Is Bigger Really Better? Moral Hazard Issues in Expanding Financial Safety Nets

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Structure

Global financial governance since the Global Financial Crisis (GFC)

Need to rethink the international Lender of Last Resort (LOLR)?

Moral Hazard aspects of central bank swap lines

Policy implications

Global financial governance since the GFC

- The GFC did not occasion an abrupt, radical shift from one regime of global financial governance to another, but innovations in global financial governance
    - Rather than a fundamental strengthening of global arrangements, we see an erosion of multilateralism, the emergence of "plurilateralisation' of global financial governance (Eichengreen 2018), i.e. the diffusion of bilateral (swap lines), regional (e.g. CMIM, FLAR, ESM) and global governance arrangements
- The post-crisis regulatory reform agenda has made the banking system more resilient
    - Some claim that the global financial landscape is still built around too-big-to fail institutions, rising shadow bank activities, including connections to banks, etc.
    - There is still scope for efforts to prevent regulatory arbitrage at the world-wide level

Global financial governance since the GFC

Reasons behind the additional plurilateral layers

- To better manage cross-border financial sector and monetary spillovers as well as capital account vulnerabilities
  - Trilemma may have morphed into a dilemma
- Under-represented countries wish to enhance ownership in global financial governance
  - Alternatives to the IMF-centered global financial architecture
- Advancing longer-term strategic objectives
  - E.g. China's network of bilateral swaps to promote the internationalization of the renminbi
- To reduce the need to accumulate foreign exchange reserves
  - Adverse impact on global macroeconomic outcome can be mitigated

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- Expansion of GFSN should reduce demand for foreign currency reserves
  - Potential benefits: e.g. reduction of mismatch of supply of and demand for foreign currency reserves
- US dollar exchange rate has taken on the role of a barometer of risk appetite
  - Changes in its value have significant consequences for the global economy far beyond the traditional direct effects on external trade
  - Risk of a dollar funding squeeze – "exorbitant duty" of the key currency issuer(s)?
- Shortcomings of the current plurilateral layers of the GFSN (EPG 2018)
  - Uneven in scale and coverage across regions
  - Lack of necessary coordination has resulted in fragmentation
  - Most elements are costly – either financially (reserves) or politically (due to stigma)

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- During the GFC central bank currency swaps have played a critical role in easing funding pressures on European and other foreign banks, limiting the need for fire sales of assets
- Central bank swap arrangements address the lack of a (fast and flexible) international LOLR arrangements for banks borrowing in key currencies
- The volume of swap operations and the wide range of countries involved was unprecedented, but the network remains uneven:
    - While central bank swap lines between reserve currencies and some emerging market countries were allowed to expire,
    - in 2013 six central banks (BoC, BoE, BoJ, ECB, FED, SNB) converted their existing temporary bilateral liquidity swap lines to standing arrangements

Moral hazard aspects of central bank swap lines

The (old) grand dilemma

- By rejecting liquidity provision to illiquid (but otherwise solvent) financial institutions during a liquidity crisis, the latter may transcend into a solvency crisis
- But providing liquidity protects the creditors and shareholders of (large) financial institutions and investors
  - The anticipation of this support may invite financial market participants to set off new adventures, eliciting ever-more support, in particular
    - ➢ the financial sectors of insured countries may be more inclined to rely too much on unhedged foreign currency financing
    - ➢ danger of foreign currency lending booms, currency mismatches on the balance sheets of households and firms
    - ➢ implicit subsidies of Too Big To Fail Banks of insured countries may be strenghtened

Moral hazard aspects of central bank swap lines

Efforts to reduce the implicit subsidies of too big to fail banks

- Higher capital and leverage ratios for large banks

  - regulator's paradox: *large complex and interconnected banks need very little capital in the good times, but they can never have enough in an extreme crisis.*" Blundell-Wignall et al. (2014)

Moral hazard aspects of central bank swap lines

Efforts to reduce the implicit subsidies of too big to fail banks

- New resolution and restructuring frameworks for large banks, including bail-in
  - Total loss-absorbing capacity (TLAC) bonds can be bailed in (converted into equity or written down) in the event of resolution
  - In the EU, bail-in of at least 8% of an institution's total liabilities is required before government stabilization tools or resolution financing can be made available
  - It is unclear whether resolution and bail-in work in a systemic crisis where large banks need to be resolved
  - Investors in bail-in instruments need to be storm-resilient! Otherwise bail-in of bank liabilities may trigger runs on essential bank liabilities.

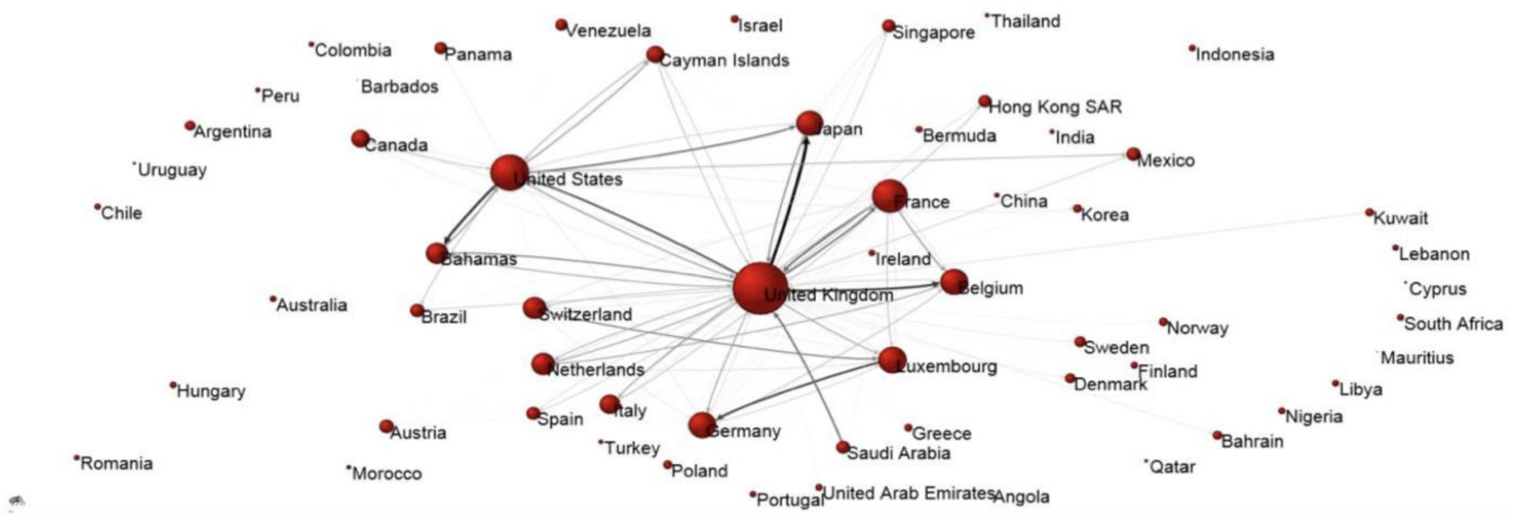
Moral hazard aspects of central bank swap lines

The role of (large) banks one decade after the GFC

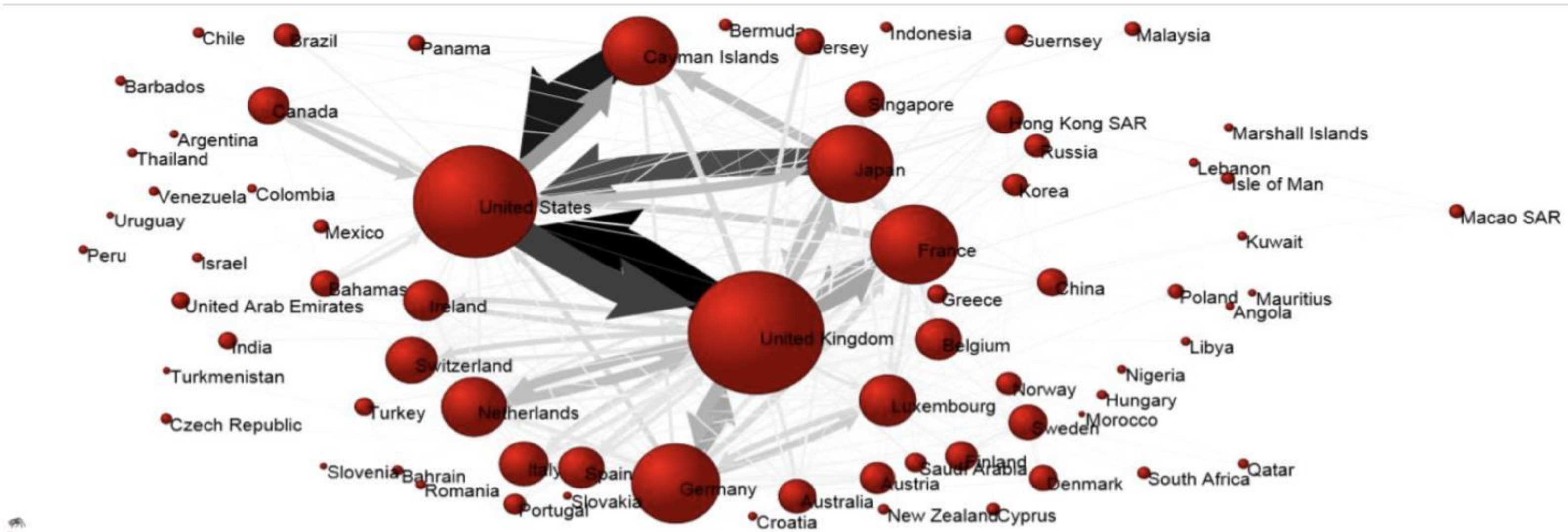
- No signs of general financial deglobalization in banking since the GFC
- Foreign bank's dollar liabilities are of similar size to 2007-08
  - Non-European banks expanded their dollar borrowing quite rapidly, but European banks have shrunk their dollar business and the role of the US affiliates since the GFC (BIS 2018)
  - Euro area banks' reliance on US dollar funding is limited in aggregate (around 10% of total funding), it is quite sizeable for some global systemically important banks (G-SIBs) (up to 29%) (ECB 2018). More than two thirds of the US dollar funding is wholesale
- The size of large banks has on average not shrunk
  - The size of the bank network links in key advanced economies has strongly increased (IMF 2016)
  - China's largest banks, having overtaken euro area banks, have become the world's largest banks by assets

Banking Integration, 1980 and 2013

1980



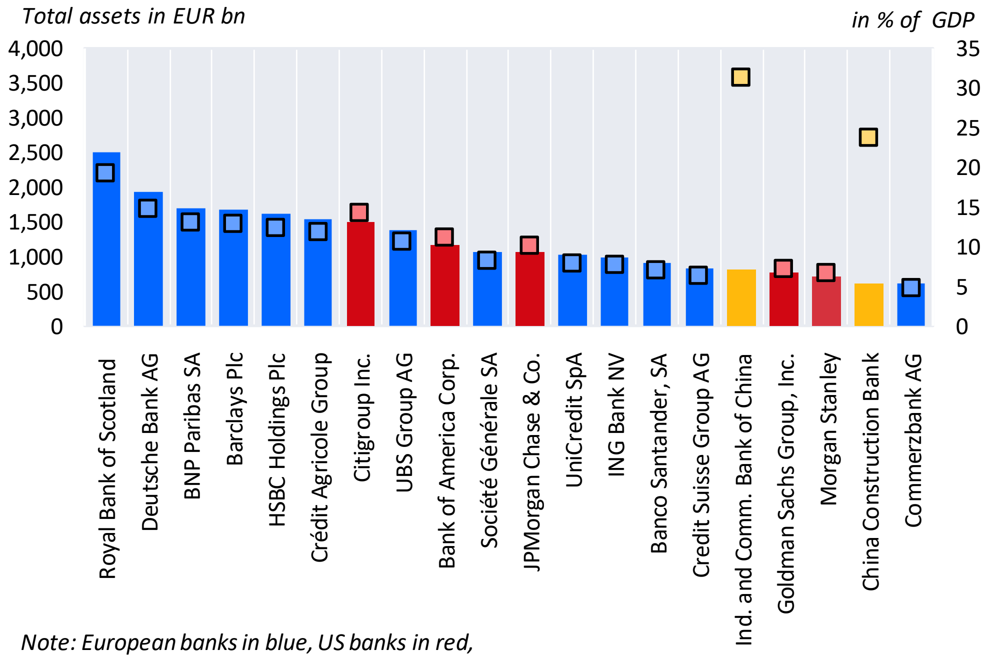
2013



Source: IMF 2016

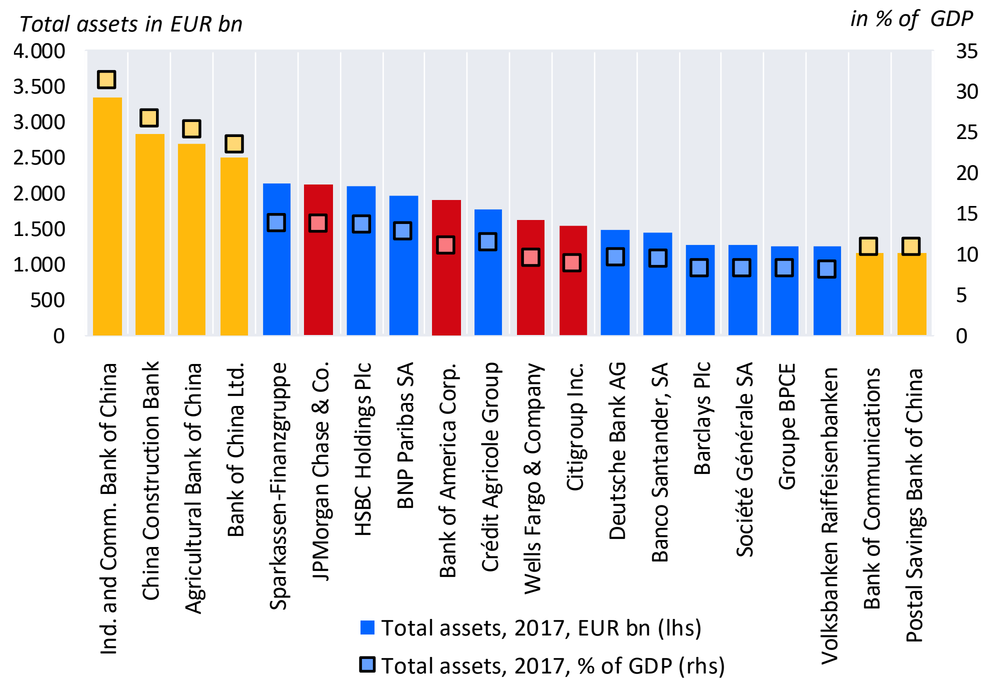
Top 20 largest banks in Europe, USA and China, 2007 and 2017

Top 20 largest banks in Europe, USA and China, 2007



Note: European banks in blue, US banks in red, Chinese banks in yellow
Source: SNL Financial.

Top 20 largest banks in Europe, USA and China, 2017

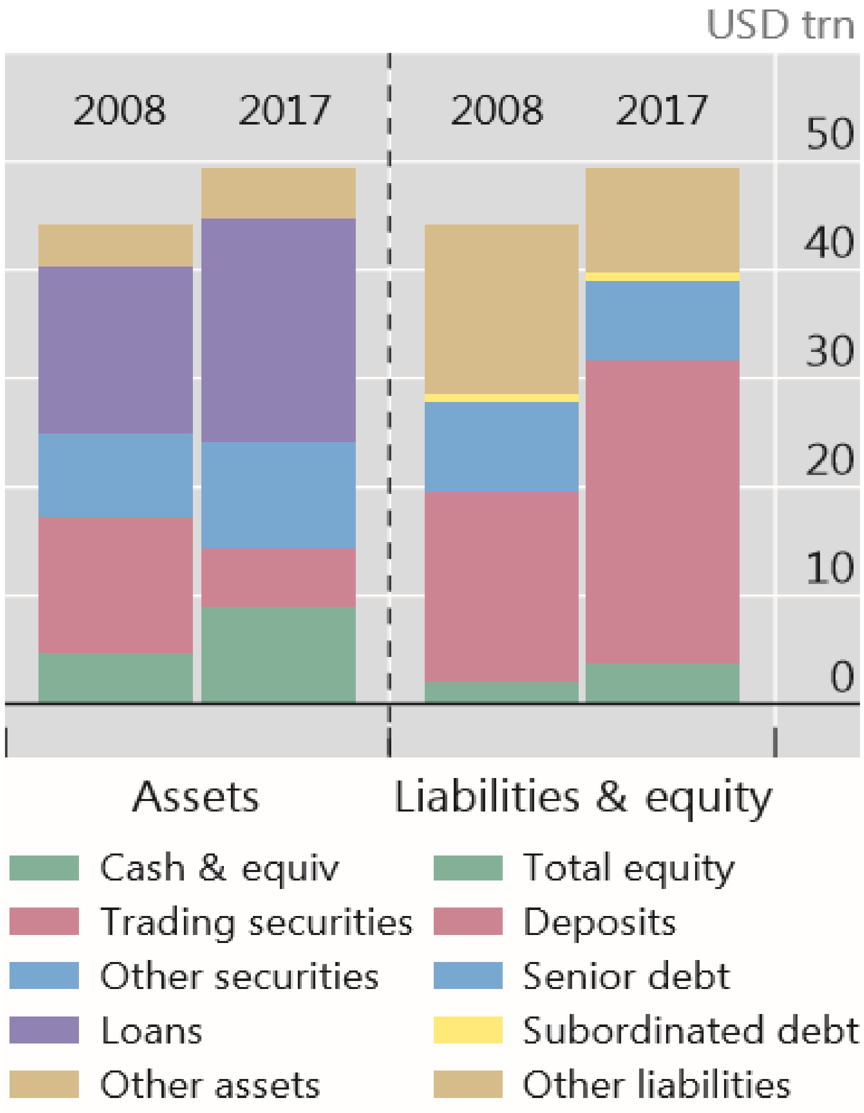


Source: SNL Financial. Note: European banks in blue, US banks in red, Chinese banks in yellow

Blue: EU
Red: US
Yellow: CN

Moral hazard aspects of central bank swap lines

G-SIB balance sheets (BIS 2018)



- More and higher-quality capital;
- less reliance on short-term wholesale funding;
- bigger high-quality liquid asset (HQLA) buffers; and
- a shift away from business lines such as proprietary trading, apparent from the shedding of trading assets.
- this reflects a broader shift towards more retail-oriented business models, with relatively stable funding and income sources.

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- Making the global financial system more resilient by strenghtening the GFSN is important,
- but in parallel, further efforts should be undertaken to lower the risks that the use of GFSN is needed, also by addressing moral hazard implications
    - Better regulation and management of capital flows and macroprudential measures, monitoring of 'international funding risks'
    - Private sector liquidity support (i.e. Vienna Initiative)
    - Global financial regulation, including coordination of regulatory measures between source and recipient countries
    - Further addressing the problem of banks too big to fail
    - Regulation of shadow banks, advance with closing data gaps, improved monitoring (derivatives, etc.)

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Thank you for your attention!

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