Elephants in the Post-Crisis Regulatory Room?

PEFM Presentation, Oxford
February 12, 2018

Piroska Nagy-Mohacsi
Programme Director & Senior Research Fellow
“I can’t thank enough the central banks and policy makers of the world for pulling off this incredibly complicated act by injecting US$11 trillion liquidity [pause] and not in an unthoughtful way ... What you have done for us investors is incredible...”

Senior JP Morgan representative in Davos on the closing macro-outlook panel, just after President Trump
Outline

1. Where are we in post-crisis regulation?
2. Are there elephants we are not seeing?
   1. “Known unknowns”
   2. ”Unknown unknowns”
   3. ... “Not-wanting-to-knows”?
So let’s see if there are any elephants around…
Crisis Prevention: Extensive post-crisis regulatory reform…

- **Micro-prudential**
  - Quality and quantity of capital (RW)
  - Leverage ratio (LR)
  - Liquidity coverage ratio (LCR)
  - Net stable funding ratio (NSFR)
  - Resolution mechanism/Total loss absorbing capacity (TLAC) targets

- **Macro-prudential**
  - Countercyclical cap buffer
  - G-SIBs; D-SIBs capital req
  - Lending standards (LTV, LTI etc)

- **Business model restrictions**: Volker rule on proprietary trading, Vickers commission on ring-fencing retail activities;

- **Other**: pay limits, governance…
Banks are better capitalised and much more liquid

Source: Structural Changes in Banking after the Crisis, BIS CGFS January 2018
Reduced bank balance sheets – except for China

Banking system assets to GDP

In per cent

Source: Structural Changes in Banking after the Crisis, BIS CGFS January 2018
MacroPru’s short term record?

- Growing use of macroprudential tools since the financial crisis, though little evidence on how effective they are (e.g. at stabilizing lending during stress)
- Evidence domestically: Iceland, Croatia, Spain…
- Internationally: new paper by Elod Takats/BIS and Judit Temesvary/US Fed asking if countries with stronger macropru did better during the 2013 QE “taper tantrum”
... MacroPru has helped

- Macroprudential tools applied in borrower countries did stabilize the taper tantrum related lending shock

- Stabilization is stronger for measures in advanced economies. Maybe due to better institutions/ enforcement and credibility

- Effect is present both in bank and non-bank lending: nice positive regulatory spillover
Yet big issues persist

- **Too much regulation?**
  - Multiple problem – multiple instruments
  - Compliance issue for small bank & entry
  - Maybe also “MacroConduct” not only “MacroPru” because of short-termism leads to risky behaviour. Only credit boom with “flash” ST strategies create crisis (Kevin James et al 2017)

- **Is regulatory capital sufficient?**
  - “Optimal”: Tier 1 ~ 16-19% (RW) - Today 2/3 of G-SIBs and D-SIBs have less
  - Does higher capital result in less lending? Good news: **No** (Cecchetti 2014); **Positive** for lending and lowering risk premium (Hyun Son Shin 2017)
  - Trade-off: capital – credible resolution mechanism TLAC (Haldane 2017)

- **Is the Too-Big-To-Fail problem solved?**
  - No (my view)

- **New system-wide risks?**

- **Complicated political economy of central banks**
  - Deeper into political territory; joint tasks with fiscal authority
  - Central bankers are primary target of populism
Elephant No1: Bank Size

Sometimes, even if I stand in the middle of the room, no one acknowledges me.
But banking sector concentration has generally increased

Banking system concentration, share of system assets of 5 largest banks

Source: Structural Changes in Banking after the Crisis, BIS CGFS January 2018
Bank size – is “bigger more efficient”? Evidence from post WW2 West Germany

- Post WW2 in 1947 Allied Forces broke up the 3 largest German banks for financing the Hitler regime (Deutsche, Dresden and Commerzbank) into 30 state banks
- Subsequently gradual reunification were allowed: in 1952 into 9 larger units and in 1957 all restrictions were lifted and the 3 large systemic banks recreated (as W Germany regained sovereignty)
- Kilian Hubert/LSE studied this natural experiment asking whether reunified large banks were better for growth and efficiency (2017)
Bank size – results

- Larger size after the 1957 reunification did not increase cost efficiency or lending to clients —> no efficiency gains or positive impact on the real economy
- No positive employment impact
- Big banks became more risk takers, maybe related to moral hazard or bank-internal agency problems
- But media presence jumped, with more lobby power for the large banks —> increased empire building despite no efficiency gains and more political influence
Elephant No 2: China risk

"Whenever I walk in a room, everyone ignores me."
China’s banking sector exploding post GFS, though still mainly domestic

New research by Cerutti & Zhou, IMF

China has by far the biggest banking sector

Though most is domestic, external claims are rapidly rising

Sources: Cerutti & Zhou: The Chinese banking system, VoxEU, February 2018; BIS, ECB, IMF

Source: BIS, External claims, 2017 Q2
China’s financial claims rising on many EMDEs, had-in-hand with trade & FDI

Sources: Cerutti & Zhou: The Chinese banking system, VoxEU, February 2018; BIS, ECB, IMF
China risk

- While external financial linkages are most systemic in EMDEs, some of it is quasi-aid (Reinhart 2017)

- The real issue is the financial contagion of any major shock in the domestic system to advanced economies: see the Shanghai stock exchange “shock” in early 2016

- Cleaning up and transforming China’s giant banking sector is a global concern - and interest
Elephant No 3: Digital currency & cyber risk?
Digital or crypto currencies (CCs)

- Semi-private monies exploding since 2009 with blockchain tech
- Bitcoin & other CCs
  - market valuation is US$520 bn at end January 2018 (down from US$830 bn in a month);
  - there are in total 1,474 CCs (up from 682 in a year earlier)
- Not all the same construct
- Very volatile as speculative demand has risen

![Figure 1. Bitcoin price](source.png)
Regulatory crack-down?

Main regulatory arguments:
• CCs do not fulfil the criteria of money (unit of account, accepted medium of exchange, store of value)
• Private money is historically proven unsustainable
• Uninformed consumers and investors need protection
• Technology/business model too disruptive to banks (sic!)
• Maybe relatively small today, they can become quickly systemic
• Money must be central bank monopoly for good reasons
• Illegality, criminality

Road to regulation:
• Augustin Carstens/BIS 02/05/2018: “Bitcoin is a combination of a bubble, a Ponzi scheme, and an environmental disaster.”
• Yves Mersch/ECB at LSE (two days later): a bit more balanced on the technology benefits
• Exception to date: BoE “no material risk”
• G20 announcement in Buenos Aires in mid-March
Is a crack-down really justified?

- Money is ultimately about social trust and historically needed large balance sheet behind it (governments). But in still a lot of countries inflation-erosion by central authorities remains a problem.
- The underpinning technology blockchain is superb to store and transfer value fast and safely, without a need for counter-party checks.
- Competition is good for innovation (governments are not).
- Industry disruption is a non-argument for substance, only for speed.
- Market signals of excessive risk taking are vital to educate investors. Why a paternalistic approach?
- Some regulation: yes. But don’t over-regulate and don’t protect the status quo in the financial system.
Is this crack-down really justified?

New research by Ousmene Mandeng/LSE (forthcoming)

- Historical analysis of private monies in Germany in second half of 19th century
- Germany adopted a **mixed central banking model** with co-existence of public/central & private monies
- Central bank quota was market dominant 85%
- Private money issue by the 30+ authorised state level private banks was regulated
- Main reasons: not trusting only 1 bank (even if federal); local development; competition; innovation
- Last private note issues in 1934.
Conclusion - with question-marks

- Massive amount of time and energy gone into post crisis regulation, and there are definite improvements at the individual bank level.
- But are macro/systemic level risks materially reduced? Do regulators focus on the right systemic risks?
- Is the system as a whole more resilient, ie adaptable to rapid change and better learner from mistakes?
- Are there risks of vested interest and regulatory capture, particularly in the face of technological change with the potential to innovate and disrupt the traditional banks?
On a final note: the “real elephant” in the room of democracies.

The most powerful chart of the last decade: Globalisation as an Elephant. @BrankoMilan

Figure 4. Change in real income between 1988 and 2008 at various percentiles of global income distribution (calculated in 2005 international dollars).
THANK YOU!