Financial system and macroeconomic resilience: revisited

Opening remarks at the Eighth BIS Annual Conference

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It is my pleasure to welcome all of you to the Eighth BIS Annual Conference. This year's conference is an update of the Sixth BIS Annual Conference held in Brunnen a little over two years ago, when the sessions and papers had titles like "Towards market completeness", "Accounting and financial system behaviour", "Financial intermediation through institutions or markets", "Risk transfer to households and macroeconomic resilience" and "Financial system: shock absorber or amplifier".

Many of the topics and authors are the same this year, so it is natural to look back and try to recall our thinking then as a basis for renewing our discussion now. Since I was not present in Brunnen for the 2007 conference, let me instead try to remember some of what I think was the consensus of the time on a number of general topics that were discussed there: market completeness; the relative merits of bank-based versus market-based finance; securitisation; and the policy framework that had been broadly adopted by many of the world's central banks. In doing this, I will be mixing some of the topics of the conference two years ago, as well as those discussed in the excellent papers that are coming today and tomorrow.

First, market completeness: What economist can argue against the creation of securities that help complete financial markets? Don't such innovations always improve efficiency?

Examples of improvements are easy to find. Once upon a time, payment streams and risks came bundled together. Bonds were sequences of coupons with principal payment at maturity, and the issuer could default on some fraction of those promises. Today, bonds are stripped so that coupons and principal can be purchased separately and the risk of default insured. And the risk of default can be sold off separately. More generally, financial engineers have made it possible to purchase or sell virtually any payment stream with any risk characteristics.

This ability to separate finance into its most fundamental pieces – the financial analogue to the particle physicist's protons, neutrons and electrons – has made it so that risk really does go to those who are most willing and able to bear it.

Next, we have bank-based versus market-based finance: Banks are okay, but markets are better.

Banks serve a variety of functions: they pool the resources of small savers and lend to large borrowers; they offer safekeeping and accounting services; they give customers access to the payment system; they supply liquidity services; they allow for risk-sharing; and they provide information services – the screening and monitoring of borrowers designed to overcome adverse selection and moral hazard arising from information asymmetries.

But in the same way subatomic finance breaks financial instruments into their most basic parts, why can't a traditional bank be split up with specialised institutions serving each of the functions? Surely the fact that GE makes jet engines doesn't make it a better financial service company or light bulb manufacturer. Why would a bank that provides access to the payment system and liquidity be better at screening potential borrowers than a specialist?

Furthermore, market-based systems should democratise finance, giving access to people who didn't have it before. Subprime mortgages – one of my favourite forms of market-based financing – allow people who would otherwise not be able to purchase homes to do so. Isn't this a good thing?

Not only did market-based finance give financial system access to a new class of people, it also made it easier for financial institutions to manage their risks. The fact that such a wide class of assets could be bought and sold meant that adjustments were easy, cheap and fast. This made the financial system much more of a shock absorber than an amplifier. Or so we thought.

Third, there is securitisation: There are so many reasons to like securitisation. The easiest to see is that it removes the need for lenders to be in close physical proximity to borrowers. That is, someone wanting a mortgage need not seek out a local bank with local depositors to finance it. My parents' first mortgage in 1965 was from a local Californian savings and loan that originated and serviced the loan. The most recent mortgage that I obtained to purchase a home in Lexington, Massachusetts, in 2002 was through a mortgage broker. All I know is that the servicing was done by someone in New Jersey.

But my personal experience is not the best example of the benefits of securitisation. A better one came on 5 May 2005 when Standard & Poor's issued simultaneous announcements of the downgrading of Ford and GM, along with a press release that stated: "GM-Related Auto Loan, ABS Deals Unaffected by Corporate Downgrade." Two things made these asset-backed securities low-risk relative to the GM bonds: car loans are collateralised, and the overall default rates on large groups of auto loans are very predictable.

Finally, in addition to divorcing the physical location of the lender from that of the borrower, securitisation separates the origination of credit from the bearing of risk. Actors along the securitisation chain can make use of their comparative strengths in processing information or managing various types of risks. All of this should improve efficiency.

Remember, I'm recalling the thinking of two years ago!

Finally, there are policy frameworks: We really thought we had this figured out. Some form of inflation targeting was the solution – and the operational instrument was to be the interest rate. It was about refinements. Should we target inflation or the price level? What is the appropriate time horizon over which we should try to hit the target? Is it better to publish central banks' own interest rate path forecasts or not? These are not big questions.

I am convinced that, combined with the developments in the financial system I just mentioned, monetary policymakers' focus on inflation brought us the Great Moderation – the reduced volatility of real growth in the developed world that started in the mid-1980s. Monetary policy has become predictable – it is a source of stability where it had been a source of instability. And, faced with income volatility, individuals today can use the financial system to ensure that their consumption remains smooth. The results were amazing, and we smugly wrote papers debating the sources of the Great Moderation.

And looking at financial stability, safeguards were in place; central banks had emergency lending authority that saved us on 11 September 2001; deposit insurance protected depositors, so bank runs became a thing of the past; investor protections freed individuals from worrying about the security of their wealth; and there were regulators and supervisors to watch over individual institutions and keep their managers and owners from taking on too much risk.

What a difference two years makes. Since August 2007, the financial system has experienced a sequence of critical failures. What does this mean about the way we think about market completeness, bank-based vs market-based finance, securitisation and policy frameworks?

For subatomic finance, it is still hard to argue with the welfare benefits of market completeness. But the ability to sell risk easily and cheaply comes with the ability to accumulate risk in almost arbitrarily large amounts. Combined with compensation schemes in which money managers share the gains but not the losses of their investment strategies, this creates incentives to take on huge amounts of risk. Without risk, there is no reward; and without big risks, there are never big rewards.

The result is that small numbers of individuals have the potential to jeopardise the stability of the entire financial system. They do this not because they fail – the right to succeed in the capitalist system is the right to fail – but because of the knock-on effects they will have when they fail. It is the interconnectedness of the system that is the biggest challenge. And the more complex the system becomes, the bigger this risk becomes.

Even more fundamental is the fact that subatomic finance only delivers the promised gains – completing markets – so long as markets are efficient and liquid. They are not. Prices can deviate significantly and persistently from fundamentals because arbitrage fails, and there are times when it becomes impossible to buy or sell some financial instruments.

For bank- vs market-based systems of finance, we have learned that banks and markets are complements, not substitutes. Bank-based finance needs market-based finance, and vice versa. One does not operate without the other. Institutions depend on markets for revenue, risk management and funding. Markets depend on institutions for market-making, underwriting and credit. We should not think of one channel of intermediate as a spare tyre in the event that the other fails.

For securitisation, we see now that there are clear limits. There are problems with incentives and with information. Originators had incentives to economise on the quantity and quality of assets that were going into securitisation pools, and so they did. And information moves along the securitisation chain more like in Chinese whispers (or, as an American would say, the game of telephone) than as one would expect when billions of dollars or euros or pounds are involved. Add to this the difficulty associated with the pricing of infrequent events – the problem of tail events. And the fact that people seem to have underappreciated is that securitisation and tranching do not eliminate risk. They shift it around. The risk has to go somewhere.

Finally, for policy frameworks, we have some very hard thinking to do and the framework almost surely needs to be refined. But change does not mean forsaking central banks' price stability objectives, as it is not aimed at changing long-term targets or goals. Instead, it means expansion. For monetary policy, we need to think harder about integrating asset price and credit booms into the policy framework. And for financial stability, we need to create appropriate tools and institutional structures that allow us to identify and mitigate the systemic risks that naturally arise in the financial system.

With that as an introduction, I now turn the meeting over to Governor Mohammed al-Jasser of the Saudi Arabian Monetary Agency, who will chair the first session.