Monetary, Financial and Prudential Policy interactions in the post-crisis world
BoE/HKMA/IMF conference

Implications of **non-bank activities** on the design and effectiveness of prudential policies

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Introduction

Financial stability threats can emerge from

1. Banking by banks
2. **Banking by non-banks**
3. **Non-banking by banks and non-banks**

Will consider items 2 and 3.

Governance and Big Issues

Will consider big issues of today…

but to ensure threats are mitigated requires also fit-for-purpose governance of policy: subject of another occasion?

- Clarity of objectives
- Capable decision-making processes
- Tools – powers, influence, instruments
- Mechanisms for resolving conflicts of policy
- Communication strategy
- Accountability

Governance needs to overarch all relevant financial authorities, not just central bank; also to cover the three components of macroprudential policy, contribution of microprudential policy and preparation for recovery and resolution.

Four pragmatic questions:

For each of …

1. Banking by non-banks
2. Non-banking by banks and non-banks

…we will consider following issues:

– What are the **worries and risks**

– **Where** are the problems

– Do we understand the **dynamics**

– What are the **mitigants**

Common concerns
List of common suspects….

Financial stability. We seem to have stability in face of **heightened uncertainties:** Brexit, Trump, Russia, Far East, rising nationalism…continued high **levels of indebtedness**

We cannot rely on stability enduring….

- Increases in **activity**
- Increases in **complexity**
- Areas of **opacity**
- Impacts on **real economy**

And multiple trade-offs:

- **Innovation/stability** trade off: keep up with Silicon Valley
- **Resilience/conjunctural** risk trade off: if more resilient you can take more risk with the conjuncture…
- Multiple policy initiatives: have **unintended consequences**

Banking by banks

….deposits, lending, maturity mismatch, trad activities…
area we know best…

- Not for today but sets the **context**
- We know [post 2008!] credit creation, leverage, and maturity mismatch = systemic problems, so:
  - Worries are **runs; collapses; fiscal recourse**
  - Withdrawal of **essential services** to the economy
- Optimism
  - Reasonable **visibility** of problems
  - Reasonable understanding of **dynamics**
  - And multiple **mitigants**: macropru, micropru, recovery and resolution
- *Certainly imperfect, but rising up the curve*

Banking by non-banks
1. what do we worry about?

- as for banks: but often we cannot see it!
- if deposits/quasi-deposits involved, possible **forms of run**
- possible **withdrawal of essential services** to the economy: ensure these are sustainable
- and if banks are lenders to non-banks potentially **banks get infected**

Banking by non-banks

2. Where are the problems?

1. **Visible** non-bank credit creation
   – e.g. **insurance:** political risk guarantees etc
   – may involve different regulators
2. **The real shadows: invisible/opaque** non-bank credit ***creation***
   – irony of unintended consequences and **arbitrage**
   – boundary issues
   – turning **unknowns** to knowns: volumes, quality etc
3. And opaque ***facilitation*** of credit
   – innovation, technology, FinTech, DLT
   – funding dynamics

Banking by non-banks

3. Do we understand the dynamics?

- For visible activities:
  - broadly, yes
  - but focus on right things not quantifiable models
- For opaque activities:
  - for credit **creation:** we cannot see!
  - for credit **facilitation:** tricky, eg understanding transmission systems in FinTech
  - made worse by **complexity** risk, **fragmentation** risk

Banking by non-banks
4. What are the mitigants?

- **Visible** activity: apply learning from banks to NBFI's, but be proportionate
  - eg **insurance is not banking**! R and R plans: how important?
  - P2P not creating credit, but **sudden withdrawal**?
- **Invisible** activity: added features for authorities:
  - address **boundary issues** – but where to stop?
  - minimise **arbitrage**
  - **learn to dig**! Needs intelligence/judgement
  - and create **engagement** with producers/firms
- For both **visible and invisible activity, consider:**
  - **vulnerabilities** from cyber to fraud
  - **innovation vs safety** trade off
  - need to focus on both **lenders and borrowers**
  - need for instruments **pre and post** event

Banking by non-banks
Observations: tough to handle factors

- premium on **discovery and relevance**
- minimise **incentive for arbitrage**
- minimise **unintended consequences**
- premium on understanding **linkages**
  - to the creation of credit
  - and facilitation
- must watch for **linkages back to banks** or potential hits on **essential services**

Non-banking by banks and non-banks
1. What are the worries?

- Huge area: market based activity and liquidity provision; assets and asset management
- **TODAY:** spotlight on **asset management**: both owners [principals] and managers [agents]

Essential question 1: **will exit be big enough if the herd decides to move?**

- Consider determinants of
  - **breadth of exit** [market liquidity]
  - **size and nature of herd** [volumes/classes of assets, nature of owners, nature of managers]
  - **behaviour of herd**
- Issues to worry about include
  - Has size of exit been **compromised**? [banks' prop securities activities curtailed…]
  - **herd behaviours uncertain**: fire sales of assets/one-way markets
- Need to avoid
  - **impact on the banks** eg from leveraged asset managers, resulting repu risk
  - losses with unintended **bailouts** eg bail-in debt, Italy
  - possible impact on **essential services**

Non-banking by banks and non-banks
1. What are the worries [contd]?

Size and nature of herd

- AUM: **huge increase**: demographics, zero bound [firms/markets]
- AUM: deliberate **move to market-based and securitisation** [banks do less; CMU etc]
- owners [principals] and asset managers [agents]: **complex behavioural interactions**

Behaviour of herd/**dynamics**?

- zero bound and 'low for long' results in **search for yield….**
- QE? Stretched asset prices? Volumes?
- open and closed end: **presumptions of liquidity**
- break the buck **pricing for liquidity risk**?

Size of exit

- reduced market liquidity of asset classes? [**regulatory initiatives**, structural policies]

Conjunctural issues

- **technology** and HFT [recent £/$ in Far East]
- where is '**sense of the systemic**'? Do asset managers have it? Will they?
- will asset managers '**engage**'

Non-banking by banks and non-banks
2. Where are the problems?

- Managers/owners: complicated **agent/principal** relationship
- Conflicts of **incentives**
- Asset **managers** mainly visible and within the boundary: acting as agents for owners
- But huge array of asset owners, and asset classes
- ?Determinants of asset **owners** behaviours: AML etc, repu risks, market integrity risks
- What are likely behaviours?

Non-banking by banks and non-banks

3. Understanding the dynamics...if only we did...

- **Herd behaviour and volatility**: what causes one way markets:
  - Behaviours hard to model! cf bank runs?
  - Calibration hard to judge!
- **Asset managers**: are they poised the same way?
  - Similar models and algorithms
  - Similar actions for given shocks
  - Exacerbated by HFT/rapid trading capabilities
- **Asset owners** with compromised risk appetites?
  - Panic if presumption of liquidity not honoured
  - Search for yield at zero-bound
  - Leads to stretched exposures to borrowers eg corporates

Non-banking by banks and non-banks

Asset management [contd]

Essential question 2: Impact of activities on 3rd parties

Stretched exposures to **borrowers** eg **corporates [EME's]:**

- eg flows stretch exposures of lenders [impact back to banks?]
- And maybe of some borrowers [quantum, fx, etc]

Analogy:

- house owners in mature economies
- corporates in EME's

Should this lead back to capital controls?

Non-banking by banks and non-banks

4. What are the mitigants [1 of 4]?

Think **outside the box**:

Look for **causes of stretch**, unintended consequences

- Why are exits (market liquidity) smaller?
- Why is the herd (asset owners and managers) bigger?
- What are the distortions from ‘low for long’?

AND

- How effective is the **governance**?

Start by looking at **other policy areas** and interactions

- – QE and exit
- – Plethora of **regulatory initiatives** [CMU]
- – Regulatory **arbitrage** and move to opacity: proportionality

Non-banking by banks and non-banks

4. What are the mitigants [2 of 4]?

What can macropru do?

– Balance need for **influence/judgement** with focus on instruments/powers/legislation
– Attention to **boundary** and **powers** to obtain data
– Distinguish between **conjunctural and resilience** measures
– Focus on both **asset holders** and in debt markets those **to whom they lend**
– Develop **instruments** for pre and post event
– Consider **instruments/incentives** for both asset owners and asset managers

Non-banking by banks and non-banks

4. What are the mitigants [3 of 4]?

Focus on: liquidity mismatch; leverage in funds; op risk and transfer; secs lending

- actions pre event
  - Governance of regulated firms and infrastructure [eg exchanges, CCP’s]
  - Firms ERM, incl liquidity risk and op risks
  - Firms and market stress tests [fund and system wide]
  - Illiquid investment limits
  - Agreement on metrics re leverage
  - Encourage disclosure to investors/fair treatment of customers
- actions post event
  - Gates, redemptions/side pockets

Non-banking by banks and non-banks
4. What are the mitigants [4 of 4]?

Stability consistent behaviour won't be created by rules

- Role of **standards** to produce desired outputs
  - Hedge Fund Standards Board type activity: how to extend to asset management?
  - FX code in the making

And not to forget infrastructure

- Focus on resilience of **infrastructure**: areas of opacity due to fragmentation and FinTech: need for RRP's
- Could be a **third dimension** [after banking by non-banks, and non-banking by banks and non-banks]

And should there be RRP's for asset managers?

Conclusions

Need for humility: there is so much we do not understand

- We need to decide **how safe we want the system to be!**
- If we improve understanding of **resilience**, can take more risk with **conjuncture**
- Challenges of **implementation:** writing laws easy; implementation difficult
- Impact of monetary policy and regulatory initiatives
  - Must improve **policy coordination**: micropru; macropru; recovery and resolution; conduct; monetary policy
  - To underpin stability should we adjust other policy measures?
  - Should we develop a **standard of resilience**: 'how safe should we be?'
- Focus on improved **governance**
  - Clarity of **mandates**, objectives, powers in each policy area
  - Tools and instruments: better **data**, spillover dynamics to banking system
  - **Conflict resolution** machinery; **communication** strategy; accountability…

Final word

- Ensure regulators and central banks are **not the creators of risk**…
- Will QE and added policy mandates foster reputation risk for central banks and **impact independence**?
- Requires significant effort on **communication strategy**
- Or politicians will think they can do it better!