On growth and financial stability

Despite the danger of market discontinuities it remains difficult to identify “tipping points”. It helps to think of financial stability more as a continuum, and to be ready for sometimes large, unexpected and self-re-enforcing shocks.

The idea of a trade-off between growth and stability is too simplistic. The starting point is the need to understand of the determinants of both growth and stability.

Topics for further discussion

There are two areas for consideration:

1. As an extension of the above discussion. What are the unintended consequences of QE for financial stability and how should policymakers be adjusting to these? What can be done to ensure financial stability?

2. How reliable will ‘gone concern’ capital prove to be? Debate as to the primacy of ‘real equity’ and the issues which might impact the reliability of bailed in debt to convert to equity ‘on the night’ is central to understanding how the question of the relationship of the financial system and the State will develop in years ahead.