Philip Lowe: Some tensions in financial regulation

Address by Mr Philip Lowe, Deputy Governor of the Reserve Bank of Australia, to the Institute of Global Finance Second Conference on Global Financial Stability and Prosperity, Sydney, 4 July 2013.

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I would like to thank the Institute of Global Finance for the invitation to speak today. It is a pleasure to be here.

As I am sure you are all aware, over recent years regulators have looked into almost every corner of the global financial system. Too often they found practices and behaviours that they judged generated unacceptable risks. In response, they have developed a very large and a very complex regulatory reform agenda. Much of this agenda is now being implemented, and other pieces are still being negotiated.

It is understandable why this reform is taking place. While financial intermediation can be a force of great good, it can also do much damage if not done well. Indeed, the decisions that were made in the 2000s by some financial institutions ended up causing very real damage to the global economy. These decisions caused many people to lose their jobs and suffer a loss of their hard-earned wealth. There were also serious ethical failings by some of the highly paid staff in a number of these institutions. And a significant amount of taxpayer dollars had to be put at risk to help solve the problems.

The societies in which this has occurred have been, and continue to be, rightly angry. I am sure that you have all heard variations of statements that run something like this: “regulators need to make sure that these problems never occur again” or “not one cent of taxpayers’ money should ever again be put at risk to support a financial institution”.

Many of you in this room would, I suspect, agree with such sentiments.

This afternoon I would like to reflect on the ideas behind both of these statements, which are clearly relevant to the theme of this conference, Global Financial Stability and Prosperity. In the world of finance, implementing what seems like simple and attractive ideas often turns out to be quite difficult. Tensions emerge and trade-offs are inevitable. You touch one piece of the financial system and another piece moves, sometimes quite unexpectedly. This partly reflects the fact that the way in which savers and borrowers connect with one another is constantly evolving. Moreover, views about the role of the public sector in the financial system are not static over time. All this means that it can be problematic to put into practice what seem like simple ideas.

“Regulators should make sure it does not happen again”

I would like to start with the first of these two ideas: that regulators should make sure that this type of financial instability never happens again.

This idea has motivated much of the reform effort. And it is entirely understandable.

Good, well-designed regulation can make an important difference. This reflects a number of features of financial intermediation, including the existence of pervasive information asymmetries and the potential for runs if confidence is shaken for any reason. In addition, financial institutions and investors seem too often to underestimate risk in the good times, with sometimes severe consequences for the broader community. This all means that our societies can benefit from a well-designed set of rules and standards to govern how financial intermediation takes place.

At the same time, though, we need to be realistic about what can be achieved through the application of rules alone. History provides some salutatory lessons here. As soon as the ink is dry on a set of rules, people start trying to find ways around them, and they generally have some success in doing so. One possible response to this is to write more rules, and this is sometimes the appropriate response. But, as we are discovering (perhaps rediscovering), as we write more rules, new tensions emerge and new difficult trade-offs become apparent.

I would like to highlight a couple of the difficult trade-offs that are evident at the moment.

The first arises from efforts to shift to a system in which a greater share of banks' exposures is collateralised. This shift is being encouraged through regulation as well as by financial institutions themselves. It can be seen in the move to secured funding markets, for example, covered bonds. It can also be seen in initiatives to increase the collateralisation of counterparty exposures in OTC derivatives markets, including by having more derivatives novated to central counterparties and by introducing margining where novation is not possible.

A common high-level objective of these changes is to reduce counterparty risk. Few would disagree that this is a sensible objective. After all, if more exposures are collateralised, shouldn't the system be safer?

The reality, though, is that there is some uncertainty as to what the end effects of this shift will be. The reasons for this uncertainty are spelt out in a recent report by the Committee on the Global Financial System (CGFS) at the Bank for International Settlements (BIS).[1] The report noted that financial institutions are likely to respond to the increased calls for collateral by changing the way they do business. Some change is clearly desirable, given that a number of risks were previously underpriced. But if past experience is any guide, as prices change and the demand for collateral increases, financial institutions will seek to manage their collateral more efficiently and this is likely to *increase interconnections* in the financial system. The report also noted that the greater collateralisation is likely to *increase the procyclicality* of the financial system and to *increase uncertainty* about the strength of the claim that unsecured creditors have over the assets of a financial institution.

So there are clearly tensions. Reducing counterparty risk is an appropriate objective. But the BIS report suggests that the side effects of doing so could run counter to achieving other high-level objectives, including reducing interconnectedness, reducing procyclicality and reducing uncertainty. The challenge is getting the balance right so that fixing one problem does not create another one.

A second example of where tension between objectives is evident is in the effort to increase the stability of banks' funding. In this context, it has become common to think of deposits as "good and stable" and wholesale funding as "bad and unstable". Signs of this thinking are evident in Australia, as they are in many other countries. Many financial institutions have had an explicit objective of increasing the share of their liabilities that are accounted for by deposits. Consequently, they have been prepared to pay large premiums for liabilities that are called deposits relative to wholesale funding liabilities of similar maturity. This has pushed up banks' overall funding costs and led to increased spreads between lending rates and wholesale rates.

It is difficult to argue with the idea that this shift towards deposits is helpful for overall financial stability. While there can be a deposit run on an individual bank, a deposit run on the system as a whole is very unlikely, as deposits tend to get recycled from one bank to another. In comparison, it is easier to think of scenarios in which disruptions to foreign wholesale funding cause system-wide stress.

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[1] CGFS (Committee on the Global Financial System) (2013), "Asset Encumbrance, Financial Reform and the Demand for Collateral Assets", CGFS Papers No 49, May. Available at <http://www.bis.org/publ/cgfs49.pdf>.

But, once again there is a balance to be struck. The recent problems in Cyprus give us a hint of this. The Cypriot banks were very heavily deposit funded. This turned out to have two distinct disadvantages.

The first was that when the value of the banks' assets fell, depositors had to bear the brunt of losses after the equity holders. This significantly complicated the resolution of the banks' problems. A similar tension is currently evident in some of the international policy discussions. In particular, some regulators want banks to have more deposit funding because it is seen as more stable. At the same time, others want heavily deposit-funded banks to rely *less* on deposits and issue certain types of wholesale debt to make it easier to resolve a problem should it occur.

The second disadvantage is that with only limited wholesale liabilities, the Cypriot banks were arguably subject to less market scrutiny than were banks with a different funding structure. One benefit of wholesale funding is that the issuing bank needs to keep turning up to the market and selling its story to sophisticated investors. There is no guarantee that this extra scrutiny will prevent problems, but it is likely to help.

The general point from both these examples is that there are tensions in financial regulation. Regulations are introduced to address one issue, and another issue emerges. Many countries have had the experience of regulating one aspect of the financial system only for other parts to grow very quickly, and problems to emerge in those other parts.

I do not want this to be interpreted as a counsel of despair. But we need to be cognisant of the limits of rules alone. It may well be possible that a set of rules could be introduced to ensure that the *specific* problems of recent times are never allowed to occur again. But what is much less certain is whether these rules could ensure that a *different* set of problems, but with broadly similar consequences, do not emerge at some point in the future.

I suspect that it is simply not possible, or in fact desirable, to regulate a modern financial system to the point that we can say with absolute confidence that problems will not occur. What we can do, however, is to reduce the likelihood and severity of future problems.

If we are to do this on a sustainable basis, we need to look beyond rule-making, as important as that is. In particular, any set of rules needs to be accompanied by strong risk management frameworks, both within financial institutions and within the regulatory community. A critical element of these frameworks, and thus ultimately of a stable and well-functioning financial system, is the undertaking of holistic risk assessments by those who manage financial institutions and by those who regulate them.

These holistic risk assessments are not easy to undertake, involving as they do both system-wide and more detailed, disaggregated views. But neither are they impossible. While each situation is different from the one before, there are a number of system-wide variables that need to be monitored carefully. These include, but are certainly not limited to: the rate of increase in the overall level of borrowing in the community; developments in key asset prices, particularly property; the amount of construction activity in the economy; the pace of innovation in financial products; the degree of competition in the financial products; and changes in market-wide lending standards.

Obviously, this is only a starting point and managers of financial institutions and supervisors need to keep their eyes and ears open for new developments in the financial system. Both need to ensure that the institutions they manage or supervise comply with the rules but, equally importantly, they need to examine what is going on in the system as a whole. In some cases, supervisors' perspectives will differ from those of bank management, and supervisors clearly face different incentives from bank management. Where they reach different judgements they need to be prepared to use their discretionary supervisory tools to buttress the rules that are in place. In the end, ensuring financial stability requires as much attention to supervision as it does to regulation.

It is important to point out that in this regard the Australian Prudential Regulation Authority (APRA) has done a better job than many prudential authorities elsewhere. It has been able to combine a sensible approach to rule-making with a focus on the big picture. It has been assisted in this by the Reserve Bank with its broad responsibility for financial stability, and the coordination arrangements between APRA and the Reserve Bank have worked well. These arrangements are one of the factors that have supported Australia's stable financial environment over recent times.

"Not one cent of public money should ever again be put at risk"

I would now like to turn to the second sentiment: that not one cent of public money should ever again be put at risk.

Over recent times, there has been a noticeable swing in international forums against the idea that the public sector's balance sheet has a role to play in dealing with financial stress. Many people find it difficult to accept the idea that the very same banks that caused the problems have been supported, either directly or indirectly, by the public sector's balance sheet. A number of the regulatory proposals under consideration aim to ensure that this does not happen again.

This response is entirely understandable, particularly where such support is seen to have benefited the management of a troubled bank and/or its shareholders. Societies rightly rail against the idea that those who were responsible for problems receive some benefit at the expense of the taxpayer. A better set of arrangements needs to be found, so that taxpayers are not always drawn into troubles in financial institutions.

It would be a mistake, however, to reject completely the idea of the public sector using its balance sheet during a period of financial stress or crisis. Indeed, in some situations the public sector can play an important stabilising role.

One example of this is where the central bank liquefies assets in a stressed environment.

In a "first best" world, all assets are liquid; they can be bought and sold at any time at a fair price. The real world is clearly not like this. Markets are incomplete, information asymmetries exist and the technology supporting trading is sometimes expensive to put in place. So we are in world of second best, which is sub-optimal from a welfare perspective.

Most of the time, this deviation from first best is probably not that costly. But in a stressed environment – when even high-quality assets cannot be bought and sold – it can become very costly.

One way of ameliorating this departure from first best is for the central bank to use its balance sheet to liquefy assets in times of stress. It can do this by purchasing assets under a repurchase agreement with a conservative haircut. In doing so, it can provide liquidity when it is most highly valued, and do so with relatively little risk.

This type of activity should not be viewed, *a priori*, as a bailout of the banks. Arguably, it is an efficient solution from society's perspective to a potentially costly deviation from the first best world of complete markets. Central banks, by virtue of their ability to create money, are uniquely placed to deal with such situations. The alternative solution is for the private financial sector to self-insure fully against liquidity problems. If the objective is to maximise the welfare of the community – as it should be – it is far from clear that full self-insurance is the right policy.

A second example of the public sector playing a stabilising role was provided during the 2008–09 financial crisis, when governments issued bank funding guarantees. During that period, risk aversion soared, capital markets shut down, and even the well-rated financial institutions found that they could not raise funding and provide critical financial intermediation services to the broader economy.

These types of temporary surges in risk aversion can be very costly for society. At least in principle they can be ameliorated if there is an entity that has a stable risk appetite and that is prepared, and financially able, to play a stabilising role. This was what happened in Australia during the crisis, where the Australian Government was prepared to insure bank debt for a fee. The fee was considerably *higher* than what the market would have normally demanded for providing such insurance, but was substantially *less* than the near infinite fee that the market was then implicitly charging. There is a strong argument that the Australian taxpayer was well compensated for the risk that it undertook, with insurance premiums paid to date by financial institutions exceeding $4 billion, and no money has had to be paid out under the guarantee.

A third example in which the public sector can play a stabilising role is through the government underwriting a capital injection for a troubled bank when a very risk-averse private sector is not prepared to do so. This example is of a distinctly different character than the other two and the threshold of action is higher. There may, however, be some very limited circumstances where it does make sense for the government to take an institution under public ownership before selling it again when the risk appetite of the private sector has returned to more normal levels. As the Scandinavian experience from a couple of decades ago illustrates, this type of policy can work. I want to emphasise, though, that I am not saying the Australian authorities would or should behave in a similar way, but rather that such a response should not be excluded from the potential toolkit. Importantly, if such a policy were to be used, then private shareholders of the troubled institution as well as its managers would need to be held to full account.

The common element in each of these three examples is that the private sector has swung from relatively normal risk preferences to being temporarily very risk averse. In modern financial systems, these swings in risk aversion can be very costly. High levels of risk aversion mean that good assets cannot be bought and sold, that otherwise sound institutions cannot access funding markets and that investors are not prepared to purchase capital in banks. In these situations, the public sector, with its more stable risk preferences and its financial capacity, can play a stabilising role. There are obviously financial risks in doing this, but there are also potential benefits to the broader community.

There are two main arguments against such involvement. The first is that financial institutions will change the way they operate if they think that the public sector will provide support, that these changes will make the system less stable. The second is that if the public sector is prepared to play the role of a countercyclical provider of liquidity, insurer or – in limited circumstances – capital, then there is the potential for this role to be misused. One way that this could happen is for support to be provided to avoid confronting problems in a financial institution, with the result that taxpayers take on additional risk.

Both of these concerns are real and they need to be taken seriously. But these concerns should not rule out public sector support in some situations. Concerns about adversely changing behaviour can be addressed through ensuring that shareholders are not bailed out and that the managers of financial institutions are exposed to the downside as well as the upside. And governance arrangements can be put in place to address concerns about public decision-making.

The critical question needs to be what set of policies best maximise social welfare, not what set of policies best minimise the risk of public sector involvement. It may be the case that the answers to these two questions are the same, but I suspect that there are circumstances where they are not. Once again, the challenge is to find the right balance.

Where does this leave us?

So where does this leave us?

I am afraid that those who want a cast-iron guarantee that financial instability will never be allowed to return, or that the public sector will never have any risk exposure to the financial sector, are likely to be disappointed.

Modern financial systems can be a force of great good. But they can be prone to bouts of instability. Attitudes to risk can change abruptly and willingness to extend credit and to trade assets can evaporate almost instantly. Over recent years we have seen too many examples of where investors seamlessly moved from seeing risk nowhere to seeing it everywhere.

If we are to live up to the challenge of this conference – Global Financial Stability and Prosperity – we need to find a better way of dealing with these swings. First and foremost, this is a responsibility of the managers of financial institutions. But public policy also has an important role to play in designing a system that is strong enough to cope with these swings. A core set of prudential rules is obviously an important element here. But rules can never be enough. An understanding of how borrowers and investors are viewing risk and how their decisions are affecting the financial system as a whole is critically important. Also, we should not lose sight of the fact that the public sector – with its more stable risk appetite – has a balance sheet that can be used to play a stabilising role. Importantly, if this balance sheet is to be used, we need to be sure that it is done in a way that promotes the welfare of the community at large, rather than just the welfare of the owners and managers of financial institutions.

Thank you.