Guy Debelle: Perspectives on financial markets

Remarks by Mr Guy Debelle, Assistant Governor (Financial Markets) of the Reserve Bank of Australia, to the Centre for International Finance and Regulation (CIFR) Forum, Sydney, 20 November 2013.

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I would like to make a few general points about the financial regulatory agenda.

A number of the regulatory changes in financial markets have increased the price of financial intermediation and the provision of financial services generally. This has very much been the intent, and not, to re-use one of the most overused expressions around at the moment, an unintended consequence.

The price of intermediation was too low before the crisis; now it is higher. It was too low in the sense that risks were underpriced. These risks include liquidity risk and counterparty risk. Reforms such as the Basel III liquidity reforms or the OTC reforms are aimed at ensuring these risks are more appropriately priced. As financial institutions are adapting to these reforms, they are repricing many of the services they are providing to take fuller account of these risks. This repricing is gradually occurring only now in many cases and there is more to come. Hence end users of these services are only now starting to see the impact of these reforms in the form of higher prices.

As in many markets, when a price goes up, the quantity tends to go down. Again, this is to be expected, and desired. It is not unintended.

What is less clear is whether various regulations are having an impact on the market, above and beyond the effect caused by a higher price. The general aim is for the price element to do most of the work, but in some cases, regulations with a quantitative element are in place as a backstop.

Let me give as one example of this, the effect of regulation on dealer inventories of fixed income. Liquidity regulation has caused some repricing in the market, with somewhat lower inventories, particularly of less liquid securities, as a result. So aspects of the regulation have increased the cost and you would expect that to increase the price of providing the service. In this case, that would be a wider bid-ask spread. In turn, you would expect that to lower turnover.

Conceptually, the leverage ratio sits there as a backstop limiting the overall size of institutions' balance sheets. Whether it binds in practice depends on the structure of the whole balance sheet. Given the general tendency to fund inventory with repo, the leverage ratio can affect the size of the inventory a dealer is willing to hold to make a market. Whether there is a quantitative effect above and beyond the price effect I mentioned earlier is an open question which warrants answering.

But in answering that question, the benchmark for the appropriate pricing and the appropriate degree of liquidity in the market is not the pre-crisis state of affairs. That was an environment of under-pricing and consequently, oversupply of this service.

That said, it would appear that some significant share of the lower inventory in recent months has resulted from self-imposed constraints, rather than those resulting from regulation. A number of institutions appear to have self-limited the size of inventories, because of the resultant mark-to-market risk, particularly in the rising yield environment that was present earlier in the year. So in a number of cases, that was the binding constraint, not the increased liquidity cost of funding inventory or the leverage ratio.

The example of dealer inventories of fixed income is reflected in a number of areas of the market. It has often been the self-imposed limit which has been the binding constraint. The regulatory-imposed constraint serves more as a backstop for when memories of the recent crisis fade, as they surely will in time. The regulatory constraint is designed to ensure that risk does not disappear from pricing when the euphoria returns.