New Economic School

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FINANCIAL STABILITY: OUT OF THE WOODS?

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2008 FINANCIAL CRISIS

Preliminary observation: Finance is indispensable

- allows households, firms and administrations to borrow and hedge against risk
- also creates savings products for these actors

What went wrong?

- Financial bubbles (e.g. on real estate in US and Spain) fueled by excess liquidity were left untamed
- High leverage and maturity transformation $\Rightarrow$ financial institutions were fragile
- Evasion of capital adequacy requirements (e.g. risk moved off-balance-sheet)
- Expectation of public bailouts- which happened even in the shadow banking sector
- Useful products and processes (derivatives- e.g. CDSs-, securitization…) were transformed into toxic ones

WHO IS TO BLAME? (1) The state's responsibility

In the end, the financial crisis of 2008 was a *crisis of the state*, disinclined to do its work as regulator

- Economic actors react to the incentives they face
  ⇒ the least scrupulous actors exploit gaps in the regulation to swindle investors and take advantage of the public safety net.

WHO IS TO BLAME? (2) The economists' role

- *They had studied many of the causes of the financial crisis*: asset bubbles, excessive maturity transformation, capital requirement evasion, excessive securitization, OTC markets, etc.
- *However they had little success in preventing the crisis. Why?*
  - Piecemeal diffusion of academic knowledge
    - ✓ in part economists' fault. Question: definition of their mission?
  - Mostly unaware of magnitudes
    - ✓ off-balance-sheet exposures, correlation of OTC contracts, etc
  - A few economists oversold virtues of deregulation, financial innovation and OTC markets
  - Economists will always be more at ease identifying factors leading to a crisis than predicting (the date of) its occurrence. Analogies: physicians, seismologists.

  Uncertainty magnified by self-fulfilling phenomena.

TEN YEARS AFTER: HAVE WE LEARNT THE LESSONS?

Our financial system is still quite fragile

- Despite substantial progress in the framework
- Framework is one thing; the devil is in the details
  - national implementation
  - actual supervision.

Hazards vary across countries, we will discuss most common ones.

THE NEW RULES (BASEL III, BRRD, Dodd-Frank…)

Progress in the framework:

1) Better supervisory infrastructures (Fed, ECB)
2) Higher capital adequacy requirements (CARs)
3) Countercyclical CARs
4) Increased emphasis on exchanges, reduced use of OTC markets
5) Broader bailinability
6) Liquidity requirements (e.g. liquidity coverage ratio)

CHALLENGES (1) DEREGULATION

An example among many: the US

- Projects to repeal Dodd Frank (consumer protection, Fed stress tests…)
- Intention to call into question international regulations (CAR…)
- Subprimes are back: Federal Housing Administration's mortgage market (less creditworthy borrowers)
    - Market share of shadow banks has increased from 20% to 75%
    - Shadow banks sell their originated loans to GSEs
    - Low skin in the game: shadow banks keep 5% on balance sheet (5 times this for regular banks in US)
    - Highly dependent on government sponsored enterprises (85% of loans are sold to GSEs).
- Risky leveraged/covenant-light loans by shadow banking

More broadly

- Permissiveness in good times (banking regulation, sovereign debt).

CHALLENGES (2) POLITICS

Public's economic illiteracy, together with frustrations and fears

- all over the world facilitate populists' call for bad economic policies

Illustration #1: reconsideration of central bank independence

- US president's criticisms of the Fed
- European populists' call for ECB's "accountability"
- India prime minister's repeated conflicts with RBI
- Turkey, South Africa
- The case of Russia

WHY CENTRAL BANKS MUST BE INDEPENDENT

- *Monetary policy*: Independent CBs better at controlling inflation. Politicians demand
  - Easing prior to elections ("pump priming")
  - Lower interest rates [which central bankers deliver in crisis times, but reason must be economic, not political]
- *Prudential supervision of banks*. Independent CBs better at
  - Maintaining capital standards
  - Closing politically connected banks, fighting corruption and money laundering

Even central banks with a record of independence are not immune to the threat

- Large balance sheets (bond buying, etc) test independence of monetary policy and supervision (US, Eurozone)

Illustration #2: Bank ownership and resolution

Two distinct hazards of public policies: non benevolence and lack of commitment. Each generates distortions.

State control $\Rightarrow$ *appoints friends and takes decisions that are bad for society*

- Politically appointed manager not always up to the task
- Policies may favor officials: Pressure on firm to achieve political goals at the detriment of efficiency
- Policies may favor firm insiders and public finances: reduction in competition (state as owner and regulator)
- Breeding ground for corruption

Implicit state guarantee

- reduces incentives for managerial performance
- destroys the level-playing field with the private sector [China: bypass through big data and Fintech: Ant Financial]

THE ROLE OF THE STATE

In my view, the modern state

- is a referee, not a player
- corrects market failures [equal opportunity- education and health-, redistribution, competition policy and regulation, consumer protection, environmental externalities , internalities..]
- finances the infrastructure and public goods.

CHALLENGES (3) CREDIT BOOMS & ASSET PRICE BUBBLES

This time is different?

- Traditional asset bubble: real estate
- Emerging markets (e.g. Turkey, South Africa, Indonesia, Latin America)
  - Crisis and QE in rich countries $\Rightarrow$ search for yield $\Rightarrow$ capital inflows in emerging countries (often borrowing in \$) $\Rightarrow$ large increase in consumption and investment (current account deficits)
  - Recovery of rich world, end of QE, appreciation of \$ $\Rightarrow$ sudden stop?

The case of cryptocurrencies

Distinction between blockchain and Bitcoin/other cryptocurrencies.

Positive side:

- Bitcoin is a pure bubble (unbacked money). Highly volatile also.
- and like open source programs, it may fork: nothing new again here.

Normative side: social value is elusive

- too often used for tax evasion, illegal activities, or money laundering
- seignorage, instead of going to the public,
  - either goes into private hands (ICOs)
  - or is fully wasted (equipment and electricity wasted in the race to mint new Bitcoins).
- countercyclical policies in a world of private cryptocurrencies?

CHALLENGES (4) HOLDINGS OF SOVEREIGNS

Risky sovereigns holdings by banks raise two distinct issues

- *Cheap risk taking by banks in general*

  [low yield, but zero risk weight and level-1 liquidity in liquidity coverage ratio]

- *Cheap risk taking by domestic banks: the doom loop*

  The example of the Eurozone (but broader pattern)

  - Initial story of the Euro = financial integration
  - Re-segmentation of financial markets in Eurozone

    [true more generally: evidence shows that during sovereign defaults, banks increase their exposure and phenomenon is concentrated in large (TBTF) banks]

  - Lack of diversification is an instance of moral hazard.

WHAT SHOULD WE DO?

Long-term

Change capital-adequacy rules

- Positive risk weights
- Concentration charges [should be higher when invested in domestic bonds rather than in foreign ones or private bonds]

Deepen financial integration, facilitate pan-European banks

- but requires careful supervision: deal with size issue, if any, with standard instruments (e.g. capital surcharges; also takeover battles must not result in undercapitalization)
- also makes issue of single resolution mechanism more significant.

Transition: painful [would have been better to do it after July 2012 "whatever it takes"?].

CHALLENGES (5) SHADOW BANKING (a) Migration and bailouts

Natural migration to shadow (= unregulated) banking when prudential rules are tightened.

Shadow banks are not meant to have access to public insurance (deposit insurance, LOLR).Yet they do

- *Indirectly through liquidity syphoning ("conduits syndrom")*

  [backstops from retail banks (puts: contingent lines of credit, tail risk insurance, name on the door)]

- *Directly through liquidity assistance and bailouts ("AIG syndrom")*

  [e.g. AIG & investment banks, Commercial Paper Funding, Primary Dealer Credit and Term Asset-Backed Securities Loan Facilities]

Direct or indirect links with fragile banking populations (retail depositors and SMEs: the "core functions") "motivate" bailouts.

SHADOW BANKING (b) Virtues of the traditional model

Is the traditional banking model's quadrilogy natural?

- Prudential supervision
- Access to public liquidity (LOLR)
- Retail deposits/access to deposit insurance (DI)
- Lending to SMEs

Suggested answer: regulation, by limiting leverage

- is particularly desirable if bank lends to SMEs, creating a put on taxpayer money: monitoring reduces frequency of bank bailouts
- similarly, reduces the cost of providing insurance (LOLR to banks, deposit insurance to depositors), as bank is less often in distress.

SHADOW BANKING (c) Benefits of ring fencing and of CCPs

Structural reforms

- US: Volcker rule
- Europe: Liikanen Commission
- UK's Vickers rule: creates a ring-fenced subsidiary (the retail bank)
  - with a limited scope of activities [lend only to households and nonfinancial firms and trade high-quality securities. It can hedge the risk on corresponding exposures]
  - prohibited from providing support to the investment bank.

Ring fencing and CCPs limit

- Bogus liquidity and syphoning of liquidity
  - counterparts in shadow banking sector not prudentially monitored (RF)
  - risk selection (correlated balance sheet) within regulated sector (CCPs).

CHALLENGES (6) EXITING LOW-INTEREST RATES

Little choice was left to monetary authorities, but…

Undesirable effects: low interest rates

- imply a massive transfer from savers to borrowers.

  [Wealth effect, together with cheaper money, is meant to keep credit flowing.

  However, the beneficiaries are not solely regulated entities (owners of real estate, stocks, bonds…), which are the targets of the policy move in the first place…

  Furthermore, raises inequality.]
- are conducive to the emergence of bubbles, and to risk taking/search for yield (MMMF, life insurance…)
- addictive drug for governments/political risk of large balance sheet [pressure to finance public programs in emerging economies, loss of independence in developed ones]
- *ZLB* when natural rate of interest below zero.

OTHER CHALLENGES (1)

(7) Macroprudential policy and market liquidity

Two dimensions

- Asset side: *fire sales*
- Liability side: *rollover shocks*, i.e. low availability of
  - cheap deposits
  - wholesale deposits
  - bailinable claims

Macro-shocks: should one provide liquidity to

- markets (like for monetary policy, non-targeted $\Rightarrow$ windfall profit for rich investors and unregulated financial institutions)
- or institutions (possibility of (a) stigma or (b) capture)?

OTHER CHALLENGES (2)

8) International cooperation

Challenge # 1: *supervision*

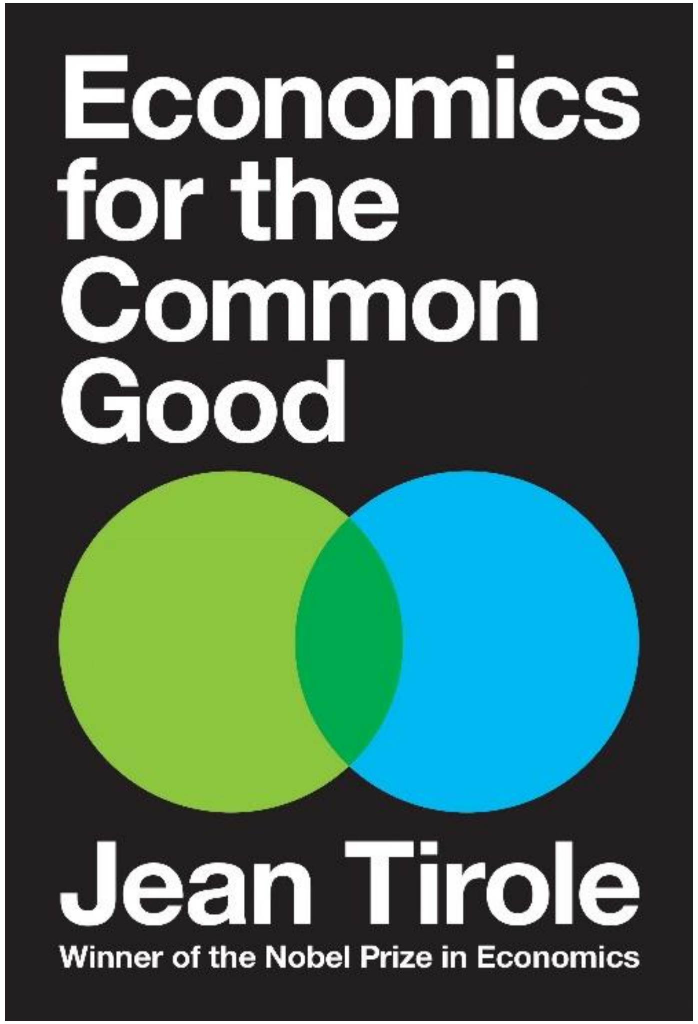
Challenge # 2: *resolution process*

- Resolution authority national
- Bank is global $\Rightarrow$ cash may be moved around.

Move entire procedure to European level? Resources?

Challenge # 3: “Maintain SI functions” (BRRD): *which ones?*

- Payment systems, market making, CCPs, resources of money market lenders
- Rationale for this classification? E.g. should MMMF be considered quasi-deposits and be insured (in contrast with current trend)? Shouldn’t there be a coincidence between core functions and regulation?



THANK YOU FOR YOUR ATTENTION