Ignazio Visco: What does society expect from the financial sector?

Panel discussion remarks by Mr Ignazio Visco, Governor of the Bank of Italy following the Per Jacobsson Lecture by Dr YV Reddy, 24 June 2012, Basel, Switzerland.

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The global crisis has spotlighted a number of problems. Some are well known (eg the fact that in some countries in the past the regulatory and supervisory approach was inadequate to address them). Others are relatively new. A comprehensive overview of the many issues facing public authorities has just been provided by Dr Reddy, with a thorough checklist of what has gone wrong, what is being done, and what direction we should probably be moving in.

I would like to focus on a more limited set of issues, which in my view are among the most telling about the weaknesses of the financial system today.

First, however, let me recall that although the title of our roundtable is "What does society expect from the financial sector?" we are likely to only be able to discuss what we think society "should" expect. With this in mind, I would like to make three points:

- Finance has long been viewed as a morally dubious activity. My appeal to authority on this matter is a reference to a lecture delivered by Amartya Sen about twenty years ago as the first Paolo Baffi Lecture (*Money and value: on the ethics and economics of finance*, Bank of Italy, Rome, 1991). Sen wondered: "How is it possible that an activity that is so useful has been viewed as being morally so dubious?" He recalled a series of historical episodes: Jesus driving the money lenders out of the temple, Solon cancelling debts and prohibiting many types of lending in ancient Greece, Aristotle describing interest as an unnatural and unjustified breeding of money from money. Recent protests against the financial industry – the Occupy Wall Street movement, the "Indignados" in Spain and their counterparts in other European countries – can certainly lay claim to an eminent series of historical precursors.
- Superimposed on this "structural" mistrust, one can detect cyclical patterns in the public's attitude towards finance, affected by the conditions of financial systems and shifts in the political mood about state intervention in the economy. Until the 1970s it was taken for granted that market failures required the presence and response of a regulator to avoid suboptimal results. Then came the great inflation of the 1970s, combined with high unemployment, and the accent began to be placed on government failures. Governments, central banks and other regulators were blamed for failing to prevent those developments. This eventually led to an ideological swing: a push to reduce the magnitude of state intervention. The failures of the "regulated economy," the pace of technological advance and the rapid expansion of international trade after the end of the Cold War fuelled a protracted process of financial deregulation that was halted only by the financial crisis that broke out in 2007. The latter triggered a move toward re-regulation – or better regulation – that is still under way. The pendulum keeps swinging and will certainly continue to do so.
- But despite the negative perception of banking and finance, blind backlash is a danger to be avoided. As Amartya Sen argued, finance is essential to the functioning of the real economy. And I share Dr Reddy's view that finance is a force for good. It is crucial for sharing and allocating risk, especially for poorer societies and people, insofar as risk aversion decreases with wealth. It is crucial for transferring resources over time and removing the liquidity constraints that hamper the economy and the exploitation of ideas. It is very important in promoting economic growth, especially by fostering innovation. We have countless historical

examples of good financial innovations. Think, for example, of the "letters of exchange" introduced by Italian merchants in the Middle Ages: they were probably the first fiduciary money, and trade benefited enormously from this financial instrument. More recently, consider the development of "micro-finance" in the 1970s: an innovation that has enhanced financial inclusion, helping poor borrowers to smooth their income and cope with illness or other temporary shocks. And, in the last two decades, recall the role of the "venture capital" industry in the promotion of successful innovative corporations such as Apple, Intel and Google.

I would now like to offer a few thoughts on issues related to what has gone wrong in the financial system in the last few decades. I will consider four points:

- Financial market participants tend not to be aware of the fundamental non-stationarity of economic developments. The wave of financial innovation in the 2000s was fuelled by the idea, in principle correct and fruitful, that the proliferation of new (and complex) financial instruments, allowing agents to insure against many dimensions of risk, was a way to "complete the markets", to get closer to the theoretical Arrow-Debreu world, enabling investors to transfer resources efficiently across time, space and states of the world. But this idea relied on the presumption that the world is basically stationary (and substantially linear), that the future is pretty much like the past, that we can extrapolate from relatively small samples, and that there is a single "data generating process" that we can identify and understand. (We must admit that all this is not limited to finance but also applies more broadly to macroeconomics, econometric modelling and forecasting.) The real world is different, though; for many years the big investment banks were able to sustain returns much higher than what was justified by economic growth, but the day of reckoning was bound to come. In a way, innovation, based on the presumption of stationarity, sows the seeds of the non-stationarity that eventually undermines that very presumption.
- Complexity was also used, somewhat perversely, as part of the case for a sort of benign neglect on the part of regulators. The big financial players argued successfully that financial innovation was too complex and too opaque for the regulators to get their heads around it. Indeed, they said, to safeguard the international financial system from systemic risk, the main priority was promoting an "industry-led" effort to improve internal risk management and related systems. This, in a nutshell, was the view espoused by the Group of Thirty report following the outbreak of the Asian crisis ("Global institutions, national supervision and systemic risk", Group of Thirty, 1997. See also the article by John Heimann, and comments therein, in the special issue of the *Banca Nazionale del Lavoro Quarterly Review* on "Globalization and stable markets", March 1998). But this thesis was often accompanied by the argument to the effect that "you, regulators and supervisors, will always be behind financial innovation; it would be better to allow us, the big financial international players, to self-regulate; we are grownups, we can take care of ourselves". And, after all, "if someone makes mistakes, some will gain what others lose; why can't we be left alone to play this zero-sum game of ours?" Accepting this argument was a critical mistake. The regulators did not, in fact, have either the right incentives or the ability to acquire the necessary information, for two reasons. First, the big financial players are global, and national regulators had powers too narrow to be able to confront them. The difficulties in coordinating the regulators' actions, in the face of a natural tendency to preserve each one's particular sphere of influence, was a powerful drag on the ability to rise to the challenge posed by a finance gone global. Second, the phenomenon of regulatory capture that Dr Reddy mentioned in his talk was a definite reality. Powerful political and economic influences were at play, and in some cases prevailed.

- Other factors that have now become well known were the financial industry's remuneration policies and incentive structure, which ultimately induced excessive risk-taking and short-termism. (On these attitudes, I would like to recall the pertinent insights of Tommaso Padoa-Schioppa and Andrew Crockett at the last two Per Jacobsson lectures.) Significantly, compensation structures that favour risk-taking are correlated with banks' default risk. Of course this may be useful to attract managers with low risk aversion, which may be a desirable trait for financial intermediaries. But from the systemic perspective, default by a bank generates costs that do not fall entirely on its shareholders, so that the "optimal policy" from the bank shareholders' standpoint may be very suboptimal for the economy overall. While this state of affairs benefited the "whole" financial industry, it may also have led to a possibly serious misallocation of resources. We may now be observing a reversal, with an outflow of highly skilled people from the financial industry. Whether this is desirable or not depends on one's view of externalities, and on the costs that a less efficient financial sector may have for society. After all, social returns might be higher in other occupations. Anyway, a reduction in salaries in the financial industry may reduce the potential skill gap between the industry and its regulators. The regulatory agencies may become better able to attract highly skilled financial workers, improving the effectiveness of their regulatory and supervisory activity.
- Finally, there has been a change in the relative importance of the various banking activities. In particular, proprietary trading has expanded very significantly. Interestingly, the cost of financial intermediation has been trending upward in the past 40 years. This is counterintuitive, given the technological advances in information and communication technologies, which should have disproportionately increased efficiency in the financial industry. It is likely that the technological advances have mostly been internalised by the industry itself and deployed to increase secondary market activities, in particular proprietary trading.

Over the last few years the crisis has heightened appreciation of the benefits of a more stringent regulatory regime. And much has been done to remedy the shortcomings of financial systems. At the international level, under the political impulse of the G-20, the Financial Stability Board and the Basel Committee on Banking Supervision introduced substantial regulatory changes to reduce the frequency of financial crises and increase the resilience of economic systems. Improvements have been introduced in many areas such as bank capital and liquidity, OTC market infrastructure, and compensation policies in finance; importantly, new macro-prudential authorities have been established in many countries. But the regulatory overhaul has not yet been completed. Several issues are still being actively discussed, such as the role of rating agencies and accounting standards. Although new regulations on systemically important financial institutions have recently been approved, the "too-big-to-fail" issue is still a major concern. It would be foolish to pretend that defaults can be avoided, so we need to be prepared for their occurrence. The ongoing work on resolution regimes is a promising approach in this regard.

Rules alone are not enough, however. Allow me to mention a few scattered areas from which progress should be expected:

- One element that is essential for guaranteeing systemic stability is the method of measuring risk-weighted assets (RWA), the denominator of capital adequacy ratios. RWA measures have recently attracted increasing attention from market analysts, banks and supervisory authorities. It has been argued that the methodologies for computing RWA may not be comparable across institutions and, especially, across jurisdictions, and that they should more properly reflect risk in order to avoid ultimately jeopardising financial stability. These problems highlight the relevance of supervisory practices in determining banks' capital requirements (for example, in validating internal banks' models for calculating risk weights). Here, rigorous micro-prudential supervision is essential. We really need to work out a single rulebook, to move with determination towards taking joint responsibility and using peer reviews as much as possible in our supervisory activity. The watchword can only be: "more and better supervision".

- Furthermore, in today's globalised world, it is crucial to make sure that countries cooperate and agree on the appropriate stringency of financial regulation. Countries should not compete by relaxing rules in order to attract financial intermediaries, as this may generate negative externalities for other countries. This is a most delicate issue, and while a perfectly level playing field may not be achievable, we have to be conscious of the consequences of a "beggar-thy-neighbour" approach to regulation. The transition to a uniform system of rules and oversight of the financial sector must be hastened. In the euro area, and in the European Union at large, the project for banking union is ambitious, but it goes in the right direction.
- Let me close on a different but related topic. Some countries are now investing increasingly in efforts to improve the financial literacy of the public. This too is important. On the one hand, it helps to build the demand side of the "inclusive finance" that Dr Reddy mentioned, while on the other, financially literate citizens are better able to understand the efforts of regulators and policy makers to improve supervision and regulation, and less likely to subscribe to the simplistic view that "finance is evil". But we should realise that – as the case of Bernard Madoff and others in the US and elsewhere clearly show – this is no panacea. (Madoff's customers were surely much better educated than the average.) Therefore, for purposes of consumer protection in the financial services industry, financial regulation and good supervision are the necessary complements to financial education and inclusion.

To conclude, following Dr Reddy's final remarks, I would like to quote from a book by the brilliant Bank of Italy economist Curzio Giannini, who passed away prematurely nine years ago (*The age of central banks*, Edward Elgar, 2011, translated from the Italian *L'età delle banche centrali*, Il Mulino, 2004). In that "beautifully written and illuminating" work, as Charles Goodhart describes it in his foreword, Curzio applied "a theory of history" to describe how from pre-industrial payment technologies through the rise and fall of convertibility we ended up with the revolution in the payment system that has accompanied the globalisation of money and the challenge of building trust in an under-institutionalised environment. Already at the turn of the century, Curzio clearly saw the likely consequences of financial developments, and concluded, "In the years to come, the most interesting developments will probably be precisely in the sphere of supervision and regulation" and that "[w]hatever its detractors may say, the central bank has no need to move into new lines of business. Capitalism generated the central bank and capitalism will come to it again, even if the current infatuation with the financial markets' self-regulating capacity were to endure. […] The central bank produces an intangible but essential good – trust – of which capitalism has an immense need. We must not forget that trust, or its synonym "confidence", derives from the Latin *fide*, meaning faith, which cannot be produced simply by contract. In fact the legitimacy of central banks does not lie in their policy activism, or the ability to generate income, or even, save in a highly indirect sense, their efficiency. Rather, […] it derives from competence, moderation, the long-term approach, and the refusal to take any tasks beyond their primary role." In the end this, perhaps, is what society should expect, if not from the financial sector, from those who are called to look after financial stability.