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Implications of NBFIs on design and effectiveness of prudential policies

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Where Post-Crisis Regulation Has Succeeded

- Higher capital ratios
- Defined liquidity standards
- Pushing Total Leverage Ratios
- Corporate Governance change
- Greater attention on conduct/protection of retail interest, plus heavy fines on AML, Terrorist Funding, Sanctions, Corruption

Where Regulatory Outcomes Have Flaws

- Bankers feel micro-managed by complex regulations, whereas NBFIs (asset management, mutual funds, FinTech etc) have much less regulatory burden and no limits on remuneration – talent loss to non-regulated fields
- Operational risks – Stream of new regulatory + technology changes made bank legacy IT systems obsolete, fragile and complex, prone to cyberattacks, failure and non-interoperability
- Risk models (too many and flawed) cannot cope with radical uncertainty from changing geopolitics, UMP + NIRP, FinTech + Blockchain challenge to legacy HR costs
- NPLs rising due to Deflation and asset bubbles reversing

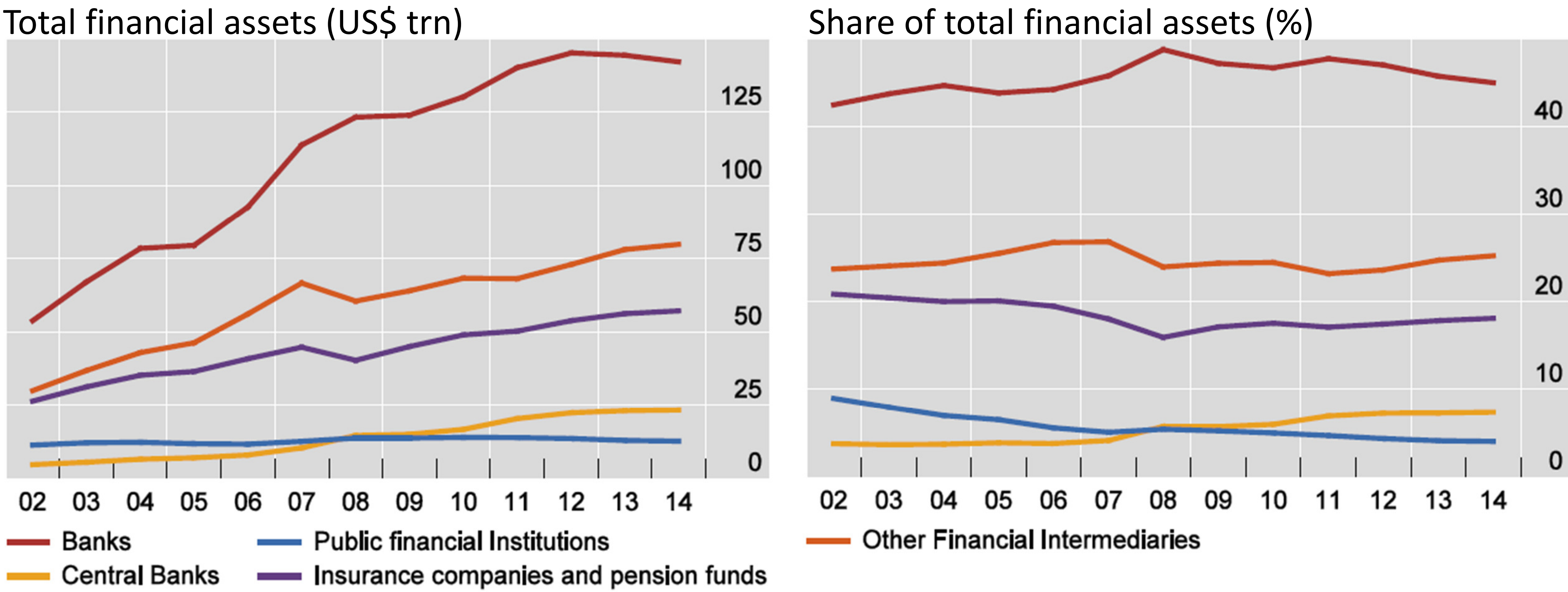
Five Radical Uncertainties Changing Normal in Financial Regulation

1. Financial markets are now driven by geopolitics (e.g. Brexit, terrorism, Middle East, South China Seas etc)
2. ZIRP and negative interest rates are conflating business models of banks (interest-rate margins), insurance and pension funds and fund managers – who wants to pay for management fee of 1.5%, when returns are zero?
3. Deleveraging due to Capital + Regulatory Requirements pro-cyclical on secular deflation
4. FinTech + Blockchain making traditional business models obsolete. Combination of complex regulations and complexity in UMP exits diverting key attention from huge risks building up in system as a whole
5. Creative destruction in Old Economy forcing losses that banks and industry have not yet recognized

We need to look at risk + uncertainty within the system as a totality, not partially that assumes away externalities or spillovers

Banking Assets Account for Half of Global Financial Assets, Shadow Banking One Quarter and Central Banks One-eighth

Banking + Shadow + Central Banking = 83% of system – short-term bias with maturity mismatch
(Assets of financial intermediaries: 20 jurisdictions and euro area)



Note: Banks = deposit-taking institutions; OFIs = Other financial intermediaries.
Data sources: National flow of funds data; other national sources; FSB calculations.
Source: FSB. 2015. "*Global Shadow Banking Monitoring Report 2015*."

NBFIs have risks, but being smaller, the risks are in banking system and flawed systemic regulations

- NBFIs exist to complement banking system, but their fragilities come if they exist as "regulatory arbitrage opportunity". They became large, because regulations allowed them to be systemic, e.g. investment banks.
- The problem with Shadow Banks or NBFIs is political – regulators need to address the political issues of capture and ring-fencing.
- If another mid-sized financial crisis occurs, will rising credit spreads, effective interest rates and devaluation in EME markets would cause another meltdown?
- What if, in event of war or big natural disaster, one major financial centre implodes?
- If real sector is going through secular deflation, how can financial sector escape further creative destruction losses?

Are we tinkering at the margin and pretense of perfection by pushing the complexity envelop?

Agree with Hyun Shin, White, Haldane et al

- Economy and finance seen as inter-dependent complex adaptive system
- Managing IMS using old lenses (national basis) is incomplete. The reason is that no one is responsible for the system as a whole.
- Hence, IMS is now run on swaps between Fed and PBC with key stakeholder central banks.
- Current IMS very much dependent on US dollar, which accounts for roughly 60-70% of global financial transactions (trade and portfolio).

Impact on EMEs

- Trend decline in world real long-term interest rate since 2000 a combination of saving glut (demographics and excess capacity), global credit glut (high leverage due to tax and other reasons), UMP and pro-cyclical regulatory pressure:
- Lower G4 rates prompted two EME trends:
  - Increased EME corporate borrowing in foreign currency
  - Foreign pension and asset managers Increased holdings of EM local currency debt
- EMEs now vulnerable to reversal of monetary policy – asset bubble reversal, capital outflows, FX depreciation, deflation?

Net International Investment Positions (NIIP): Unsustainable Deficits growing faster than surplus

	USD TN			%GDP			%World GDP		
Country	**1997**	**2007**	**2014**	**1997**	**2007**	**2014**	**1997**	**2007**	**2014**
Deficit countries	**-0.95**	**-4.43**	**-10.15**	**-6.5**	**-14.2**	**-33.9**	**-3.1**	**-7.8**	**-13.0**
US	-0.79	-1.28	-7.02	-9.2	-8.8	-40.3	-2.6	-2.3	-9.0
Euro area except Germany	-0.08	-2.54	-2.60	-1.7	-18.5	-27.3	-0.3	-4.5	-3.3
UK	-0.08	-0.60	-0.53	-6.1	-21.1	-17.7	-0.3	-1.1	-0.7
Surplus countries	**0.99**	**4.19**	**6.87**	**13.3**	**37.5**	**36.5**	**3.2**	**7.4**	**8.8**
China	-0.12	1.19	1.78	-12.9	34.0	17.1	-0.4	2.1	2.3
Japan	1.03	2.12	3.46	23.8	48.8	75.3	3.3	3.7	4.4
Germany	0.08	0.88	1.63	3.9	26.5	42.1	0.3	1.6	2.1
ROW	**-0.04**	**0.23**	**3.28**	**-0.5**	**1.6**	**11.3**	**-0.1**	**0.4**	**4.2**
World GDP	30.9	56.7	77.8						

Data source: US BEA, China SAFE, Japan MoF, Eurostat, Deutsche Bundesbank, World Bank, IMF.

Source: Ruskin, Alan. 2016, January 26. "*Plan for a US-China 'Plaza Accord'*." DB special report.

Are we in a Dollar Trap?

- Global stock and flow balances in US terms are widening and probably unsustainable.
- Deficit NIIP rising from 3% of world GDP (6.5% of deficit country GDP) to 13% of world GDP or 33% of national GDP
- Gross liabilities of US$31 trillion, net NIIP $7 trillion or 40% of US GDP, roughly 70% of global NIIP deficits. If we add another $10 trillion (created outside Fed control), USD gross liabilities already $41 trillion or 234% of US GDP or 53% of world GDP.

Under NIRP, world going into Secular Deflation

- World going through Secular Deflation due to excessive debt and consequent balance sheet adjustment
- Debt driven model, supported by QE, is fragile, concentrated, unequal and unsustainable
- Strong Dollar with ZIRP and inability to reflate = Deflating Gold Standard in 1930s
- Breakdown of transmission mechanism to real sector
- Central bank liquidity reaches banks and fund managers, who are being risk adverse due to huge uncertainties from all quarters.
- Thus, we have large Macro-Liquidity, and yet Micro-Illiquidity.

Role of Central Banks in New (Ab)Normal

- Operating in hugely distorted environment
- Important to deal with volatile exchange rates, shadow banking and reduce financial repression, especially long-term pension rights (avoid Japan trap)
- Dealing with Shadow credit and systemic risks – using Tobin tax and controls on capital, liquidity and leverage caps
- Changes in Capital markets – helping SMEs, innovation and global reach
- How to finance long-term infrastructure and environmental change?

Implications of QQE and flat JGB yield curve at 0%

- BoJ already owns one third of JGB's.
- If inflation rises to 2% as targeted and long-term interest rates increases, holders of all long-term bonds in Japan (pension and insurance funds) will suffer huge losses.
- By announcing flat yield curve, and being able to finance holdings of long-term JGB, BoJ is transferring all long-term bond risks to its balance sheet. This ensures financial stability for Japanese long-term savers.
- However, massive liquidity at ZIRP will flow out, as holders of Yen will seek to invest in overseas assets, thus creating downward pressure on Yen.
- This solves two problems – weaker yen to aid exports and generate profits for large FX holders when Yen depreciates.

Global Inter-connectedness means that all UMP is reflexive – feedback mechanisms is where change lies

- Financialization has created “money illusion”, which has distorted real sector behaviour.
- Central banks and regulators have responsibility to ensure that financialization should be “neutral”, rather than funding speculative and short-term behaviour that worsens inequality and climate change.
- Are central banks in charge of system stability or propping up bubbles and disruptive capital flows?
- Finance is still derivative of real sector, but can change real sector. This may be politically inevitable, but central bankers should understand that there are limits to what they can do.
- “Whatever it takes”, does not mean that central banks can displace painful decisions that politicians have to take to restore fiscal and financial discipline.

Can revised IMF/SDR recycle imbalances to get out of Secular Deflation?

- Global debt overhang because G4 became over-leveraged, sustainable only with reserve currency status
- EMEs cannot use QE to reflate (hard budget constraint) due to fear of inflation or currency depreciation (no $ lender of last resort)
- Fed unwilling to recycle surplus/savings of non-allies and therefore system is imbalanced and fragile
- IMF and MDBs (World Bank etc) have capital constraints
- Geopolitical fears lead to flight to USD, increasing capital outflows and more deflation
- As long as dominant shareholders (AEs) refuse to increase capital of Bretton Woods, we are heading for secular deflation. No global central bank + global fiscal policy (Eurozone problem writ large)

Who's the Systemic Risk Now? - WSJ Editorial 2 October, 2016

- "Regulators like to bray about the dangers of systemic risk, but they seem not to care when they're the source of the risk."
- Does it make sense that the sanction on Deutsche Bank is \$14 billion, around same value as market cap, but balance sheet of \$2 trillion?
- Does it make sense to punish shareholders but no individual bankers, that takes away half as much as capital that shareholders put in to replace capital after the GFC?
- If sophisticated regulators can't solve the mutual fund potential run problem, how should EME regulators react?
- "These bank robberies are political"…."Government caprice has become a major risk, and maybe *the* major risk, to the global financial system."

Threats to global financial system

- Regulators and central bankers need to appreciate that the combination of huge geopolitical uncertainties, NIRP, technology, complex regulations and demoralized bankers who do not understand much of the detailed regulations, have TOGETHER, destroyed the old business model of the banking system. We are still responding to these threats as silos.
- DB and others are symptomatic of these fragilities.
- Blaming Shadow Banks is a copout.
- Need to align incentives between central banks, regulators and industry to give priority to which key areas need urgent reforms. We cannot do all the current regulatory reforms at the same time – maybe even time for "time out".
- Needs leadership to reach out to the banking community to address smooth transition in major transformation in both real economy and financial system

Thank you

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