Digital transformations and financial system turbulences: lessons for policy makers

Hirohide Kouguchi - Executive Director, Financial Stability and Bank Examination, Bank of Japan
Fernando Restoy - Chair, Financial Stability Institute
David Wright - President, EUROFI

David Wright

Our next session is with two outstanding people. On my left is Fernando Restoy, the chair of the Financial Stability Institute in Basel. I was looking at your CV, Fernando. I do not think it could be any more complete or better. He has a fantastic academic record in the London School of Economics (LSE) and from Harvard University, including a doctorate. He has had extensive experience in the Comisión Nacional del Mercadeo de Valores (CNMV) and was also deputy governor at Banco de España. He is somebody who is, I know, very thoughtful about the key regulatory questions of our time.

On my right is somebody also of great distinction, who we saw on the previous panel. Hirohide Kouguchi has been at the Bank of Japan since 1988, if I am right, which is a long stint by anybody's measurement, and has held a lot of very important positions. He also holds an MBA from Wharton School at the University of Pennsylvania in the United States.

We are going to talk perhaps in a little more granular detail about the digital issues and financial turbulence, and the lessons for policymakers. Fernando, when you have looked at these recent events that we saw in the US and in Switzerland, do you think that, practically, intellectually and financially speaking, these new digital issues that have arisen represent a new and clearly material risk to financial stability?

Fernando Restoy

Many thanks, David. It is always a pleasure to be at Eurofi. Of course, we have seen in the previous session that we are all quite impressed with what has happened particularly in the US, but also in Switzerland recently. We have this turmoil affecting a few banks. You could argue that, by and large, recent bank failures were not directly related to the technological disruption as such. They were mainly triggered by the materialisation of more traditional sources of risk, particularly interestrate and concentrations risk. Those sources of risk t were already addressed by the international community when it embarked on regulatory reforms after the great financial crisis.

What has happened then? What is new? The new element here is, probably, the unprecedented speed and intensity of banks' destabilising dynamics, particularly in the US. Thus, we have seen a rapid contagion from market price correction to deposit outflows. Market corrections triggered panic that spread out very quickly supported by social networks. That triggered massive and unprecedently fast deposit runs. That destabilising dynamics could partially be explained by digital banking which made massive outflows possible.,. Those developments suggest that we could be entering a a new environment in which bank runs can be more frequent and intense thereby calling into question, to some extent, the assumed stability of the deposit base of financial institutions.

The new element here in the room is precisely this: some signs that we could be observing some structural reduction in the stability of deposits of financial institutions. Of course, the good news is that authorities have reacted well with their own crisis management frameworks, and were able to preserve financial stability.

However, we should not forget about potential implications of these signs of deposit instability on the whole policy framework. Deposit stability is not only a core assumption within the current regulatory and supervisory framework, but also a necessary condition for the very sustainability of the business model of commercial banks, so we had better take this seriously.

We need to understand how the policy framework has so far contributed to this required deposit stability, and analyse whether some adjustments are required for this to continue being the case. We need to bear in mind that regulation and supervision were born in parallel to deposit insurance, with the clear and precise objective of protecting deposit stability. Afterwards, the resolution framework was developed with precisely the objective to preserve failing banks' critical functions, including access to clients' deposits. Deposit stability is a cornerstone of our policy framework and, therefore, we need to assess whether that policy framework remains sufficiently fit for purpose in a context in which banks may be facing a structural reduction in deposit stability.

David Wright

Hirohide, do you see a permanent risk now or new types of risks specifically coming through the digital framework?

Hirohide Kouguchi

I agree with Fernando on many points. Digitalisation might have brought about some vulnerabilities to the financial system. Of course, it brings about positive effects, but, at the same time, it brings new threats to the financial system. It is very challenging for financial institutions and supervisors, but I would say that there is some way to address it.

Digitalisation has dramatically enhanced efficiency in communication and data processing, thereby facilitating financial transactions in a more convenient and costless way. From the viewpoint of financial stability, a couple features of recent digitalisation are important.

First, networking massive firms and people. Information, even if it is a rumour, will spread instantaneously via social media, and tends to trigger "herd behaviour". Secondly, enormous speed and volumes of data processing and communication. Thirdly, digitalisation enables unbundling financial services and creating sophisticated ecosystems, including banks, asset management, pensions, fintechs and digital companies, non-bank payment services providers, crypto-assets and stablecoin providers. Central bank digital currencies may also be a part of it. Interactions in the ecosystem are getting more and more active, which may bring about more complex systemic implications, now that overall pictures are hard to be obtained. And fourthly, digital technology enhanced AI, algorithms or high-frequency trading. It has improved market efficiency, but, at the same time, it may increase market volatility, responding to various information at a time of stress.

As we discussed in the previous session, we observed some of these features during the banking turmoil last March, with the rapid contagion of loss of confidence in banks' financial soundness and unprecedented speed and volume of deposit withdrawal. We are enjoying convenient and costless financial services, thanks to digitalisation, so we should not stop this kind of innovation. But, at the same time, we need to pay close and due attention to how to address systemic vulnerability, that digitalisation potentially brings about.

David Wright

Thank you very much. Fernando, taking this a bit further forward in terms of the policy implications, which seem to me to be very important here, where do you see the priorities? Where do you think we should concentrate our effort?

Fernando Restoy

Going back to the scheme that I tried to put forward before, there are a number of elements in the Going back to the scheme that I tried to put forward before, there are a number of elements in the policy framework that may need to be revisited eventually in light of what we have learned from the recent turmoil. We could start by discussing some ideas that have already been floating around in different areas.

First, I mentioned deposit insurance. There are ideas out there to try to enlarge the maximum coverage of deposit insurance. Is this a good idea? In principle, deposit insurance has been revised regularly, and rightly so. Should we go all the way to guarantee 100% of deposits? Frankly, I do not think that it is a good idea and it may have important counterproductive effects due to moral hazard and also some possible frictions and distortions that it could create in the capital markets.

In the area of regulation, which is the second piece that I mentioned earlier, we have already seen and read a number of ideas and proposals starting with a possible re-parameterisation of the Basel III liquidity requirements—liquidity coverage ratio (LCR) and net stable funding ratio (NSFR)—Soem have proposed further-reaching measures such as asking banks to fully collateralise all non-covered deposits. or constraining the amount of runnable liabilities that banks could have as a function of the amount of assets that they could pledge to get central bank lending.

Those more radical reforms could eventually constrain severely the ability of banks to continue intermediating funds, or to continue being in business. Therefore, we need to be very careful about whether we consider those as possible options, because the drawbacks could be quite significant.

As a matter of urgency, we probably need the implementation of Basel III. For the first time, we have liquidity requirements in the Basel framework. We know that LCR and NSFR are not necessarily standards that have been more broadly adopted so far. In the note published by the BCBS a couple of days ago, it is clear that there is progress, but we are not yet there, so we had better attach priority to the implementation of Basel III.

Certainly, what it demonstrates as well, as has been mentioned before, is that supervision should be a priority. There is much to be gained there. When you look at the turmoil, particularly in the US, what you see is not that some vulnerabilities of the banks in relation to exposure to specific risk have created the turmoil. We have identified a series of banks that have clearly unsustainable business models characterised by excessive maturity transformation, excessive risk concentration on the assets side, and excessive reliance on unstable sources of funding. When you have an unsustainable business model, there is no capital or liquidity that could compensate for that.

If this is about business models, the tool is not regulation but supervision. Supervisors should have the powers, the tools and the culture that will allow them to enact this impressive intervention in the banks and try to correct what is wrong, such as poor risk management practices or poor governance structures. All of that will explain why, at the end of the day, they are running business models that are considered unsustainable. For me, supervision has to be the first priority.

David Wright

One point that I thought Dominique Laboureix made very powerfully on the last panel was about greater transparency and real-time reporting to central banks and improving early warning systems. Would you go along with that?

Fernando Restoy

Absolutely, but I would go even further. The current supervisory reporting system is really quite obsolete. This idea is that, whenever the supervisor needs to receive information, they have to ask the bank. They send them a template that they have to fill in. We really need much more agile interactions between supervisory and bank systems. They have to talk to each other. That is the only way in which you can get all the information that you need in a timely way in order to do exactly what you were suggesting.

David Wright

Hirohide, give us your regulatory thoughts on this issue.

Hirohide Kouguchi

Again, I agree with Fernando on many points. As we discussed in the previous session, since financial intermediation intrinsically involves maturity and liquidity transformation with asymmetric information, financial institutions are, in a sense, susceptible to digital bank runs by nature at a time of stress. It is getting more and more so. To address it, I would reiterate that macro and micro prudential policy during ordinary times should be important. And as far as non-bank financial intermediation is concerned, "same function, same risk, same regulation" should be the principle.

Since the allowance time gets shorter and shorter at a time of stress, liquidity management has become more significant. The most fundamental public backstop should be the current account balances at the central banks and the access to the central banks' standing facilities. In Japan, all the major and regional banks have access to BOJ's standing facility via a digital platform, with eligible collateral posted in advance, and BOJ is monitoring banks' liquidity management operations daily. We sometimes request banks to post more collateral, as necessary. This is a part of the lessons learned from Japan's financial crisis in the 1990s.

Another measure to tackle this issue might be the well-designed deposit insurance, as Fernando pointed out. In Japan, approximately 70% of deposits are covered by deposit insurance and, on top of that, deposits for the purpose of payments with 0% interest rates are covered 100% by deposit insurance, no matter whether the depositors are firms or households. Of course, we need to address moral hazard issue by introducing some incentive mechanisms to overcome that topic.

It may also become more important for financial institutions to monitor social media on what is being talked about them as part of market intelligence.

At a time of stress, appropriate management actions by financial institutions that are of course most important, nimble liquidity provision by central banks and a public backstop, as necessary and appropriate, should play the key roles, as I mentioned in the previous session.

David Wright

In closing, let me ask you this, Hirohide. You know everything that is going on at the Bank of Japan. Do you have real-time information systems about what is happening in the banking system in Japan? Can you or the governor look at a screen and see big movements of yen deposits instantaneously?

Hirohide Kouguchi

We are working to establish that kind of digital platform for more granular data together with Japan's Financial Services Agency (JFSA).

David Wright

You made a very important point, Fernando, about modernising this linkage between private banking system data and supervisors' data. Thank you both very much for a very interesting discussion. They are always too short, of course, with such eminent people, but I do think we have identified here a serious set of issues that need attention.

Just one point, Fernando, on the deposit guarantee. What happened in Silicon Valley Bank (SVB) was that the Fed had to bail out commercial users. It was the big deposits that ran from the big holders of positions in these banks. Deposit insurance takes you so far on the retail side, but it does not solve the problem on the major deposit holdings of corporates. Is that right?

Fernando Restoy

It is quite the opposite. Everything not covered by a deposit guarantee scheme is part of the liability base of the institution, which is very vulnerable. It could become unstable and could run very easily. That is why we are talking about business models. Should we do something about limiting somewhat the amount of non-covered deposits that banks should have? That is very important from the point of view of ensuring the stability of the business model. It is also very important in resolution. It is absolutely key. Those are elements to look at within this regulatory friction that I am suggesting. Going back to what I said before, I do not think that the solution is just to decide to use a blanket guarantee for everyone with all deposits covered. That will lead to huge moral hazard issues.

David Wright

Thank you both very much.