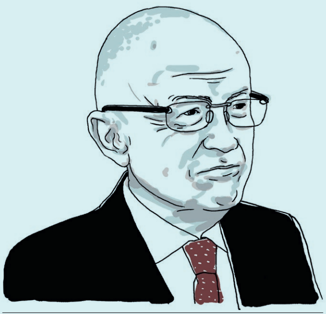
Jon Moulton's Diary

Is the Bank of England playing games with SWES?



Veteran financier Jon Moulton has been involved in buyouts, turnarounds and venture capital since 1979 with firms such as CVC, Permira, Apax, Alchemy and, most recently, Better Capital, where he has been the chair since 2009

'The only certainty is that the next financial crisis will contain elements that are different than we have seen before'

An eternity ago, this bloke from a Stoke-on-Trent grammar school was summoned to a job interview for the new graduate at the daunting Bank of England. It was his first trip to London. He was sat at a giant table, barely able to hear the questions and clearly possessed of very different political views to his inquisitors.

To his great surprise, having received a job offer he decided against taking it up and started in the direction which led to a venture capital career.

My subsequent career has seen an ever-increasing load of regulators – the Bank of England has joined up with five other regulators to launch the Private Markets System-Wide Explanatory Scenario (the SWES) to run a scenario game on what would happen if things went astray in the economy. (Lots more detail on the Bank's website.)

Rediscovering the past

People, are it seems, nowadays paid to rediscover that high leverage, poor financial controls, feeble economies, unstable currencies, illiquidity and the like can lead to problems.

A long list of assumed parameters – interest rates, growth (or its absence), unemployment and the like is being fed to participants to enable them to generate conclusions.

(I would have personally thought that US President Donald Trump would at least get a mention as a potential source of economic problems. But that fits poorly into scenario modelling and he does not feature as a parameter.)

I'm not opposed to people being maintained in employment running the SWES but the only certainty is that the next financial crisis will contain elements that are different than we have seen before. The reward for the study will likely be slight.

The SWES does not try to model such possibilities as AI becoming dominant and malignant. Human fund managers will certainly be largely replaced by AI over the years ahead – drawing on common data their behaviour could be unstable and/or herd-like,

The BoE's SWES scenario maybe an enjoyable game, but it omits some fundamental trends and risks in the global economy

which would require new tools and actions to control. A clever AI could even precipitate a crisis by speculative dealing.

Crypto currencies pose another set of risks with increasingly wider financial effects.

Crypto currencies are a good illustration of the influence of market confidence – people either believe or disbelieve that these funny bits of electronics have a value or do not.

Collapse of confidence

The one common factor in all financial crises is the collapse of confidence. And that is not easily estimated as to timing or extent.

Many countries already have levels of sovereign debt that a few years back would have generated financial collapses. The breaking point of market confidence is critical and essentially inestimable – there are too many human factors that influence this for useful prediction.

I am sure that there is considerable wit and experience at the BoE regarding crisis management. But the available tool kits are well known, albeit in broad terms. This SWES exercise will undoubtedly reinforce the knowledge of what may lead to distress, but I fear by not a lot.

Personally, I must confess to an unhealthy liking for periods of distress. You can get things done quickly. And I will cheerfully point out that distressed markets have their good side. A good crisis should not be wasted.

Capitalism has always been dependent on corporate (or even sovereign) failure to destroy poor models. Good assets and good humans need to be in good businesses and economies– not propping up long obsolete business models or way overindebted and overtaxed countries. Very obviously, responding to economic distress will result in pain for those involved but the temptation to eliminate that pain will need robust governance.

I've always been good at Monopoly – but I fear the BoE will not be calling on my skills. Hope they enjoy the gaming!

Alamy