Svein Gjedrem: Government intervention and moral hazard in the financial sector

Opening address by Mr Svein Gjedrem, Governor of Norges Bank (Central Bank of Norway), at the conference “Government intervention and moral hazard in the financial sector”, Oslo, 2 September 2010.

* * *

It is my pleasure to wish the participants of this research conference welcome to Oslo and Norges Bank. I also welcome participants to our annual financial industry day. This year we have chosen to make that event an integrated part of the research conference. We believe the topic of this research conference should be of particular interest to practitioners. We have also put together the program for this first day of the conference with practitioners in mind.

The topic that you will be discussing during the conference is very important for our work at the Norges Bank. Moral hazard in the financial sector is a main concern for the design of government regulation and for the planning of government intervention in periods of financial distress. Norges Bank is not the bank supervisor in this country. The Financial Supervisory Authority is a separate institution. But Norges Bank does have a general responsibility for the smooth functioning of the financial system: We have what are now being termed macroprudential responsibilities.

We have been doing macroprudential supervision and published our findings in our Financial Stability Reports since 1997. We were thus one of the first central banks to publish such reports. Our semi-annual reports have been gradually improved over time. We believe that they are now important contributions to financial supervisory work in Norway. We are concentrating our analyses on the macro developments of the financial industry and the macro risks that the industry is facing. For this purpose we are using data bases with detailed information on banks, non-financial firms and households. This gives us an intimate knowledge of the health of the banks and of their customers.

Macroprudential policies have at least two components. The most important is arguably the long term design of the regulatory framework for the financial sector. Ideally we wish to build institutional stabilizers that will prevent financial boom and bust cycles, or at least make them less frequent. One example of such a stabilizer would be a capital buffer requirement above the minimum. A buffer requirement, combined with automatic dividend restrictions for institutions that do not meet the requirement, will most likely become part of the new international regulatory regime. Another example is leverage ratio limits that will reduce the scope for expanding financial activities on a very small capital base. A third example is Spanish style rule-based dynamic provisioning. This latter stabilizer seems unfortunately not likely to be included in the reform package.

It is very important that these kind of automatic stabilizers are built into the new regulatory framework. It is important that they are rule-based. Leaving stabilization to the discretion of regulators will always give more uncertain results. Rules are often preferable even if they have to be crude and suboptimal.

Norway is part of the European Economic Area, and EU regulations are thus applicable in this country. Within the remaining national discretion, Norwegian regulations are laid down by the Ministry of Finance, and implemented by the Financial Supervisory Authority. But Norges Bank aims to be an active advisor on these issues. Our work on macroprudential supervision provides insights that we wish to share with other supervisory authorities.

The second component of macroprudential policies consists of short and medium term measures to alleviate the effects from the procyclical behaviour of financial institutions. There are two macroprudential aspect of procyclicality. It is the common exposures of a group of financial institutions. And it is the interconnectivity of financial institutions through trading and credit relationships. Common exposures are probably the most important of these interdependencies for crisis generation. Individual institutions can look perfectly healthy even when vulnerabilities are building up on the systemic level. The prime example of this phenomenon is naturally lending stimulating a price bubble in the property market.

Developing time-varying macroprudential policies is not straightforward. The interest rate policy targets the inflation rate, and cannot always be set as would be appropriate for asset prices. There might be conflicting targets. We should thus be looking for new instruments.

As you are certainly aware, most of the macroprudential policy instruments that have been proposed are the same as those already being used for microprudential purposes. Examples are loan-to-value or loan-to-income limitations, and add-ons to the risk weights on relevant bank exposures. The latter instrument is being used in New Zealand, where supervisors have recently introduced a 15 percentage point risk weight add-on to property lending.

Since these instruments are also microprudential, they are all in the domain of the Financial Supervisory Authority and are needed there. But the macroprudential objective is different from the microprudential, and may call for different calibration of the instruments. The implementation may for practical reasons need to rest with the FSA. But Norges Bank can make strong recommendations on how these instruments shall be used for macroprudential purposes. We shall seek very close cooperation with the Financial Supervisory Authority to implement our macro prudential agenda.

The Nordic region is currently close to being a separate banking market, where non-Nordic banks have small market shares. But branches with parents in other Nordic countries have substantial market shares in all national markets. There is scope for fruitful cooperation between the Nordic supervisory authorities.

The countercyclical buffer proposal from the Basel committee includes a prescription to that effect. It stipulates that the time-varying capital buffer targets shall be applicable to all banks operating in a jurisdiction, including branches of foreign banks. The home supervisor shall impose the buffer decision of the host supervisor. This is a step in the right direction, but differences in risk modeling will remain. There is hardly any good reason for different risk weightings on similar loans given by a domestic bank and a branch of a foreign bank.

With these thoughts on central banks and macroprudential policies, I would remind you that we organize this conference hoping that we shall be able to take something useful away for our further work on financial stability. I would like to thank the program committee for putting together what looks like an engaging program. I wish all of you good luck and hope you shall have fruitful discussions in the next two days.