What toolbox is needed to deal with new emerging risks?

Dino Falaschetti - Director, OFR - **Sam Woods** - Deputy Governor, Bank of England - **Francesco Mazzaferro** - Head of the ESRB Secretariat, ECB

Francesco Mazzaferro

The Chair welcomed the attendees and introduced the panel. The topic concerns new emerging risks, of which there are many possibilities to choose from. One question is about how to interpret the extraordinary new situation where 30% of international yields are negative. BlackRock stated two days ago that the situation could continue for 30 years. Another market participant even takes the view that it could continue forever.

Another issue of great interest is the speech that Governor Carney gave in Jackson Hole, covering the idea of whether authorities should use digital currencies, whether there should be an international currency, the pros and cons of the use of a national currency for international markets and what the role is of private initiatives like Libra. Libra is possibly a player in international monetary policy, and what is thought about it should be understood.

A number of countries' authorities have undertaken initiatives to check whether the level of risk weights is of concern. In some countries institutions have been setting a floor to risk weights to try to ensure a minimum of resilience in the financial sector.

On the negative level of interest, two years ago the European Systemic Risk Board (ESRB) issued a report on the low-for-long and it was the first really discussing the medium-term implications of the low level of interest rates. To now speak of the low level of interest rates is embarrassing because there are in fact negative interest rates.

The Chair asked how to interpret and rationalise a situation in which there are so many negative interest rates around the world, and whether it is a curiosity of the period or a new normal. The Chair queried whether it raises concerns.

Dino Falaschetti

Dino Falaschetti stated that it certainly is concerning. In a macroeconomics class at the University of Chicago, Bob Lucas had insisted that there could never be negative interest rates, but now they are a reality. One concern is that there is not a lot of transparency in markets. They seem to be contradicting themselves in terms of the bond market and the equity market, and the Office of Financial Research (OFR) is trying to carry out research to identify what is the signal and what is the noise.

Sam Woods

Sam Woods noted that the obvious deduction is that the danger it creates for supervisors is the pressure it puts on firms to move up the risk curve. The loosening in terms and in price in the UK mortgage market are not alarming in themselves but are, in part, a reaction to that pressure. National catastrophe pricing on the insurance side in the London market has been hardening recently, but the longer-term trend is a perfect example, with more capital coming from non-traditional sources into things like catastrophe bonds, thereby driving down prices. Leveraged lending is the other part of this market to be worried about.

The most obvious part of the toolbox that regulators and central banks have been given is the cyclical buffer. The logic of that tool is plain. The question mark is around the various sets of indicators that have been created. There are numerous versions aiming to indicate what should be done with that part of the capital stack. The question is whether those indicators will provide what needs to be known fast enough, given the lagging nature of some of them and of the implementation period. That goes to the question of what the resting place of the counter-cyclical buffer should be. In many jurisdictions it is currently set at zero. There is a question as to whether it will be high enough before something hits if it stays at zero for long.

Francesco Mazzaferro

The Chair noted that one of the winners of the situation is the Republic of Austria with its 100-year bonds. Those who had been buying at the beginning of the year have been gaining 65%. This is a consequence of the fact of a 100-year bond at negative interest rates. It is remarkable in terms of yield.

There is also the consumer protection aspect. If the interest rates will be negative and that becomes predominant, sooner or later there will be the question of whether it is possible for banks to pass the rates on to customers. Then there will be any number of implications, such as the business model or whether people will accept having a negative interest rate payment on bank accounts. There might be cases of banks offering mortgages at negative interest rates, which effectively means that you are paid by the bank to start a contractual relation in order to buy a house.

The Chair asked what the view of Libra is in London. The Bank of England seems to be an institution that has reflected extensively on it.

Sam Woods

Sam Woods replied that the EU should not be closed to new ideas and new technologies. Indeed, the thrust of the remarks from the first speaker at Eurofi that day were precisely the risks of doing so, of being left behind or possibly of things happening outside the EU's perimeter.

Libra has the potential to become a large and systemic payment system, and that should not be allowed to occur outside of the regulatory perimeter. It is very easy to say that, but it is much more difficult to work out what the regulatory attachment point is. The reason it is complex is that it is the Libra system, rather than a single point, that should be thought of. One of the main questions to work through is in relation to the coin and whether it is a regulated security. That also goes to the question of what the nature is of the claim a coin holder has over the Libra reserve, whether it is electronic money or a crypto-asset outside of the regulated system. All of that concerns Libra as a store of wealth.

However, the more important questions are about Libra as a means of transacting. All of this is speculation and potentially for the future, but looking at the heart of the Libra system, with the validators within the association, the exchanges, the dealers and the coin itself, common sense and the Committee on Payments and Market Infrastructures and International Organization of Securities Commissions (CPMI-IOSCO) definition both suggest that it is a payment system. However, it is a different question to ask what that means in law in the various jurisdictions.

At the edge there are also other parts of the system which already exist today. Those would likely remain outside the regulatory perimeter, although that could be debated. Those issues need to be debated urgently in order to try and agree a shared position.

Francesco Mazzaferro

The Chair noted that the US could look at Libra and consider that US society has been producing the technology and the big IT winners come from there, but, alternatively, it could note that it produces the dollar, which is the most important currency in the world, and does not want to have a private competitor. The Chair asked for Dino Falaschetti's view.

Dino Falaschetti

Dino Falaschetti confirmed that the issue is being studied very carefully in the Treasury Department. After 2008, a lot of frameworks were created to try and stem systemic risk, and even to preclude it. 2008 was not a surprise. Raghuram Rajan gave a talk at Jackson Hole in 2005 and was criticised at the time. In 2004, the Minneapolis Fed, one of the strongest research institutes in the federal reserve system, had spoken of 'too big to fail.' The President's Council of Economic Advisors in 2005, chaired by Ben Bernanke, wrote a report on the importance of financial services to not only the real economy but for households more generally. It pointed to systemic risks in the housing crisis. This was not just economics; this was at the White House. That was not an easy thing for the White House to say at the time. Ben Bernanke then went to the Fed and presided over the great recession.

Researchers and rule makers do a lot of good work but should be soberer in terms of what is known. For many briefs on systemic risks it seems that 'systemic risk' is appended after anything. In Washington, anything new is a systemic risk until proven otherwise.

Francesco Mazzaferro

The Chair asked about the micro/macro aspect of the risk weight question. There are a number of countries where the view is that there is a necessity to set a regulatory minimum from a macro side, for an instrument that is also micro.

Sam Woods

Sam Woods replied that a risk-weight-only system of the kind there was in the UK before the crisis is a thoroughly dangerous system both because the risk weights can be wrong – either for political reasons in standardised formulae, or for incentive or indeed analytical problems where those risk weights are modelled – and because even if the risk weights are right there can be a massively leveraged banking system. The basic construct that has been developed, albeit with slightly different variances in different jurisdictions, of having the two measures of leverage and risk weight, is absolutely essential.

More narrowly, there is a live debate in the UK and elsewhere about mortgage risk weights. There is a 15% floor in Finland and a 25% floor in Sweden. In the UK, modelled mortgage risk weights have dropped from 15.1% to 9.7% over about the last eight years. All of the reasons why that has occurred are eminently explicable, effectively in terms of house price increases, lowering the loss given default, and a small amount of PD as well. Notwithstanding that, it is good ask whether there is a level below at which it is just not sensible. Even if that capital is captured in the pillar 2 requirements, it can be asked whether there is some level below which pillar 1 requirements should not drop. That should be looked at further.

Francesco Mazzaferro

The Chair noted that that is not a new risk in some respects. It concerns the normal business of banks. The Chair asked Dino Falaschetti whether the regulator or the financial stability person should think about risk weights or have some distance.

Dino Falaschetti

Dino Falaschetti accepts that the question of where to set risk weights is difficult. Though he is an economist, he is sceptical about trade as well. The preference is for a leverage ratio. In the last Congress, the House Financial Services Committee created a bill which would have provided regulatory relief for a sufficiently high leverage ratio, and there was a lot of research into what would be a reasonable leverage ratio. There was really solid research-backed work coming out indicating that 30% or

20% does not curtail lending too much. Ultimately, when the politics played out, it went from 30% to 20% and then ended up at 10%. Dino Falaschetti asked Sam Woods for his opinion of a framework like that.

Sam Woods

Sam Woods confirmed that that process was followed with great interest in the UK. The idea of the potential for a simpler regime, particularly for smaller firms, in the off-ramp mechanism is interesting. There is interest in some of the risk weighting elements, though in a couple of cases there is a degree of complexity which is harder for smaller firms. He does not approve of leverage only, because it makes two firms that have very different levels of risk look the same with respect to their capital metrics, which creates strange incentives.

From a European perspective the number sounds quite good for regulators, but not for bankers. Using UK banks as an example, the combined effect of the leverage stress test hurdle and the nature of the stress test means that banks need to run at about 20-times levered. That is where the debate is settling in the UK. That is a significant degree more permissive than for the USA.

Francesco Mazzaferro

The Chair was interested in Dino Falaschetti's comment about defining anything new and not yet seen as systemic. The Chair asked how a systemic risk is defined, and at what time a risk is taken to be systemic.

Dino Falaschetti

Dino Falaschetti explained that there are a number of transmission channels. Many people talk about contagion, correlation and connectedness. As a student of Bob Lucas, and a micro-based macro type of person, it is more sensible to look at the fundamentals of what is common amongst all of those risks.

Francesco Mazzaferro

The Chair noted that there has recently been an enormous amount of geopolitical announcements and strange things happening in the world, some of which are not spoken about. By listening to radio from around the world, it is possible to hear about issues such as the very complex situation between Japan and Korea, which Europe never speaks about but which is very significant in Asia. There is a major problem between Pakistan and India. Benjamin Netanyahu's announcement that Israel could annex the territories is significant and a shock. The Chair queried how the market has managed to not explode after all of these events. It appears as if there are organised experiments every two or three weeks with something formidably new that it has never been expected could happen, but the financial markets remain resilient. The Chair asked how that should be interpreted.

Sam Woods

Sam Woods noted that the Chair did not mention Brexit. To some extent, those present are paid to be prepared for downside scenarios, and that is how to proceed. In relation to Brexit, the approach taken from almost three years ago was to get the financial system ready for no deal. That is what the Bank of England spends most of its time doing on this issue, and as best it can it has covered that. It is possible that the market has placed some confidence in aspects of that. He is unable to provide an answer for the broader picture

Dino Falaschetti

Dino Falaschetti stated that the date is 9/11. On that day, anything that was left on the ground was considered to be a bomb. The worry is that that is the perspective held in the wake of the financial crisis, and the deep research that is necessary to figure out whether there is a true systemic risk that needs to be halted immediately, or if this is superficial, is not being done. Better can be done on those margins.

Francesco Mazzaferro

The Chair wondered whether it is possible that the world is not exploding because the work by public institutions is good.

Sam Woods

Sam Woods suggested that people would perceive delusion in someone replying yes, and excessive pessimism in someone replying no, and so answered that it may be the reason.

Dino Falaschetti

Dino Falaschetti replied that with experience at the White House, the Financial Services Committee and the OFR it is clear the work is incredibly hard.

Francesco Mazzaferro

The Chair thanked the panellists. ■