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On the right track? Debating the tough questions facing central banks

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Contents

Foreword 4

Turning tide: 6
Is it time for a rethink of monetary policy?

Job done? 8
Is the banking system now in the right shape?

Once and for all change: 10
Turning around a failing banking system

Rising to the challenge: 12
How well are central banks responding to their new and expanded remit?

The key questions facing central banks 14

Contacts 15

Foreword

Welcome to the report on PwC's annual Central Bank Forum 2015, which this year was held in PwC's More London office.

Central banks are operating within an environment of heightened scrutiny and intense public expectation, and yet there is still no clear consensus about how to tackle the key challenges they face.

The global political, economic and financial landscape continues to evolve, providing our Forum with even more relevant and topical material to debate this year. 'Central Banking: Ahead of the curve' provided a starting point for discussing the changing roles of central banks and how they can respond to the evolving demands placed upon them. Ever since the financial crisis broke out in 2007, it's been clear that price stability doesn't guarantee financial stability. But there are still questions over how the dual mandates of monetary and macro-prudential policy fit together in the post-crisis world.

Further questions within the markets most affected by the financial crisis include if, when and how to begin unwinding monetary stimulus and raising interest rates. While the Federal Reserve has made the first step[1], the European Central Bank is moving in the opposite direction through talk of "a more forceful monetary policy response" to boost demand and prices[2]. While such actions might be good for financial stability, what do they do for price stability (however defined)? Amid the decelerating growth in emerging markets and signs that the post-crisis upturn in many developed economies may be coming to an end, the direction of monetary policy will remain a matter of intense debate.

Now that the Federal Reserve has instituted its first rise in interest rates since 2006[3], many of the emerging markets that have seen a surge in investment as a result of the stimulus-fuelled carry trade could face a destabilising rise in borrowing costs and repatriation of funds. How can central banks insulate their markets from the fallout from unwinding? How can central banks work together to manage the impact on economies already weakened by falling commodity prices, exchange rate volatility and capital flight?

1 Federal Reserve media release, 16 December 2015

2 Speech by Mario Draghi, President of the ECB, Economic Club of New York, 4 December 2015

3 Federal Reserve media release and Forbes, 16 December 2015

Further debate centred on whether restructuring and reform within the banking system have achieved their key aim of protecting tax payers from the cost of bail-outs. While several Forum participants argued that the system is now more resilient, others challenged the assumptions that underpin much of today's banking reform and the unintended consequences they may be creating – one went so far as to describe the reforms as "jumping out of the frying pan and into the fire".

Cutting across these questions are the challenges of how to sustain the relevance and influence of central banks. Some participants pointed to a troubling reluctance to go against the prevailing political wind. Others described markets where banking systems are so compromised by corruption and political interference that central banks are virtually powerless. How can central banks ensure they are able to act independently? How can they ensure credibility and democratic accountability when the nature and impact of their decisions are becoming increasingly contentious and politicised?

The two days of round table discussions were an opportunity for senior central bankers and PwC representatives from around the world to share ideas, learn from each other's experiences and discuss the strategies needed to address these questions. Kenneth Sullivan, of Sullivan Consulting and former Senior Advisor at the IMF, and I had the honour of chairing the fascinating debates. What came through strongly was the importance of diversity and innovation within the financial system and an open-minded approach among the central banks overseeing it. The financial crisis highlighted the dangers of 'group think'. The post-crisis response is still marked by considerable uncertainty and experimentation. It would therefore take a brave soul to say that all the problems are behind us, let alone that we're on top of the new and emerging threats.

This summary paper is designed to provide a record of the issues debated, and a platform for ongoing discussions among the participants. The quotes are all from participants. To ensure full and free discussion, the participants' comments are un-attributable under the Chatham House rule.

Our sincere condolences to the family of Niall Merrimam, Head of Financial Reporting and Policy Division at the European Central Bank, and a long-standing supporter of our Forum, who died suddenly on 15 September 2015.

If you would like to know more about the annual Central Bank Forum or would like to discuss any of the issues in more detail, please feel free to contact me.

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"The post-crisis process of policymaking in some countries could be described as 'fire, aim, load', as laws are enacted before it's clear how they will be applied."

1

Turning tide: Is it time for a rethink of monetary policy?

Talk of tapering is now giving way to calls for further stimulus in some quarters. Has some central banks' reluctance to raise interest rates and unwind monetary easing reduced their room for manoeuvre now we're facing a possible slowdown? How can central banks manage short-term demands while sustaining the traditional medium-term strategic approach to monetary policy?

Having spent the first half of 2015 preparing the ground for a possible increase, why are many developed market central banks now so reluctant to raise interest rates? In September, the Federal Reserve said it wanted "a little bit more time to evaluate the likely impacts" of recent market volatility[4], though it did raise rates in December. A key reason for September's uncertainty appears to have been the mixed economic news in many emerging markets and its impact on still-fragile developed markets. The prospect of a renewed slowdown raises difficult questions for central banks, with some leading figures even floating the idea of further monetary stimulus and cuts in interest rates. Divergent paces in developed markets' recovery from the crisis prevent any clear picture from emerging.

Reduced room for manoeuvre

Are central banks ready to deal with a further downturn? A participant argued that central banks have backed themselves into a corner by not gradually raising interest rates when economic conditions were more benign. "If rates had been raised at a steady quarter per cent or so a year over the last few years, they would now be at around 1.5 per cent. This would give central banks room to cut them back again if we begin to see a slowdown. But with rates so low, there is very little room for cuts," he said. During the Forum debates, some participants countered that the sensitivity in the global financial markets had prevented them from following this route.

Fresh options

So how can central banks breathe fresh life into flagging economies if the traditional fillip of cutting interest rates is constrained? Among the ideas under discussion were sub-zero interest rates, raising inflation targets and creating what would in effect be permanent quantitative easing (PQE).

4 Reuters reporting press conference by Janet Yellen, Chair of the Federal Reserve, 17 September 2015

While participants expressed reservations about all these options, several noted that savers have already endured below-inflation rate returns. Where 'zero lower bound' rates have been applied they have not had a major impact on saving, though this might change if such temporary expedients endure. Many saw the bigger issue as the inter-generational impact of low interest rates on pension returns at a time when state welfare is being scaled back and people are living longer.

What about raising inflation targets? Several participants were worried about the risk to central bank credibility if they relinquish long-established targets. If workers respond with higher pay demands, it may also be difficult to re-establish control. However, price inflation has been kept low by the fall in oil and other commodity prices. In turn, labour market reforms have helped to keep wage rises in check.

Having been introduced as an emergency measure, QE has already taken on an air of permanence. Several participants pointed to the resulting risk of asset bubbles and worrying impact on central banks' own balance sheets. Is QE here to stay? If GDP growth were to dip as the cycle turns, there may well be pressure from the public, markets and politicians to turn up the gas. But several participants questioned whether turning QE into a routine element of economic management is sustainable. Some went further by questioning whether GDP growth should have the 'totemic significance' it has acquired. Retail spending, business surveys and labour market trends could actually provide a more relevant indicator of the health of the economy and provide the focus for more targeted intervention, they argue.

Are there more radical alternatives? Some economists and politicians now advocate injecting QE straight into the pockets of consumers through so-called 'helicopter money'. They believe that this would provide a stronger boost to investment and growth than directing the stimulus towards banks, many of whom use the money to buy gilts or deleverage, so reducing the amount available for credit. But most participants doubted whether helicopter money would work, expressing concerns about the impact on inflation and the potential for further politicisation of monetary policy.

Looking to the long-term

Are central banks taking a long enough view on monetary policy? The Forum discussions raised questions about some of the assumptions that are driving current monetary policy within developed markets. In particular, a participant argued that while many central banks don't foresee a major hike in inflation, this is heavily dependent on labour market developments and a continued supply of low-priced imports from the Far East. But as China shifts towards higher value production, it will be making fewer low-priced goods and the cost of many basics will therefore rise.

A participant went further by arguing that too much focus on short-term economic conditions and market sentiment is preventing central banks from taking a strategic view on monetary policy. He cited the impact of low interest rates on savings and pensions as an important consideration that was being lost as a result of what he sees as a narrow short-term view. He joined a number of other participants in wanting to see broader input into interest rate policy, which would include more representation from business on policymaking committees.

Further discussions centred on what some see as the growing political influence on central bank policy. Citing the reluctance to raise interest rates, a participant argued that central banks should be more prepared to take politically difficult decisions in the interests of long-term economic stability. However, others argued that the caution over interest rates owes more to uncertainty and competing demands (e.g. variations in rates of growth between countries and sectors) than political influence.

"Too much focus on the short-term is leaving us without a clear strategic view of monetary policy."

Job done? Is the banking system now in the right shape?

2

Governments, regulators and central banks have been seeking to eradicate the weaknesses in the banking system exposed by the financial crisis. Is the system in better shape? Are tax payers protected against the need to fund further bail-outs? Have the reforms created unintended consequences that need to be addressed?

"The financial crisis wasn't so much a perfect storm as bad weather exposing a horribly fragile structure," said a Forum participant. "Over-leveraged banks coped badly with the shock. Universal bank structures made it worse, as governments and central banks could not say 'we will save this part but not that'."

The main responses have been deleveraging, higher capital demands and either curbs on proprietary trading or ring-fencing of systemically critical operations such as payments and retail/SME banking.

Many countries have opted for higher capital demands than what a participant described as a "too weak" Basel III. Some commentators are concerned that relatively high capital requirements in a particular country could make it harder for local banks to compete with their international rivals, though many participants argued that taxpayer interests should come first.

Others have argued that high capital costs will simply shift more business into the shadow banking sector. But several participants countered that the distinction between mainstream and shadow banking is increasing artificial as the two are inexorably linked, be this through funding from banks or their own moves into peer-to-peer lending.

Do we actually need more capital buffers at all? Some commentators argue that leverage ratios could alone protect against failure. But several participants countered that capital is a good backstop, guarding against errors in risk-weighting. They also believe that the growing level of fines being imposed on banks calls for additional equity.

Loss-absorbing equity

If one considers the principal recommendations of the UK's Independent Commission on Banking (ICB), banks have certainly increased Loss-absorbing equity as a result of regulatory and other demands.

Several participants argued that banks still need more Loss-absorbing equity, though others doubted whether the Financial Stability Board's (FSB) move to impose a minimum total loss-absorbing capacity (TLAC) on global systemically important banks (G-SIBs) would reduce taxpayer exposure.[5] A participant argued that TLAC is a

5 FSB media release, 10 November 2014 (http://www.financialstabilityboard.org/2014/11/fsb-consults-on-proposal-for-a-common-international-standard-on-total-loss-absorbing-capacity-tlac-for-global-systemic-banks/)

misnomer as it doesn't represent the entirety of the equity/liabilities that could be bailed-in. By missing domestic systemically important banks (D-SIBs), taxpayers are still exposed. Indeed, in comparison to global frameworks developed for G-SIBs, many said that the measures directed at D-SIBs have been patchy to date.

Bail-in or bail-out?

The questions over TLAC opened up a wider debate over bail-in resolution. Bail-in debt forces creditors to bear some of the burden if a bank requires rescue. A participant argued that bonuses should also be paid in bail-in-able debt and that there should be no limits on the liability to enhance scrutiny. Yet while bail-in might look good on the surface, as the creditors not the taxpayers bear the liability, participants highlighted practical issues. These include who holds this debt – is it safe for a pension fund to hold it, for example? Moreover, as the plethora of legal cases following the triggering of bail-in provisions in Cyprus attests, there is also the potential for lengthy litigation.

A participant went further by questioning whether bail-outs are really such a burden on taxpayers. He argued that the US troubled asset relief programme (TARP) and Sweden's bail-out fund had actually returned a healthy profit for taxpayers though, pointing to the UK, others questioned whether this is always the case.

The case for and against ring-fencing

Several participants argued that the separation of systemically critical operations from what are deemed to be riskier and more volatile trading and investment banking activities would help to strengthen protection for taxpayers. It could also lessen the 'moral hazard' of implicit too big to fail guarantees. Some also argued that ring-fencing is easier to apply in practice than the proprietary curbs set out in US Dodd-Frank Act.

Participants also debated whether ring-fencing might miss the point. In particular, housing booms/retail mortgages were at the root of what one described as the "spectacular excess" that precipitated the global financial crisis and many other banking crises before that. As a result, taxpayers would be no safer if retail operations are within the protected ring-fence. Removing access to retail deposits would also heighten investment banks' reliance on higher risk wholesale funding.

Economically essential areas of banking such as commercial lending and project finance could still be retained within the protected ring-fence. However, drawing on PwC research, a participant questioned whether ring-fencing and curbs on proprietary trading were holding back fixed-income market liquidity and market-making[6], which are essential elements of a properly functioning economy. Moreover, if liquidity is constrained and the central bank therefore has to step in as market-maker of last resort, which to some extent was the case in China during the market volatility of mid-2015, then it becomes hard to withdraw this.

Are there alternatives to wholesale restructuring? Possible solutions put forward during the Forum discussions included a rethink of the way the housing market is financed by the banking system to help control the systemic risks. Others suggested that governance of a bank should be widened to include fixed interest creditors as well as shareholders. Several participants also raised the possibility of further compensation reform. Many favoured more deferral. "Deferral strengthens loss absorbency," said a participant. But others countered that bonus caps would simply lead to higher salaries and hence actually reduce the link between risk and reward.

"The real beneficiaries of bail-in will be the bankruptcy lawyers."

"Separation simply concentrates the risks within the banking system."

6 http://www.pwc.com/gx/en/financial-services/publications/assets/global-financial-market-liquidity-study.pdf

3

Once and for all change: Turning around a failing banking system

A financial crisis is not the only reason for a banking system to fail. Many central banks are also struggling to overcome a systemic breakdown in governance across the banking system they oversee, which undermines the operation of and public trust in banks. Looking at real life examples, Forum participants discussed how both banking systems and central banks could be reformed to address such failings.

Some banking systems now find themselves undermined by a combination of persistently poor oversight, high levels of insider lending and a lack of focus on how best to serve customers. This can often be compounded by political influence, either by banks on politicians or politicians on banks and central banks. The results erode public trust, stifle investment and damage the economy on the one side and open up the risk of money laundering and other forms of criminal infiltration on the other.

So what are the first steps to tackling such weaknesses in the banking system? One of the quickest and most decisive potential 'wins' highlighted within the Forum discussions is to impose unlimited liability on owners and major shareholders to force them to act more responsibly and prevent them "simply handing in the keys if the bank fails". In countries where ownership is opaque, it's important to clarify ultimate ownership and the lines of management reporting and control. These initial steps can be augmented by moves to identify and replace judges who've been known to provide light or partial rulings in favour of banks in cases of credit, tax and other disputes.

Participants also highlighted the importance of a viability test on all banks. Challenging banks to justify why they are in operation would help to root out institutions simply set up for tax evasion and/or money laundering. The process would also help to identify financially vulnerable banks, which supervisors could encourage to close or consolidate.

Central bank reform

Central bank reform is the other key foundation for overcoming failing banking systems, as this can be where the roots of weak or compromised oversight are found. This can lie in weaknesses within the central bank or in poor communications with external supervisors.

A participant highlighted the importance of redefining the central bank mandate to ensure it directly addresses weaknesses in the banking system, at both the systemic and individual entity level. Central bank boards can then begin to develop the road map for reform and challenge the entrenched interests and unwarranted political interference that could impede it.

Clearly, some of the entrenched interests will be within the central bank itself. A participant highlighted the importance of reducing hierarchies and dismantling 'silos', while rooting out institutional time-serving and a 'look the other way' culture. This in turn requires a clear map of processes to understand who owns them so they can be streamlined and audited more effectively.

"The building blocks of effective reform are the mandate, the culture, the decision making and the data."

It's then possible to begin the process of modernisation by bringing in new blood, including more people who have worked in other markets. Streamlining reporting structures and improving data quality can help to speed up decision making. Improving the speed and comprehensiveness of market reporting can in turn help central banks to identify problems quicker and respond more effectively.

This is a journey. People will try to stand in the way. Reformers may also face the threat of physical harm and therefore security is a critical element of reform. Mistakes will be made. So it's important to monitor progress against the road map, tackle areas that are stalling and judge where changes need to be made.

There is bound to be resistance. A participant talked about the need to identify champions, sceptics, agnostics and active resisters of reform, and then seek to turn the sceptics into champions and agnostics into believers, while at the same time seeking to neutralise or remove the active resisters.

4

Rising to the challenge: How well are central banks responding to their new and expanded remit?

Central banks now have a triple mandate to manage price stability, financial stability and economic stability. They also face the challenge of overseeing a sector being reshaped by technology, regulation and changing customer expectations. Are they on the right track and what risks are emerging?

"Oversight and regulation should take account of their impact on market diversity."

Central banks continue to sail through uncharted waters. Participants highlighted the challenges of managing financial stability when there is no clear or agreed definition of what this really entails and many of the tools they're using have yet to be tested in a crisis. Many of the interventions could also affect different groups in different ways (e.g. loan-to-value curbs), creating a more politicised environment. There is even the potential for what a participant described as "constitutional issues" if central banks overstep the boundaries of impartiality and democratic legitimacy. Most current central bank laws define a narrow base for central bank independence.

Could banking controls be creating dangerous uniformity?

Is a consensus view on the way forward emerging? Most participants still see a good deal of uncertainty and experimentation ahead. Others went further by challenging the need for a new policy orthodoxy and the uniformity within the market this could foster.

Likening the banking system to a biological ecosystem, a participant underlined the "'Darwinian' importance of diversity as the best safeguard against 'extinction events'". When one species disappears, others expand to fill the void, creating an adaptable and thriving source of life. While banks have in the past followed a similarly regenerative pattern following a crisis, he believes that weaker institutions have been protected rather than weeded out following the latest crisis and that today's high levels of intervention and control are creating dangerous uniformity.

Common threats cited by the participant include the propensity for very different financial institutions to follow similar return expectations. This can create an 'unhealthy ecosystem' in which when one falls, everyone does. Therefore encouraging diversity should be an explicit objective of central banks.

Is regulation distorting the ecosystem? Several participants pointed to the low risk-weighting for mortgage-backed securities in the lead up to the global financial crisis as an example of how regulation can dangerously skew the market and create hazardous consequences. Could the swing in the pendulum since be creating comparable market clustering and distortion? A participant argued that “high capital demands are creating a barrier to new entrants”. Echoing these concerns, a participant argued that limited competition favours large and systemically critical too big to fail groups, which may be tempted to take more risk if they think they are invulnerable. Another highlighted further dangers in the distorting impact of QE – “organisms dependent on antibiotics”. Borrowing cheap on the back of QE and re-investing this in fast-growth emerging markets could in turn be creating destabilising trends within the FX carry trade, he argued.

Where entrants have been successful is in picking off valuable slices of business in areas such as payments and peer-to-peer lending, rather than challenging banks right along their value chain. Several participants noted that these entrants have strong links with traditional banks, either as a source of funding or in channelling funds into payment portals. Nonetheless, several participants questioned whether these non-bank players are prepared for the transfer of risk and are capable of bearing it. What will the transition look like? If these entities are not good at allocating capital, could there be distorting effects?

Technology is changing the nature of the system

Technology has already changed how banks view and serve their customers on one side and is creating new forms of analytics and trading on the other.

The discussions at the Forum looked at even more revolutionary innovations that are now about to move into the mainstream. Virtual currencies have already created what a participant described as a new foundation for value, which is based on trading rather than tax receipts. Other block-chain applications facilitate crowdfunding, peer-to-peer transactions and foreign currency exchanges through a collectively managed, distributed ledger. A participant argued that these ledgers effectively serve the function of a financial institution by creating the mechanisms to validate, safeguard and preserve transactions. This could open the way to increased efficiency and innovative new business models.

Several participants argued that central banks need to take a proactive approach to these innovations by developing governance and management standards and monitoring the potential build-ups in risks in areas such as cyber-crime. This will in turn demand new skills and systems.

Where will the funding come from? Several participants highlighted the extent to which central bank income has been dented by the low interest environment. Many of their high-yielding bonds are also maturing. If technology does eventually lead to a cash-lite economy, this will in turn reduce seigniorage income.

Given the challenge of increased demands and declining income, participants underlined the importance of using technology to monitor the changing financial system and enable them to operate with greater efficiency and manage costs.

The key questions facing central banks

Central banks are in the invidious position of still grappling with the fallout from the financial crisis, while trying to get to grips with a fast-changing banking sector and the new and emerging risks this throws up. But as the Forum discussions highlight, this is also a time of intense innovation within central banking, in which old orthodoxies are being challenged and new approaches are emerging.

Drawing on the Forum discussions and our wide-ranging work with banks and central banks around the world, we believe that there are four key questions that central banks will need to address to ensure they're equipped to deal with the challenges ahead:

- ? What is the essence of central banking – is the desired role and nature of the financial system and your role within it sufficiently defined in its mandate and its law?
- ? What are the conflicts between your different mandates and how can you most effectively manage the potentially competing demands?
- ? What risks are emerging within a rapidly changing banking market and do you have the skills, data and systems to manage them?
- ? As your role becomes increasingly politicised, how can you sustain public understanding, support and credibility?

As we continue to work with our central bank clients, we will refresh our ideas and seek out answers to many more questions. For now – thank you Forum participants for your time, intellect, professionalism and camaraderie. We look forward to seeing you next year!

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