

Brexit and Systemic Risk

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Brexit and the Implications for Financial Services

Brexit and systemic risk

- We are increasingly seeing serious concerns about financial stability consequences of Brexit
- But
- Brexit should *not increase or decrease* systemic risk
- It causes considerable uncertainty, but
- We are scared and looking hard
- Unlike 2006, the great moderation and the Greenspan put
- But I can suggest where to look

Systemic financial risk is the unlikely eventuality that

- Some parts of the financial system fail
- Spilling over to the entire financial system
- Causing a serious financial crisis
- That *may* result in a real economy recession/depression
- The average OECD country suffers one every 42 years, on average (IMF)
 - The UK once every 17 years (is the next one is hence due in 2024?)
- This is an overestimate
- *A once in a lifetime event*

What matters is the unknown unknowns

- The US stock market goes down by \$200 billion in one day and nobody cares
- Potential subprime losses of less than \$200 billion, and a once-in-a-lifetime crisis ensues
- Risk we know can be reduced and/or prepared for
- If there is will to do so
- It is the *unknown unknowns* that are most damaging
- Like in the 2008 crisis
- What are the unknown unknowns for Brexit?

Risk is endogenous

- Systemic risk arises from the interaction of economic agents, all with their individual objectives, information, biases and abilities
- We have classified risk as
 - exogenous** Shocks to the financial system arrive from outside the system, like with an asteroid
 - endogenous** Financial risk is created by the interaction of market participants

“The received wisdom is that risk increases in recessions and falls in booms. In contrast, it may be more helpful to think of risk as increasing during upswings, as financial imbalances build up, and materialising in recessions.”

Andrew Crockett, then head of the BIS, 2000

Endogenous risk, triggers and mechanisms

- Very few mechanisms can cause a systemic crisis
- Very many triggers can unleash a systemic crisis, when mechanisms are in place and significant hidden risk has built up
- We should search for the mechanisms not triggers
 - Vicious feedback with forced sales leading to falling prices and back to more forced sales
 - Leverage
 - Overconfidence
 - Trust in the competence of bankers and authorities
 - Efficient trading and regulatory environments
 - Globalism

Regulations and market structure

- Many financial regulations *can* increase systemic risk
 - e.g. Solvency 2 and Basel 2/3
- By forcing financial institutions to *see and react to risk* in the same way
- More fragmented and local financial systems *can be* more resilient than globalized and efficient systems
- Best way to reduce systemic risk is to avoid too much homogeneity in regulations and market structure
- *More fragmented systems could be more stable*

European systemic risk today

- The sovereign — bank doom loop
- The growth, inflation and interest rate doom loop
- Stability and fragile growth depend on near-zero rates
- Will the 'Gnomes of Zurich' strike again?
- Zero risk rating on sovereigns
 - (financial repression increasing systemic risk)
- Common currency, separate taxation

Fixed income and Italy

Brexit systemic risk

- The 30-year assumption that the UK is a part of the European financial market
- Market participants take and offset risk under existing rules
- Post Brexit, the ability to offset some risk could unexpectedly disappear
- Needs to be a surprise
- And pervasive and hard to avoid

Two areas to look at

1. Legal plumbing

- Some boring, totally mundane function
- Perhaps some settlement or rehypotheication will have its post-Brexit legal basis questioned
- Everyone will *prudently and immediately* stop some activities
- 2008, the cessation of lending to banks, Lehman
- No burden of proof needed, *a question is enough*
- Nationalist rhetoric, or rational economic analysis may get in the way of solution

2. Equivalence

- Equivalence only says that we are treating rules as equivalent today
- It does not imply permanence in the same way as membership of the common market
- *Assumption of permanence* encourages risk-taking
- And then the *questioning of equivalence* could lead to a crisis

EU financial stability strategies

- *Soft Brexit is the most destabilizing outcome*
 - Creates unknown unknowns in legal plumbing and equivalence
 - Makes it harder to measure and manage systemic risk
- From a purely Euro-zone financial stability point of view
- Rational for EU to have most EU connected financial activity migrate
- So hard Brexit

UK financial stability strategies

- A good economic outcome demands maximum access —
Soft Brexit
- OK if comes with common market
- But maximum equivalence best it can hope for
- So more systemic risk?
- Will it accept that, already being just about the most
crisis prone OECD country?
- Or seek to stabilize?
- Possible without competitive consequences?
- The natural instinct of the UK authorities is not exactly
laissez-faire

Systemic consequences possible but unlikely

- Systemic crises happen when we suddenly question existing assumptions for how the world works
- It is hard to identify what will go wrong, *in advance*
- Soft Brexit may increase systemic risk
- Brexit may result in *lower systemic risk* if the regulatory landscape fragments and globalism is reduced
- Hard Brexit and a tough EU stand in the negotiations may lower systemic risk
- Unknown unknowns are the threat
- They may lurk in the legal plumbing and equivalence