Financial Stability: towards a delivery Framework.
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Introduction

Just as financial systems act as both lubricant and engines of market economies, we can see all too clearly that today's leveraged financial systems are inherently unstable. That is why the state needs to be involved in safeguarding systemic stability. It is not just that free market forces have been discredited for coping with financial instability: the social costs of a systemic failure are otherwise too high. Many of the early warnings were all too visible. But certainly in the main open mature economies they clearly received an inadequate response and measures that might have mitigated disaster were not taken. Perhaps we should have heeded the lessons from your own problems here in Asia. And they too are resorting to some unorthodox measures. Let's hope they work as well as those once developed in Malaysia!

Much is now being written about the need for new regulations and redefining the regulatory perimeter. But to my mind this largely misses the point. I of course applaud all the good work being done in so many quarters But what has been lacking is a delivery system, a more effective response to the build-up of systemic pressures. We need an actual framework for systemic oversight that takes account of human, political and social realities: that 'hard-wires" mechanisms both for sounding early warnings and which contains the necessary architecture and instruments actually to **deliver**. Now is surely the right time to respond to this and create something better.

Apart from the neglect over years of liquidity standards, the root of the crisis in recent years is the huge increase in leverage - in the broad sense– at the level of banks, asset managers, consumers, embedded within products, and now, increasingly, and perhaps inevitably at the level of governments. We have long known the dangers and could see coming the self-feeding vortex of reduced asset prices we see today. Whether this asset price deflation then leads chaotically to eventual inflation as the easiest way of alleviating the pressures is too early yet to say.

Historically most financial crises have during their course destroyed 15-25 per cent of one year's national income of affected states. As we can see we risk this happening today on a global level given the joined-up nature of the financial system in the liberalized and information technology-enabled world.

Delivery of financial stability

So just as I am conscious of all that good work, my thesis is that not enough radical thought has been given on how actually to deliver and act in ways which secure stability.
It might be worth reflecting that perhaps the processes involved in Monetary Policy have shown a way forward here. In many jurisdictions we now have a well tuned process, with policy instruments, accountability, transparency. It may not be perfect, but it surely delivers better than the vacuum we had before where politicians often held the ring. General understanding of the issues has risen dramatically; deployment of the policy instruments are widely

regarded as ‘legitimate’ by society; and expectations and behaviours are altered.
But financial stability has not been accorded a status yet which is capable of being handled as a recognized ongoing policy area. Up to now financial stability has often been looked at in binary terms. It’s about mitigation techniques in good times – always assuming you can get your hands on the resources, people and budget -. And it’s about crisis handling in bad times. In a policy sense it hasn’t been joined up – as was the case too for monetary policy up to the 1970’s and 80’s. It lacks a policy making framework that can steer; there is little transparency of process; and, with that, inadequate ability to command respect and influence behaviors and expectations.

So I think the mature economies should now have the self confidence to rethink, to acknowledge our failure, but to build such a framework both on what we have learnt in the monetary policy area as far as process is concerned, and what we have observed in this crisis. We are now in materially better shape in understanding both what the early warnings of leverage build up are, and the type of things needed to restrain them. So to my mind if a transparent process is put in place, early warnings will both be more clearly articulated and understood, and, more importantly, we will have a better chance to act in advance to alleviate pressures before that so costly tipping point is reached.
I know many will say ‘but you never know where the tipping point is.’ To you I would respectfully say that I think that’s a specious argument, not dissimilar to the thesis that monetary policy can’t take account of asset prices or bubbles. Indeed in monetary policy itself you don’t know if 2% or any number is actually the ‘right’ level for inflation, nor can you prove what is the true non inflationary trend growth rate. Yet it doesn’t stop you from trying, and so far with some success, to create a valuable process for steering and achieving a more optimal economic, and indeed social result over time.

Of course monetary policy and financial stability interrelate. But the underlying determinants of behavior, and necessary intellectual approaches and policy disciplines are so different that I would argue that trying to incorporate financial stability into the existing monetary policy framework would be too much of a stretch. Perhaps that’s part of the debate. If you are going to stop a party with potentially deeply unpopular measures, you need a tailored process it seems to me for it to be accorded the necessary legitimacy and respect.

So I in no way want to underplay the problems and the uncertainties. But I strongly feel we cannot just put all this in the too difficult box. And I would suggest that we will not be thanked if we do not use this short window of opportunity, when the pain of the failure is so manifest, to examine the underlying territory.

I’d like to do this briefly in two separate but interconnected areas. Firstly as a precondition, the real managerial and organizational challenges that must be met in actually **doing** financial stability work, and secondly how to approach the creation of the sort of **framework** itself which I’ve just referred to above.

Management challenges
So firstly the challenges which affect those actually doing financial stability work. I fear these are not well enough understood: sometimes even by policymakers themselves.

I think they can be grouped into three areas:
- Policy crowd out;
- challenges within the financial stability sphere itself;
- and the essential need for three separate areas of public policy to be coordinated and seamless.

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Firstly Policy Crowd out. We have to deal with two major but separate policy areas which overlap, namely Monetary Policy and Financial stability. Given the interface between public policy and political and social issues, this gives rise to competing priorities over time, and the danger of policy crowd out for financial stability.

Put bluntly how do you maintain a sense of alertness let alone delivery in both areas: when financial instability is relatively infrequent and only occurs after long benign periods? And when stopping it would be so deeply unpopular?

For Central Banks this poses a particular challenge. Because the central bank has to be involved with both areas. It alone possesses the essential policy instrument - namely the creation of central bank money – which is vital for conduct of policy in both areas.

So the central bank has to be resourced and to manage internally two cultures or mindsets that need to coexist and be mutually reinforcing. The fact is that the mindset you need in the monetary policy area relates to regular decision making and steering – monthly, quarterly or whatever; with possibilities of adjustment –you can try again; the course can be adjusted as you go along; and finally you can rely to some extent on models of behaviour – you can judge what the response to policy is likely to be.

But for financial stability it’s quite different. You have to think the unthinkable; anticipate fat tail events: low probability but high impact. There are great difficulties of prediction and handling. Tipping points by their very nature are unmodelable and handling them even more so. You are also wholly reliant on ex ante preparations. The ‘creation of central bank money’ policy instrument is infrequently used, and its impact is far from certain; behaviours are irrational in the macro sense, even if rational at the micro; And often you only have one shot: if you get the policy wrong the social cost can be horrendous. Look at Lehman. Managing both mindsets is not easy!

The second managerial complication is having to cope with two very different types of work in the Financial Stability sphere itself, namely preparatory and mitigatory work on the one hand and handling crisis events on the other. This also needs the coexistence of two different mindsets.

Mitigation work of course takes place during steady state. You have the luxury of time to think about what measures or standards will reduce leverage build up: get them discussed and implemented. You can prepare and test for disasters.

But in crisis handling you have no time for any preparations. It doesn't matter what the policy area is: you are stuck with what you've got. So there are real management challenges in getting the two mindsets - and the two types of people best qualified to handle each - to work together.

Which brings me to managerial challenge number three:
There are three separate functional areas of public policy that need to work together seamlessly. Each of these areas needs a vital voice in handling financial stability. And often each has conflicting priorities: even if for all minimising social cost is the policy imperative. Firstly the Ministry of Finance or Treasury: the ultimate guardian of the taxpayer; and within the political process. Secondly the Central Bank with the operational capability and monopoly for the policy instrument that everyone wants in crisis: namely central bank money. And an understanding and instinct for that vital liquidity environment. And thirdly the Supervisory authority: which oversees individual institutions, and the solvency environment. Whatever the architecture, these three areas must relate to each other effectively and be mutually reinforcing even if supervisor and Central bank are one and the same.

This cannot be taken for granted. The UK experience is relevant here. You can achieve a lot during steady state times without the need for complete rigour. Our simple principles based MOU got us quite a long way. But when the crisis hits, the points of weakness that were 'too difficult' were exposed, And as we found any ambiguity of role here can be perilous.
There are of course many models of institutional architecture: and no one has yet found the ultimate solution.

- [Whether the integrated supervisor model with a separate central bank– UK, but also Japan and Germany:
- the Australian 'supervisory twin peaks' model, with two supervisory bodies;
- the Malaysian Singaporean or Dutch model which houses the supervision of Banks actually with the central bank. This was the old Bank of England style;
- or finally the US model: under the new administration we are clearly all watching that space!]

The bottom line is that each jurisdiction must choose its own path; ideally learning from the mistakes of others. But to my mind too much time and argument is directed to questions of architecture, and not enough on the human, organisational and managerial issues that impact delivery of the stability objective.

Towards a hard wired framework
This leads neatly to the second area I'd like to examine: getting things well managed is one thing. But you also need a hard wired framework to ensure delivery on financial stability issues: for taking and implementing tough decisions. This goes beyond the questions of architecture in the sense of who does what. Instead I would argue that we need new constructs and thinking about process if we are to prevent leverage build up, in a way which commands respect.

None of this is easy. The central problem is the sheer power of the vested interests in good times ranged against appropriate policy action to contain leverage build-up. There's a sort of unholy alliance. Politicians want growth, even if it is debt-fuelled. Banks want profits. Bankers want bonuses. Borrowers and consumers – voters – want to go on borrowing and spending. I think many of us observed this in the last decade. Just imagine the outcry there would have been if the party had been stopped by the imposition of higher capital adequacy standards during the good times! Personally I am convinced this would have been a cheaper option than allowing the bust to happen. But we lacked a framework or mechanism to deliver the unpalatable medicine.

So what should individual states do to prevent a recurrence? My thesis would be that the starting point needs to be with individual jurisdictions, but with vital encouragement and perhaps persuasion, from global authorities such as the FSF, IMF, Basle process etc.
And for those who feel they already act as follows please forgive me.
We need to create firstly **processes** ; and secondly**, an effective range of policy tools** both to help limit on a broad front the build-up of leverage and minimise the damage if instability ensues.

To achieve this, first, nations need to define the delivery process by empowering under statute an independent party, with an explicit mandate to oversee the build-up of leverage and deploy the necessary policy instruments to contain it. Its responsibilities, powers and accountability should be explicit and transparent under the law, giving it the independence to stand up to vested interests for which financial instability may seem remote. And the transparency of process should enhance understanding of the underlying issues.

Note that this systemic oversight role differs from day-to-day banking supervision. Both are important but the former role has been under-emphasised in recent years. You can think of it as macro-prudential policy, enhanced by micro prudential knowledge, but with teeth. In my view the party best equipped to carry out this role is the central bank. The ministry of finance or treasury is likely to be too remote from the intricacies of the market and its participants and too close to the political process. Only the central bank has the necessary closeness to the financial nervous system and operational capability because it alone creates risk-free central bank money – that essential ingredient in times of stress. Experience also suggests that people respect central banks that are able and willing to stand up to politicians and governments, as much as the vested interests of bankers and their customers.

Apart from the process and institutional basis itself however we also need the appropriate policy instruments. This too is a challenge but in essence they need to conform to a very simple principle. The creation of the credit that leads to extra leverage should be made more expensive as leverage builds, and priced at the margin accordingly. One thing we have learnt during this crisis is that, whatever shadow banking system may have emerged, the ultimate sources of credit creation under central banks were the banks or investment banks. In future, as leverage mounts, capital requirements for these should come under the aegis of the central bank, as is de facto the case now in the US. A system that requires higher capital requirements as leverage builds would increase the cost of credit, affecting directly the banks and then, importantly, their clients, including the shadow banking system, leveraged asset managers such as hedge funds, proprietary trading desks and insurance investors – even long-only asset managers who deploy products that contain embedded leverage. This would discourage the build-up that is the source of danger. And I might emphasize that while the central bank should be the main whistle-blower and make the policy recommendation, the actual deployment of the policy instruments could be handled by the banking supervisor where that is a separate body as in the UK. To my mind this new process could be put in place without needing in the first instance to rethink the existing institutional architecture. In a sense it would be superimposed on it, and use the existing institutions to deliver something better than they have been able to do hitherto.

Would it work? Or is the proposal naïve? I believe not. The basic issues are known. Leverage whether within institutions; arising as a result of derivatives, or embedded in products is now better understood. The policy instruments could be and in many respects are already in the process of being created. We can see much more clearly the procyclical tendencies of the first round of Basle two and fair value accounting. And we can see what is needed to alleviate the impact by creating more dynamic capital adequacy requirements whether directly or in conjunction with forms of dynamic provisioning. The will exists in the case of important standard setters such as the IASB to rethink the systemic implications of those standards. Modifications in this and a number of areas are indeed under way.

So to conclude, the bottom line is that improved understanding of relevant policy issues has enabled us to implement independent systems of monetary policy in recent decades. Implementing these without independence too on financial stability may have been inevitable, but has to my mind been at the root of our problems. We now need to put this right both by the creation of a process or framework for delivery, based on our better understanding of the underlying management realities. So let's have the confidence to rethink this and to come up with the financial stability equivalents.

Ladies and Gentlemen, a failure to grasp the nettles that have led us to today's situation would condemn us to another bout of instability of perhaps even greater intensity within a generation. I hope you will agree that those future generations would owe us no thanks for our insouciance.
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