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THE IMPLICATIONS OF DISINTERMEDIATION FOR CENTRAL BANK POLICY

Banks' deposit taking, credit provision and payment services, together with their risk management, foreign exchange operations and investment banking activities, are essential for the operation of a modern economy. The growth of digital technology and the spread of tokenisation could lead to significant disintermediation of the banks – and possibly central banks – in the provision of these services.

Disintermediation may be welcome. If the financial system is to serve society well, it must surely be open to competition from new entrants and evolve so that society can have a more efficient – and cheaper – financial system. The historically high profitability of financial firms, supposedly reflecting their absorption of risk, could be a consequence of market failures, information asymmetries and the lack of meaningful competition.

Our concern here is the challenges that central banks face. As financial transactions increasingly occur outside traditional banking, the effectiveness of monetary policy is at risk of being compromised. The growing prominence of private digital currencies and non-bank financial institutions could reshape the financial landscape, demanding a reevaluation of existing regulatory frameworks and what central banks can and should do to foster financial stability.

Prospects

Activities undertaken by traditional banks are now being offered by a variety of new players in a multiplicity of ways. These include:

- Trading and market-making undertaken by hedge funds or similar entities (e.g., Citadel).
- Non-bank credit provision by venture capitalists, private equity and hedge funds, and peer-to-peer lending systems.
- Money market funds offering products akin to deposits.
- On-line payments systems including cross-border (e.g. Revolut, Wise).
- Alternatives for store of value and payments in the form of cryptocurrencies and other new forms of financial instrument.

Tokenisation is of a different character. It is the least developed but potentially the most consequential of the technological innovations for central banks, particularly if it occurs through permissionless systems outside their purview. Not only can it provide for settlement without the use of central bank money, but it can also, if programmable, merge the entire chain of operations involved in financial or commercial transactions.

Take for example a standard transaction involving a publicly traded security. It will involve the following activities

- Issuance
- Listing
- Trading
- Securities settlement
- Payments settlement
- Delivery
- Custody

In principle all these steps can be performed by a programmable token, implying a massive increase in efficiency. For central banks, the most significant feature is that settlement can (but need not) take place without reference to any item on their balance sheets. If it does, that implies not only disintermediation of the banking system but of the central bank itself.

One can look separately at the policy areas of monetary policy and financial stability, and then examine disintermediation through a geopolitical lens.

Monetary policy

Innovation and disintermediation have been going on for decades. Central banks have been able to, and can still, conduct monetary policy by operating in the markets for Treasury and other securities. It is the banks that face the challenges. In short, monetary policy can still be conducted even if banks are disintermediated, as long as central bank money constitutes the ultimate means of settlement. If however, tokenisation was to lead to significant changes in this, central banks could face a loss of effectiveness.

Central Bank operations can and do take place in the wider market, including with non-banks, some of which have been given access to the central bank balance sheet (e.g. special deposit facilities for large cash players, and repo facilities for money market funds in the US; the opening of accounts for investment banks and some market infrastructure providers at the Bank of England). The widening of access to central bank standing facilities could enable continued control of interest rates as long as central bank money remained the ultimate means of settlement.

One issue is the speed of transition and whether the authorities will be quick enough to make necessary changes to take account of the new environment and respond to its implications: the historical approach of relying on authorised banks as the sole class of counterparties may not be sustainable.

In addition, the relative lack of confidence in central banks following the recent bout of inflation and other (perceived) missteps adds to the difficulty. Any loss of credibility would mean that price expectations would be less well-anchored and hence inflationary control more costly in terms of interest rate volatility. Warnings about financial stability risks could be increasingly ignored.

Financial stability

The conduct of policy in relation to financial stability requires a framework which recognises that no single party can deliver stability on its own: it needs an overarching view with common or compatible objectives and agreed roles and responsibilities for all the the parties concerned: ministry of finance, central bank, and regulators, both prudential and conduct.

The question is whether and how this framework can be adapted appropriately and fast enough to handle the many changes that may be needed to engender instability.

To understand the implications of disintermediation for financial stability, it is useful to consider it in terms of macroprudential oversight, microprudentual regulation and supervision and recovery, and resolution.

Macroprudential oversight

The issues here are whether horizon scanning will be effective enough to identify new threats to stability arising from disintermediation and whether the policy response will be sufficient to mitigate them. When the financial landscape is changing rapidly and fundamentally, there is a real risk that instability just cannot be seen with sufficient clarity or certainty. This makes it hard to justify the often-unpopular measures needed if mitigation is to work. For example, there is clearly a risk of a sudden collapse in the value of crypto currencies – not least if new, tight regulations are brought in to protect 'retail' investors or perhaps if major central banks introduced their own digital currencies.

The bigger the growth of private crypto currencies, the more systemic the issues could be following a collapse. On the other hand, waiting for a crisis to happen and then clearing up afterwards may not be seen as an acceptable strategy. So, the emphasis is on better scanning, intelligence and cooperation with the private sector.

Microprudential regulation

This includes conduct, market and prudential regulatory action. The main issue here will be whether individually or collectively the different regulators are quick enough to find ways to deliver required outputs and actions among the new players whose behaviour might otherwise generate instability. There is a risk that new regulations via orthodox channels will drive activity from the banking sector into the non-banks where there is less regulatory control. Extending the regulatory perimeter will be neither easy nor popular – until it is justified by a costly occurrence of crisis.

Recovery and resolution

An ingredient in avoiding panics and instability is confidence that there is the ability and will to restore stability in the event of failure. This requires ongoing trust in mechanisms to inject liquidity and prevent contagion. Given their unique Lender of Last Resort capabilities, Central banks play a vital role in this domain. The question is whether there will be legitimacy and political agreement through legislation to develop the necessary framework and make reforms in the face of the changes in the environment.

There is already little appetite to rescue banks, especially in the US. Rescuing non-banks, or even providing LoLR or secured support, may not be politically feasible, even where it is legal. Innaddition recent structural changes in long term insurance with the advent of major activity from providers of private capital and disintermediation of the traditional structures are a new source of systemic risks.

In addition, support measures require preparatory action by the rescuer and the institutions that are to be rescued. This may be in the common good, but it will be resisted by the potential recipients if they perceive preparation to be costly or otherwise detrimental to their interests.

The concept of 'same business, same risk, same regulation' may be accepted. But the political will to make the changes in law and practice to achieve it may lag behind what is needed. Part of the problem is that the public, politicians and business tend to be tolerant of risk before an event, and highly critical of such a laissez faire approach if and when the risk crystalises. And different jurisdictions are taking different approaches. China will naturally be more controlling, while the EU tends to be risk-averse, but the US is more complex – with a multitude of authorities with different risk appetites, but generally in the direction of being less regulated. For example, the US never implemented the Basel regime for all its banks for example, only for the larger banks, unlike Europe. And the election of Donald Trump to the Presidency adds further uncertainties.

The global agenda

The fragmentation of the global commercial and financial arrangements may lead to significant disintermediation, particularly of clearing and settlement arrangements involving the US dollar, which has been the linchpin of the international monetary system since that last world war. Given the dominant position of the dollar, it is tempting for the US authorities to use it for political agendas through the imposition of restrictions on its use. However, sanctions on adversaries enforced by payments restrictions and tariffs will divert trade invoiced in dollars and lead to the use of other currencies and settlement systems. The number of transactions taking place without reference to the dollar is growing and noteworthy. Gold has been one beneficiary, as central bank buying is partly responsible for driving its price to successive record highs during 2024. India, Brazil and Russia have all moved into payments intermediated through new technology. Moreover, increasing US government debt could add to the erosion of confidence in the dollar, particularly if people begin to work with multi polarity, and alternatives are available.

Conclusions

Disintermediation is an immediate and likely ongoing threat, with a rapid pace of change being seen. This should not create an insurmountable problem for central banks, but it will need to be addressed – including by legislators – and without too much delay.

The challenges for financial stability are likely to be greater than for monetary policy. Tokenisation has the potential to have a great impact both in making the financial system more efficient and in its implications for central bank policy, particularly if it leads to disintermediation not only of banks but also of the central bank. Meanwhile, the fragmentation of international economic relations threatens to undermine the existing international monetary order, accelerating the use of new technology across borders.