BoE-HKMA-IMF conference on monetary, financial and prudential policy interactions in the post-crisis world

During 16–17 June 2015, the Bank of England (BoE), the Hong Kong Monetary Authority (HKMA) and the International Monetary Fund (IMF) held the first joint conference on monetary, financial and prudential policy interactions in the post-crisis world. The conference provided a forum for leading academics and senior policymakers from across the world to discuss challenges that central banks and other policymakers face in choosing the optimal mix of monetary, macroprudential and microprudential policies.(1)

This article summarises the main issues discussed by participants during the two-day conference. The programme and presentation slides for the sessions held on 16 June are available on the Bank's website.(2) The roundtable discussion on 17 June was conducted under 'Chatham House Rules'.(3)

How has the financial system changed since the global financial crisis?

Participants noted two key developments since the financial crisis. First, many bank holding companies and non-banks had turned into 'hybrid intermediaries' which provided specific services in the process of credit intermediation — for example, in asset securitisation and securities lending. It was not yet clear whether this represented efficient evolution of the industry, or more worryingly, its attempt to shift risks to spheres that were less visible to regulators. This could suggest that financial activities, rather than entities, should be regulated, thus requiring greater co-ordination among regulatory agencies, both domestically and internationally. Enhancing the information available on non-bank financial institutions would make it easier for regulators to monitor their activities more effectively.

Second, it was noted that global credit growth since the crisis has been driven by corporate bond issuance rather than cross-border bank lending; and that asset managers now held a significant proportion of these corporate bonds — most of which were denominated in US dollars. Even though asset managers were not leveraged, they typically benchmarked their performance against broad indices, held only small amounts of cash to meet redemptions, and tended to use Value-at-Risk type position limits on specific currency exposures. So a rise in policy rates in advanced economies, particularly in the United States, could reduce the value of these bonds and potentially trigger a sell-off by asset managers.

Some participants were concerned that a large-scale sell-off by asset managers could potentially amplify the impact of rate increases across the financial system. But others remarked that it was not yet clear how quantitatively significant this transmission mechanism was.

End of 'too big to fail'?

Some participants thought that the 'too big to fail' problem for banks would be largely solved once the international reforms to facilitate recovery and resolution, including the designs of total loss-absorbing capacity and cross-border resolution, were completed. These reforms could restore market discipline on big banks by creating a clear mechanism for imposing losses on private claimholders through equity write-downs and debt holder 'bail-in'. But a number of others urged governments and central banks to have a contingency plan, given that 'bail-in' was untested. Some maintained that having an orderly and transparent mechanism for public capital injection remained important and worked well in some countries, for example in Japan.

Participants also noted that 'too big to fail' remained a problem outside the banking sector, particularly for central counterparties (CCPs), which had grown more systemic with the increased central clearing of derivatives. Some participants argued that, in some countries, CCPs were at present not adequately supervised and regulated, and effective resolution mechanisms were yet to be developed.

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(2) www.bankofengland.co.uk/research/Pages/conferences/160615prog.aspx.
(3) This summary does not represent the views of the BoE, the Monetary Policy Committee, the Financial Policy Committee, the HKMA or the IMF.

Is the current set of macroprudential policy tools adequate?

Participants noted that many macroprudential tools were available for banks, but some asked whether prudential rules needed to evolve in light of the growth of the asset management industry and other non-bank financial institutions. Others, however, cautioned against expanding the set of macroprudential policy tools, arguing that the focus should instead be on maintaining market discipline on non-banks by keeping them small, so that they could fail without causing system-wide disruptions.

There was a broad consensus that stress tests were a useful tool for testing the resilience of the banking system, but also other parts of the financial system. Some participants noted that stress tests had ensured that banks were now able to report their exposures to a particular sector. Some also argued that, in the future, stress tests could be used to set the countercyclical capital buffer (CCB) such that a desired degree of systemic resilience is achieved at any point in the cycle. Variability in stress-testing scenario design might help regulators stay ahead of regulatory arbitrage by firms.

Participants discussed which authority should be responsible for operating macroprudential policy. Some highlighted that the fragmented regulatory structure in the United States impeded the effective operation of macroprudential policy tools, and thought that the concentration of regulatory powers at central banks was appropriate. Central banks that had powers over macroprudential policy were also less likely to be compelled to use monetary policy for financial stability purposes. Others, however, argued against this view, pointing out that central banks already had too much power, and that they might not be able to assess financial stability risks objectively, given that monetary policy might be a contributing factor to those risks.

It was also noted that misconduct problems, for example in fixed income, currency and commodities (FICC) markets, could have macroeconomic consequences. Mechanisms to ensure greater accountability among individuals and firms operating in FICC markets were therefore needed.

Finally, participants noted that little progress had been made in reducing tax incentives to take on excessive debt in the form of tax deductibility for interest payments. Although this was a fiscal issue, some thought that central banks should collectively voice concerns over tax incentives to issue debt rather than equity, arguing that excessive debt was the root cause of financial instability.

How should monetary policy and macroprudential policy be co-ordinated?

Several participants noted that monetary policy should not be used as the primary tool for achieving financial stability. One example cited was the Riksbank's attempt to use monetary policy to 'lean against the wind' (LATW) in the face of rising house prices and household debt: some argued that it ultimately generated below-target inflation, higher unemployment and probably even higher real debt. Hence, cost-benefit analysis was needed before monetary policy is used for LATW.

Others, however, were sceptical that this principle could be applied, in particular to emerging market economies (EMEs), which typically had less developed financial systems, were prone to rapid credit growth, and had a shorter history of monetary and fiscal credibility. Pointing to the vulnerabilities that such structural weaknesses create, some argued that EMEs should use all policy levers — including monetary policy — to maintain macroeconomic and financial stability, in line with the so-called 'precautionary principle'. Some participants also argued that any quantitative cost-benefit analysis to assess the appropriateness of using monetary policy to LATW was unlikely to be credible, given the high degree of uncertainty over the monetary policy strategies of advanced economies and the spillover mechanisms from their conventional and unconventional monetary policies.

Participants also noted that the effectiveness of macroprudential policy tools was, as yet, largely untested. For example, the CCB could enhance the resilience of banks to shocks, but it was not yet clear how effective it would be in taming the credit cycle. Others questioned whether countercyclical macroprudential policies would be used in the first place: for example, the institutional set-up in the United States might prevent such policies and therefore lead to more pressure on monetary policy to fill the gap.

What has been the aggregate impact of post-crisis regulatory reforms on the global financial system?

Several participants noted that the new regulatory framework was highly complex, and that the aggregate impact of all the policy reforms could be assessed properly only after some time. In particular, there was a high degree of uncertainty over how the Basel III leverage ratio and the risk-weighted capital ratio regulations would jointly affect banks' incentives. Some expressed concerns that the leverage ratio could encourage banks to take greater risks in order to maintain a high return on equity, while others emphasised its financial stability benefits.

It was argued by some that, while the core of the financial system — the banking sector — was likely to have become more resilient, the combination of new prudential requirements on dealers and structural changes in markets might have reduced market depth and increased asset price volatility. Policymakers needed to be alert to these developments, including their consequences for investment funds that offer daily liquidity while investing in securities that may not turn out to be liquid during periods of market stress.

Several participants noted that risks were already migrating into the non-bank sector in many countries in response to tighter bank regulations. But views were mixed as to whether that was a good thing. For some participants, aspects of non-banks' activities needed to be regulated better, as they were responsible for a large part of credit provision in some economies. But others thought that it would be better if risky activities moved outside the banking sector, and the banking sector focused on its core business of supplying credit to the real economy. For example, some expressed support for the regulatory regime that discouraged banks from holding securitised debt through higher risk weights, while allowing non-banks to take these risks onto their balance sheets.

An open question going forward was how central banks should support liquidity in key financial markets. Some argued that safety nets should be extended to some non-banks in exchange for closer supervision and regulation, while others argued that the aim should be to allow non-banks to fail safely without causing contagion to banks.

Is there a need for international policy co-ordination to mitigate global risks?

Participants noted that monetary policy in major advanced economies and global risk appetite were the two main, and interrelated, drivers of global capital flows in general, and the correlation of bond markets in particular. EMEs were therefore particularly exposed to the vagaries of global policy cycles and investor behaviour.

For some, this called for increased availability of international contingent credit lines and better risk-sharing mechanisms. In their absence, EMEs would simply self-insure, with competitive policy easing going hand in hand with competitive reserve accumulation. But several participants noted that international monetary policy co-ordination had previously backfired and that there was no clear need for co-ordinating monetary policies now.

On macroprudential policies, there was disagreement as to whether more co-ordination was a priority, given differing views on the size of policy spillovers. However, some participants argued that recent changes in financial regulation did have an effect on market liquidity in EMEs. Moreover, the effects of capital controls by countries on each other were identifiable in the data. It was also noted that there was a clear need for international co-operation in making CCPs safer.

Participants also noted that EMEs had several tools at their disposal to defend themselves against external risks. For example, they could increase the resilience of their financial system and economy against external shocks by strengthening financial regulation and deploying macroprudential policies; and by monitoring foreign currency exposure of financial and non-financial corporates more closely and encouraging hedging. Some participants also emphasised the need to use capital flow management measures at times, in part because macroprudential policy may turn out to be insufficiently powerful to deal with risks associated with capital flows. It was noted, however, that the evidence on their effectiveness was mixed. Some participants therefore concluded that establishing sound fiscal policies and good governance, and implementing structural reforms, could potentially be the most reliable ways for EMEs to achieve resilience against external shocks.