Nor Shamsiah Mohd Yunus: Crisis preparedness menu for guardians of financial stability

Opening address by Ms Nor Shamsiah Mohd Yunus, Deputy Governor of the Central Bank of Malaysia (Bank Negara Malaysia), at the 14th IADI Conference on "Crisis Preparedness Institutional Arrangements and Coordination, Crisis Communication and Contingency Planning", Kuala Lumpur, 28 October 2015.

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It is a great pleasure to be here amongst the company of distinguished members of the deposit insurers' fraternity, fellow supervisors and central bankers. We meet here today, almost seven years, after the collapse of a single firm that shattered conventional wisdom and redefined the "rules of the game" for the management of financial system stability. Seven years later and counting, the path to sustainable recovery remains unclear. The cumulative impact of reforms in the financial sector also remains to be seen. In such an increasingly unpredictable world, crisis preparedness has become more important.

Much is already being done on various fronts to prepare us better to manage crises. This has mostly focused on policy reforms, the supporting infrastructure and institutional arrangements. Also important however, and much less discussed, are aspects of crisis preparedness that cannot easily be reduced to a pre-defined framework or template for action. These aspects are ***humility, agility and trust***, and this is what I would like to address today.

Let me begin with a short story. On 10 May 1996, three teams set out to conquer the world's tallest peak, Mount Everest. Due to a combination of factors, including over- confidence, a hostile environment and poor communication, the expedition ended in one of the worst tragedies of the peak's history. Rob Hall, one of three team leaders of the great expedition, had successfully scaled the mountain numerous times before. Underestimating the risks when faced with unstable weather conditions, Hall decided to proceed with the climb rather than turning back. He had strong belief that his past successes, which invariably inflated his confidence, sufficiently equipped him for the challenges ahead.

This has now become a classic case study on leadership and risk management under extreme conditions. Interesting parallels can be drawn in the context of crisis preparedness in the financial sector.

Over the course of crises history, policymakers and market participants that were involved in every financial bubble were repeatedly afflicted with the conviction that "this time would be different". The majority voice was quick to dismiss rising risks, and contrarian views were often ignored. It was reasoned that efficient markets would work as they should to contain risks, and economies would have the structural flexibility to adjust to residual risks that might materialise. In hindsight, such views were surprisingly intractable throughout periods that have followed multiple episodes of crises – from the 30's Great Depression, the 80's debt crisis, the 90's Asian and Latin American meltdowns, to the Great Recession of this century. Conditions surrounding each crisis differed widely, but this recurring mindset appeared to prevail in the run-up to each major collapse.

Playing to form, during the period of the Great Moderation, it was held that central banks and policymakers had successfully moderated destabilising booms and busts in the long term. Financial 'innovation', while not eliminating risk completely, had found new ways to effectively distribute risks across diversified agents and borders. Or so it seemed, even though no one fully understood or had enough information to know where the risks ultimately ended up. All of the above lent credence to the deep-seated faith that "this time would be different", until the extended period of macroeconomic calm was abruptly brought to a jolting halt by the Great Recession.

The future terrain of crises will continue to be fraught with uncertainty and a humbling recognition of our inherent limitations. Policymakers therefore need to proceed with a healthy dose of ***humility***. Much like the harsh, volatile weather conditions at the world's highest peak, the next crisis will be unpredictable, and likely exceed our capacity to control or prevent. In this post-crisis era, we have seen wide ranging policy and institutional reforms in many jurisdictions. They are important, even critical, to correct past errors and respond to future anticipated challenges. But their implementation, and our reliance on them, should acknowledge the constraints that we face. Contemporary understanding of the sources, drivers and transmission channels of systemic risks remains incomplete. Multifaceted policy frameworks and toolkits designed to curb systemic risks and manage crisis are also still evolving. We can certainly expect that data quality and analytical frameworks will continue to improve over time. But our understanding of future crisis dynamics will never be perfect. Far from it. This means that we must be prepared to change course when required and acknowledge errors in judgment sooner rather than later, even if it means re-evaluating well-reasoned positions.

This brings me to my second point on ***agility***. Financial crises are inflection points of a cycle which materialise in the least predictable manner. This demands a high degree of agility of policymakers and the financial system to adapt to the new operating reality. Such agility is derived from crisis management frameworks that are well-anchored in clearly defined strategic outcomes and accountability structures, but also flexible enough to respond to a range of conditions. And critically, it requires investing in resources with deep experience and knowledge.

Going back to the 1996 Everest expedition, Hall and his team had made every reasonable effort to incorporate comprehensive risk management and contingency planning into the pre-climb plan. As things turned south, it became clear that the team was unable to respond quickly to the dynamic situation. Outdated and inefficient radio systems led to a communication breakdown of vital information. Physiological, psychological and technical readiness of some of the climbers was also in question. Their inability to respond fluidly to changing conditions created an overdependence on key resource persons. Combined with lack of experience to deal with a series of new challenges, leaders were incapacitated and team dynamics disintegrated quickly.

In essence, crisis preparedness frameworks should provide clarity of purpose for actions taken, enable policy options to be properly evaluated, and support effective and swift execution of crisis responses, including the communication of such responses. It is not however intended to be a fail-safe mechanism with a pre-set comprehensive plan, designed exclusively for each likely manifestation of a crisis. We need to anticipate that plans will fall apart midway, or work selectively throughout various stages of the crisis for a variety of reasons. Market participants are irrational, infrastructures flawed, economies and financial systems are imperfect, and the political environment is unpredictable. Markets are also prone to excesses, manipulations and fickleness. Therefore crisis preparedness frameworks need to flex and evolve accordingly and ensure that framework, instrument and resource rigidities do not become binding constraints to the effective management of future crises.

At the heart of the operational and governance framework for crisis management will be a team comprising first responders, surveillance/crisis experts and decision makers, cutting across a range of competent authorities. The ability of these key operating agents to respond nimbly is imperative during a fast-moving crisis to reconnect the financial system lifeline, and maintain coherence in the overall crisis management process. This in turn depends on the ability to bring together a dynamic set of crisis managers across jurisdictions and agencies. Such a pool of crisis expertise needs to be identified beforehand and continuously developed, including through simulations, to reduce the time to action during a crisis.

Last, but certainly not least, is the element of ***trust***. In the panic and chaos during crisis situations, feeble coordination and communication arrangements will falter easily. This can occur even with well-established frameworks and dynamic resource persons at hand. Communication failures during Robert Hall's expedition were not caused by the lack of infrastructure or defined channels for information dissemination. It stemmed from a more fundamental issue. Those involved in the final climb were complete strangers until several weeks before. Unfamiliarity among team members generated communication barriers, distrust and uncertainties. This did not engender efforts to create a robust co-dependency and coordination structure to collectively weather extremities faced on Mount Everest. Strong policy frameworks and institutional arrangements only make interagency coordination and communication feasible. But it is entrenched mutual trust, fostered during stable times, that makes them *credible* in challenging times. Trust ensures that collaboration arrangements, secured in good times, remain firm and functional in the face of crises. Trust nurtures confidence and enables reliance on the competence of others. Without trust and symbiotic crisis networks within and across agencies, a crisis framework offers little more than false comfort during crises.

The Bank's own experience in the management of crises, as well as global reforms that are taking place in this area, continue to be useful in guiding us as we navigate this increasingly demanding policy domain. We have continued to make important progress. In the spirit of building trust and agility during normal times, we have worked hard to strengthen coordination arrangements with our regional counterparts and key domestic authorities. To name a few, this has included the development of crisis management protocols that are outlined in the Strategic Alliance Agreement with PIDM, the Operational Framework for Financial Crisis Management and Resolution with the Securities Commission, and the Executives' Meeting of Asia-Pacific Central Banks (EMEAP) Crisis Management and Resolution Framework involving 11 jurisdictions. Numerous refinements have been introduced, and several crisis simulations were conducted. All in response to anticipated changes in the financial and regulatory landscape, and to continuously elevate our level of operational preparedness. We remain committed to building strong relationships based on mutual trust that will serve us well through the uncertainties that invariably accompany any crises. And we continue to work on ensuring that these arrangements are credible when disaster strikes. For us, it is as important to encourage open and honest communications with our counterparts, as it is to have formal arrangements for information exchange. We cooperate with each other in conducting joint surveillance and capacity building initiatives. Through these collaborations, we gradually build respect, trust and goodwill, the kind that no framework can hope to manufacture.

Let me now conclude. In no trivial part due to my mentors, predecessors and colleagues, past crises that affected Malaysia were well-managed, leading to speedy recovery with minimal losses to taxpayers, and the equally important structural transformations that followed. Clear statutory remits. Independent policy making. Effective coordination and implementation. Sound governance and accountability. Building agility and trust. And proceeding with utmost humility. These building blocks and experience accumulated laid the necessary foundation for the Bank's work on crisis management, and continue to anchor our efforts to enhance crisis preparedness on various fronts.