Elephants in the Post-Crisis Regulatory Room?

PEFM Presentation, Oxford
February 12, 2018

LSE Institute of Global Affairs

Piroska Nagy-Mohacsi
Programme Director & Senior Research Fellow

Motivation

“ 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”?
3. Are financial systems safe/safer? Wrong question. Are they more resilient? Right question. Hmmm…

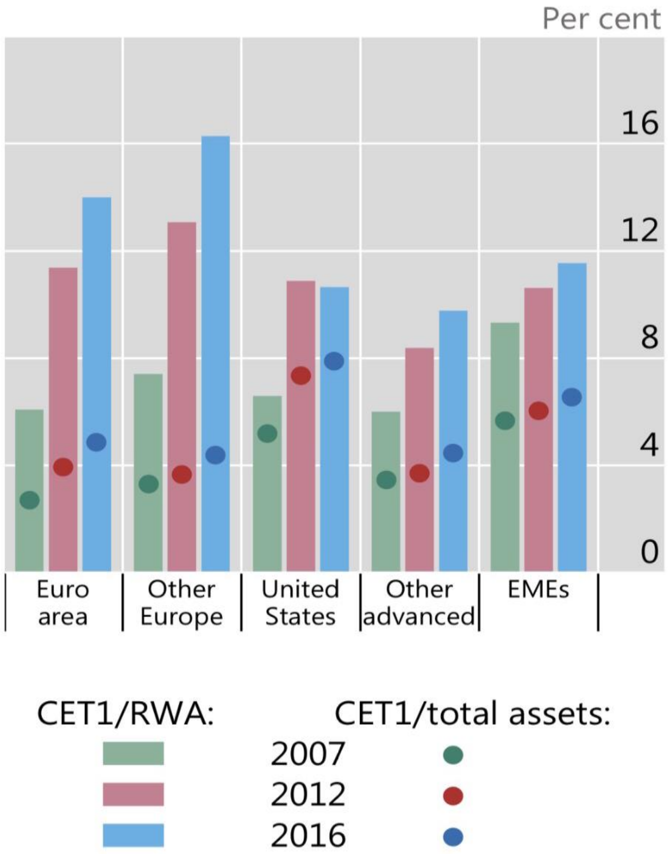
So let's see if there are any elephants around…

Crisis Prevention: Extensive post-crisis regulatory reform…

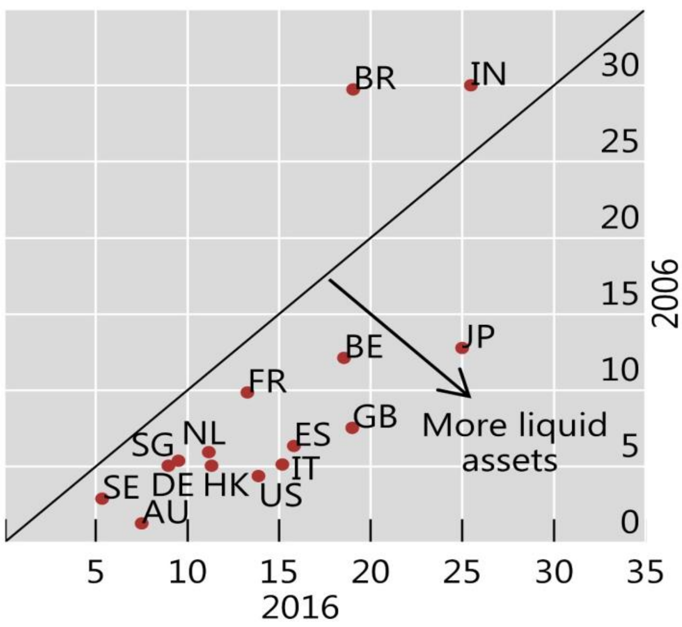
- **Micro-prudential**
  - Quality and quantity of capital (RW)
  - Leverage ratio (LR)
  - Liquidity coverage ratio (LCR)
  - Net stable funding ratio (NSFR)
  - Resolution mechanism/Total loss absorbing capacity (TLAC) targets
- **Macro-prudential**
  - Countercyclical cap buffer
  - G-SIBs; D-SIBs 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

Bank capital ratios[1, 2]

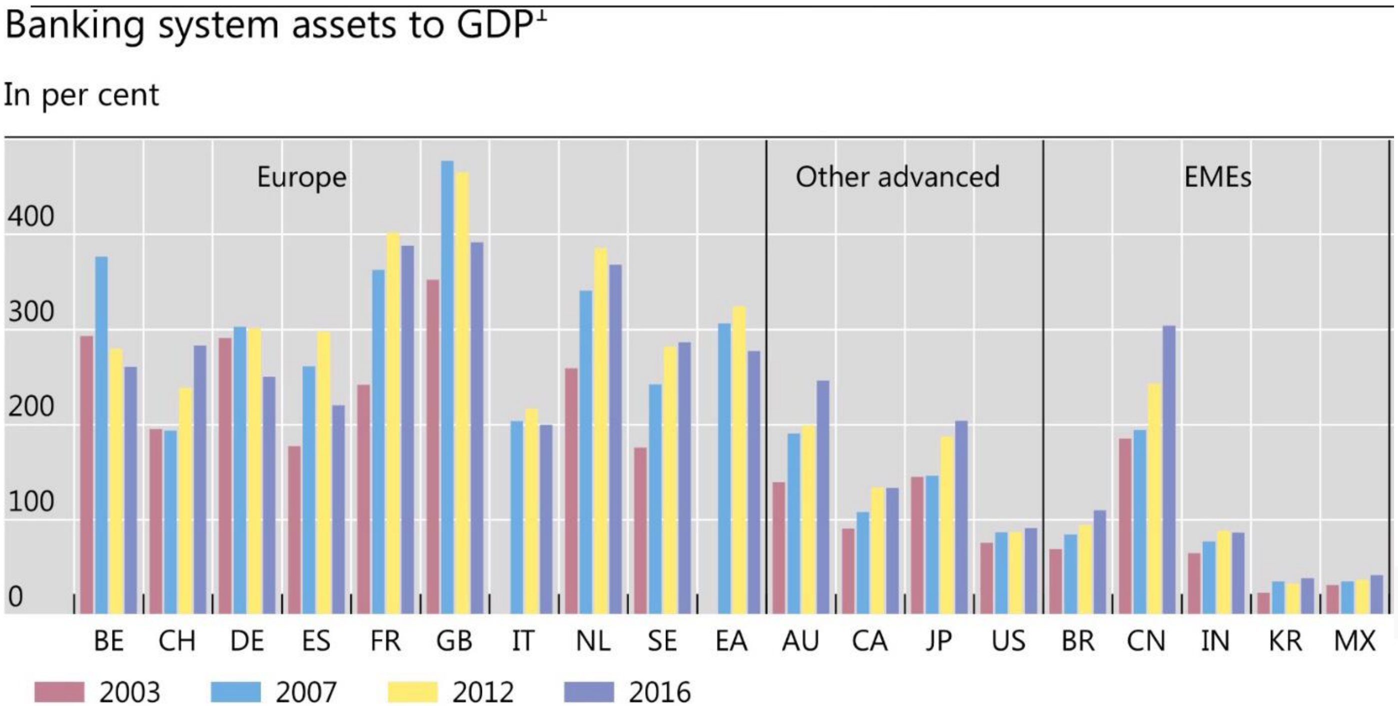


Share of liquid assets in total assets, in per cent[1]



Source: Structural Changes in Banking after the Crisis, BIS CGFS January 2018

Reduced bank balance sheets – except for China



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

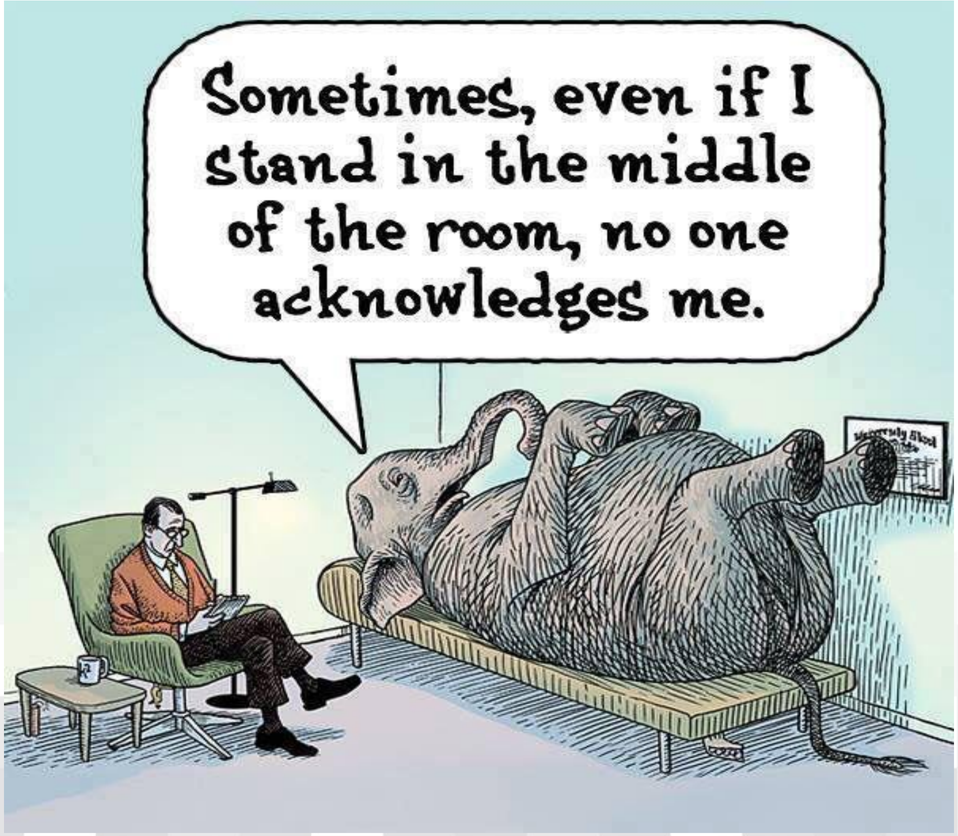
- Stabilization is stronger for measures in advanced economies. Maybe due to better institutions/ enforcement and credibility

- Effect is present both in bank and non-bank lending: nice positive regulatory spillover

Yet big issues persist

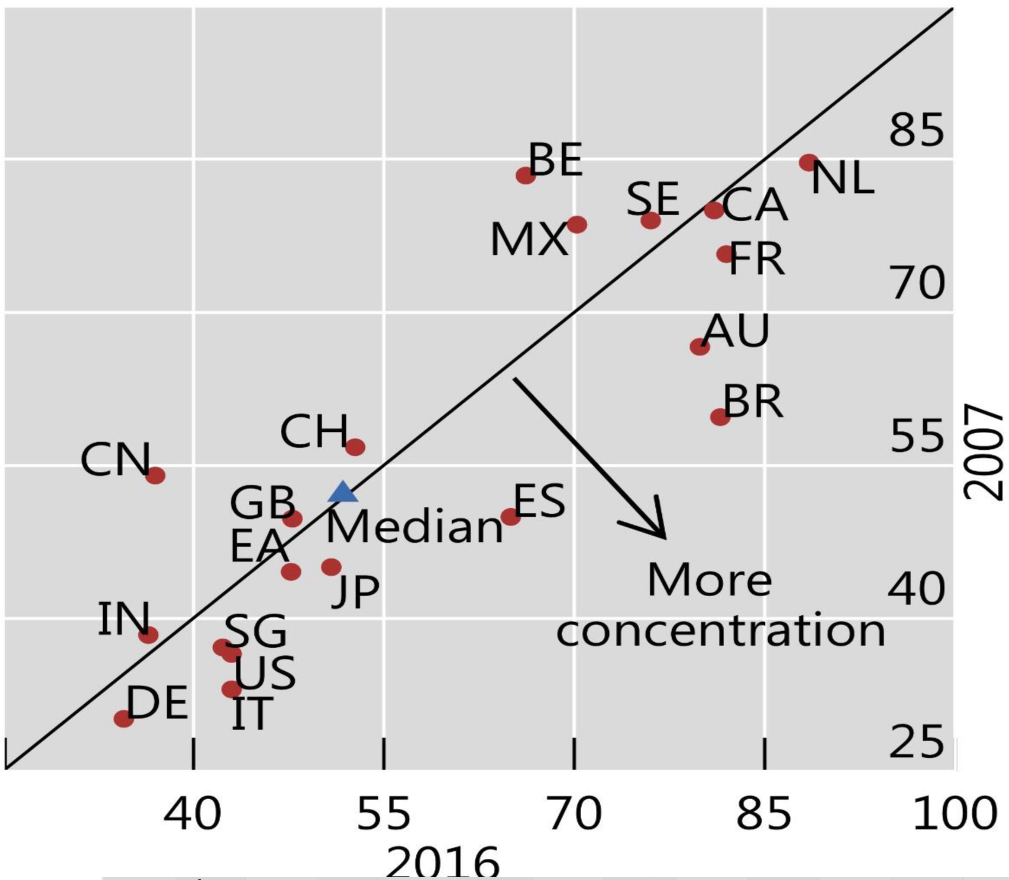
- **Too much regulation?**
  - Multiple problem – multiple instruments
  - Compliance issue for small bank & entry
  - Maybe also ”MacroConduct” not only ”MacroPru” because of short-termism leads to risky behaviour. Only credit boom with “flash” ST strategies create crisis (Kevin James et al 2017)
-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



But banking sector concentration has generally increased

Banking system concentration, share of system assets of 5 largest banks[3]



Source: Structural Changes in Banking after the Crisis, BIS CGFS January 2018

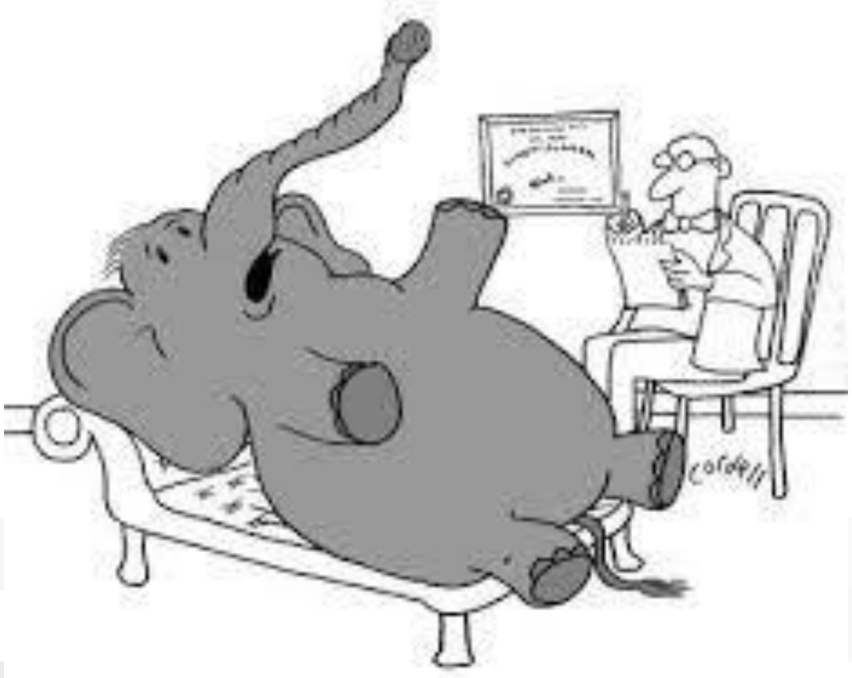
Bank size – is “bigger more efficient”? Evidence from post WW2 West Germany

- 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

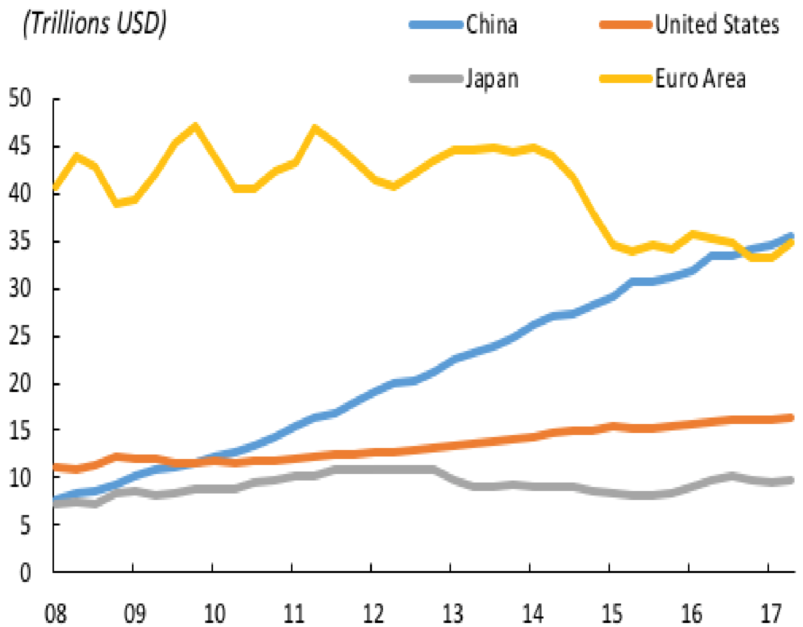


"Whenever I walk in a room, everyone ignores me."

China's banking sector exploding post GFS, though still mainly domestic

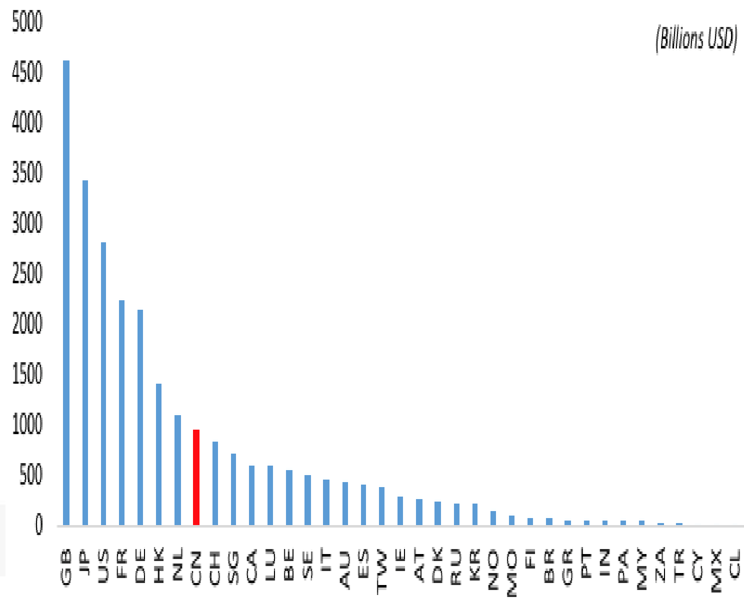
New research by Cerutti & Zhou, IMF

China has by far the biggest banking sector



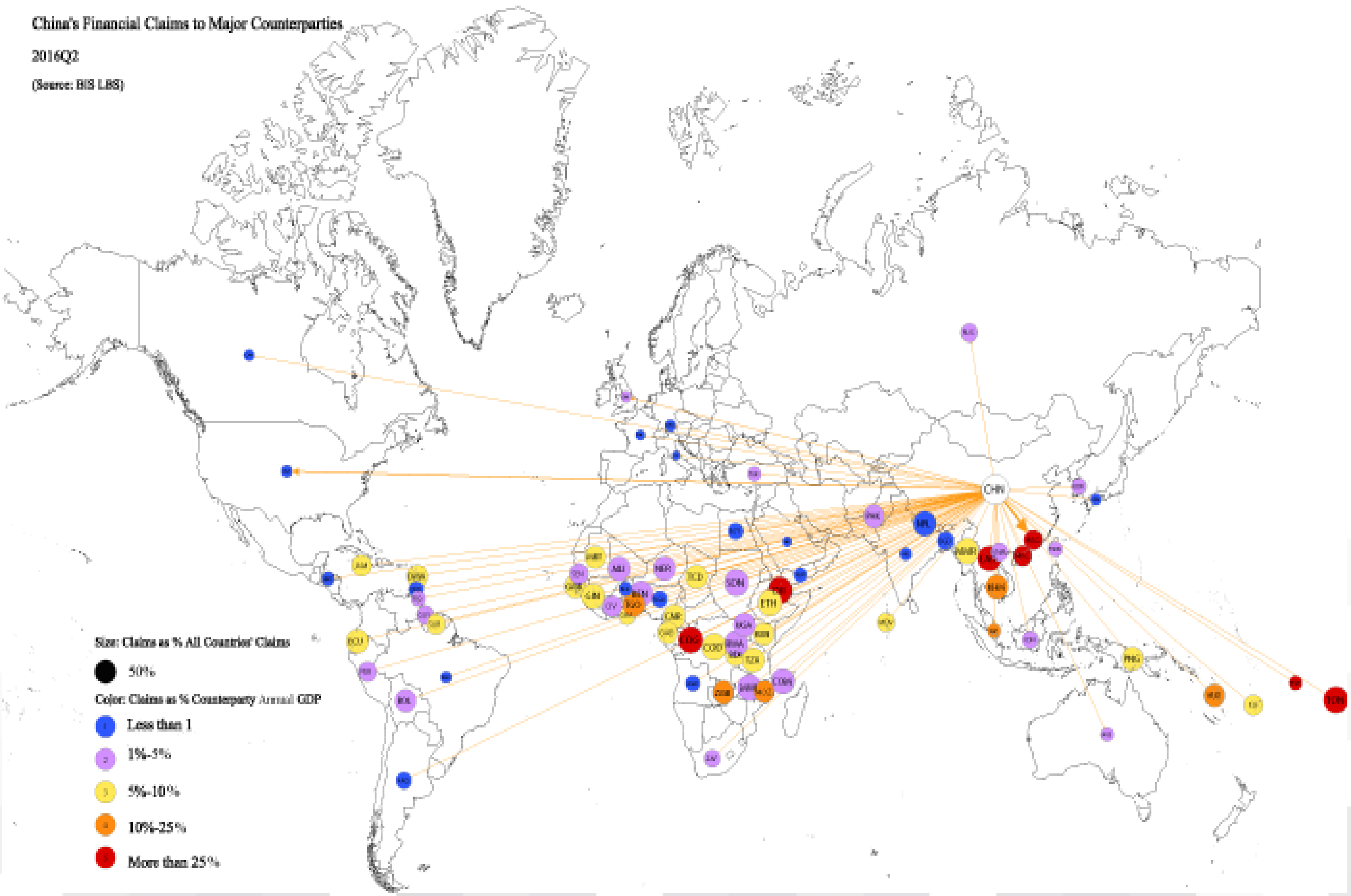
Sources: Cerutti & Zhou: The Chinese banking system, VoxEU, February 2018; BIS, ECB, IMF

Though most is domestic, external claims are rapidly rising



Source: BIS, External claims, 2017 Q2

China's financial claims rising on many EMDEs, had-in-hand with trade & FDI

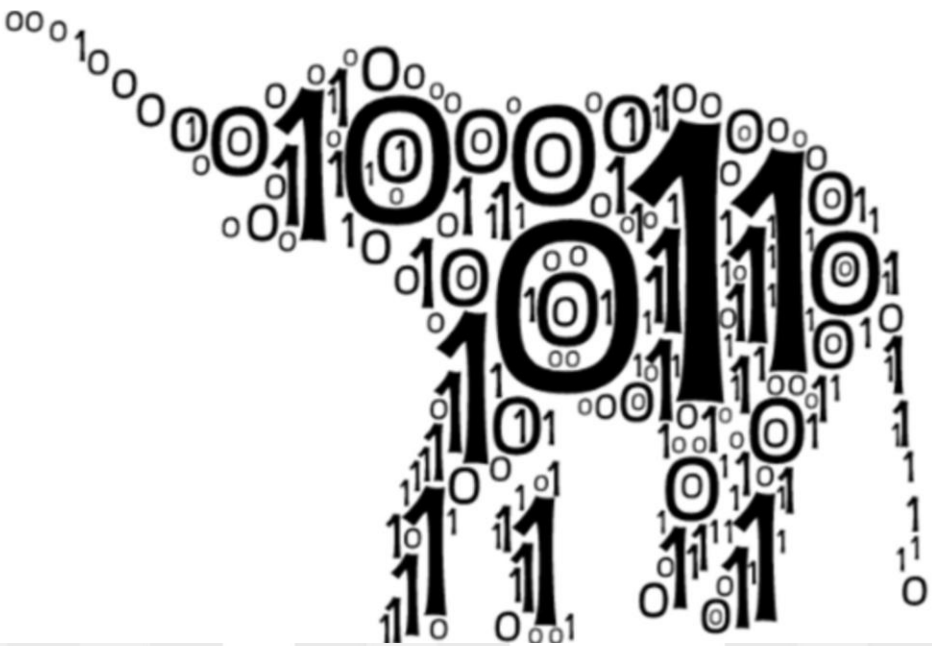


Sources: Cerutti & Zhou: The Chinese banking system, VoxEU, February 2018; BIS, ECB, IMF

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

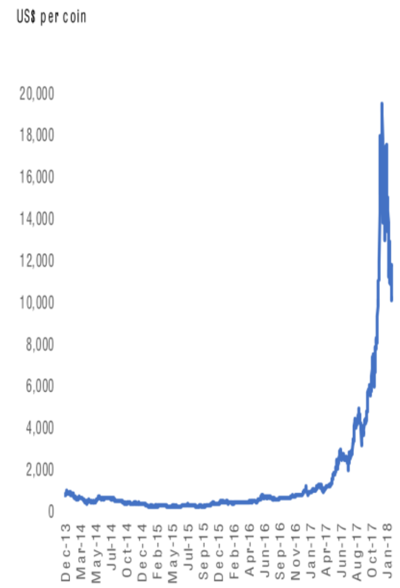
Elephant No 3:
Digital currency & cyber risk ?



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: Coinmarketcap.com. Through 31 January 2018.

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.

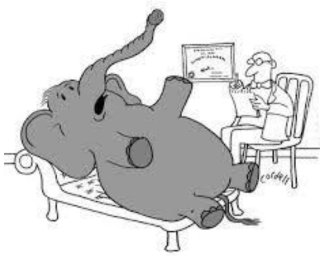
Is this crack-down really justified?

New research by Ousmene Mandeng/LSE (forthcoming)

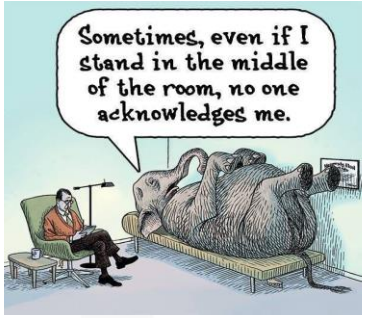
- Historical analysis of private monies in Germany in second half of 19th century
- Germany adopted a **mixed central banking model** with co-existence of public/central & private monies
- Central bank quota was market dominant 85%
- Private money issue by the 30+ authorised state level private banks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

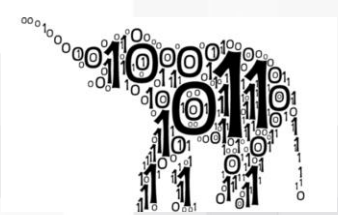
Conclusion - with question-marks

- 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?



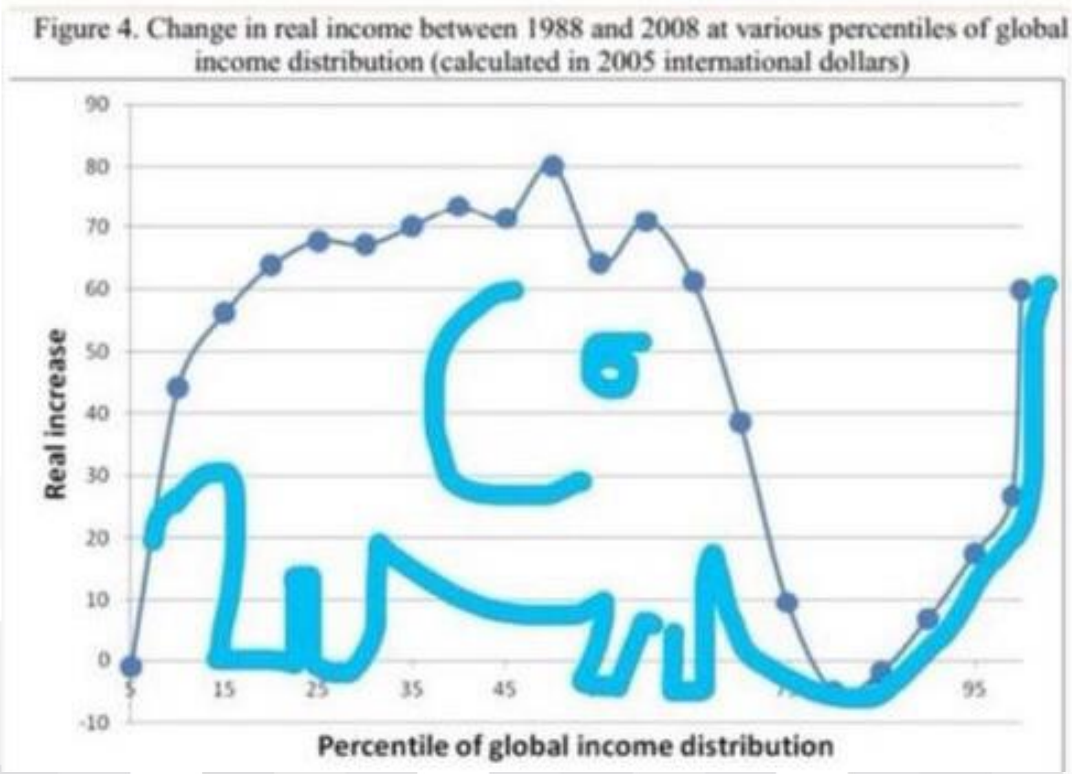
"Whenever I walk in a room, everyone ignores me."





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



THANK YOU!

LSE Institute of Global Affairs